CORPORATE GOVERNANCE

(For Undergraduate Classes)

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PREFACE

I am extremely happy to present a text book "Corporate Governance" to the teacher and student community of various Universities of Karnataka. It is prepared in accordance with the latest syllabus of the Universities.

I do not claim any originality of this book since many standard text books are being referred while writing this book. The main purpose of preparing this book is to make the subject Corporate Governance student friendly. Hope this book will motivate the students for further study in the subject.

I express my profound gratitude to my teachers, well-wishers and teacher friends for their encouragement in the preparation of this book. I am also thankful to Edwise Publishers, Mangalore, for bringing out this book.

I am thankful to my wife Dr. Sulatha Vidyadhar of Alvas College, Moodbidri and son Suveeksh for their constant support. I am thankful to our Principal Prof. Shrivarma Ajri M and my institute colleagues for their support and encouragement.

I shall consider my efforts amply rewarded if this book is found useful by the teachers and the students. Suggestions and guidance for improvement of this book will be gratefully accepted.

2022 **Vidyadhara Hegde S.**

Moodbidri

CORPORATE GOVERNANCE

Objective: To familiarize the students about corporate governance and corporate governance practices.

Module I **12 hrs**

CORPORATE GOVERNANCE –Meaning and definitions, Evolution of Corporate Governance – Ancient and Modern Concept, Scope of Corporate Governance, Principles of Corporate Governance, Factor Influencing Corporate Governance, Strategies of Corporate Governance, Benefits of Corporate Governance, Models of Corporate Governance, Corporate Governance Rating, Transparency and Corporate Governance, Best Practices of Corporate Governance, Value Creation through Corporate Governance, Corporate Governance and Shareholder Activism and Changing role of Institutional Investor, Challenges in Corporate Governance, Business Ethics and Corporate Governance, Corporate Governance and Economic Performance, Corporate Social Responsibilities and Good Corporate Citizenship.

Module II **12 hrs**

CORPORATE GOVERNANCE ISSUES – Corporate Governance Issues in various Managerial Decisions, Corporate Business Ownership Structure, Codes of Corporate Governance, Committees on Corporate Governance, Corporate Governance Legislation- Need, Provisions in Companies Act, 2013, Securities (Contracts and Regulations) Act, 1956 (SCRA), Depositories Act 1996, Securities and Exchange Board of India Act 1992, Corporate Governance Reforms, Board Committees - Audit Committee, Remuneration Committee, Shareholders' Grievance Committee, Other Committees, Disclosures in Annual Report; Integrity of Financial Reporting Systems, Role of Professionals in Board Committees, Role of Company Secretaries in Compliance of Corporate Governance. Corporate Scandals, Common Wealth Association for Corporate Governance (CACG), Organization for Economic Cooperation and Development.

Total = 24 hours

CONTENTS

MODULE –I CORPORATE GOVERNANCE

INTRODUCTION:

A voluntary association of persons incorporated under law with funds raised through public contribution and using such funds for the mutual benefits of all such persons through taking up of any specific activities is called a corporation. The corporation is an organization engaged in mobilizing resources for productive uses in order to create wealth and other benefits for its multiple constituents, or stakeholders. Corporation is a legal entity (such as an association, company, society, person, government, government agency, or institution) identified by a particular name. Also called corporate body, corporate entity. The corporate form originated in medieval times, when it was used by governments to grant special institutional status to cities, religious institutions, and universities.

During the Industrial Revolution in 18th and 19th centuries, business corporations were increasingly chartered in North America and Europe, typically in order to pursue narrow purposes—financing ocean voyages and building canals, or railroads. By the 20th century governments in many countries were granting corporate charters with broad and general purposes—such as "to carry on business for a profit." In 21st century "Corporations ARE what they DO." As a result, corporations operating within market-oriented environments became free to pursue almost any legal business activity and to change their purposes, activities, and organizational structures almost at will. Freedom of action is, of course, more limited for corporations operating within authoritarian settings. However, the scope of market processes has been widening globally—and the extent of government control over business correspondingly declining—for a couple of decades, and this trend is expected to continue.

In recent years, there have been perceptible changes in the corporate ownership on account of exponential growth of capital market activities, and active monitoring of corporate activities by financial institutions. The globalization efforts have rendered overall corporate environment complex and challenging necessitating urgent review of the system corporate management with particular emphasis on reporting and accountability, the role of financial institutions, non- executive directors, managing directors, chairman and audit committees, and the relationship between stock exchanges and companies and also companies and stakeholders.

Corporate Governance is a phenomenon of recent origin in the wake of increasing competition and globalization, stipulates parameters of accountability, control and reporting functions of the Board of Directors and encompasses the relationship among various participants in determining the direction and performance of the corporation, the board, management team, shareholders and other stakeholders. The term Corporate Governance gained much importance when accounting fraud of high profile companies were observed in the business world and the reason was due to lack of adequate governance mechanism.

CORPORATION AND ITS STAKEHOLDERS:

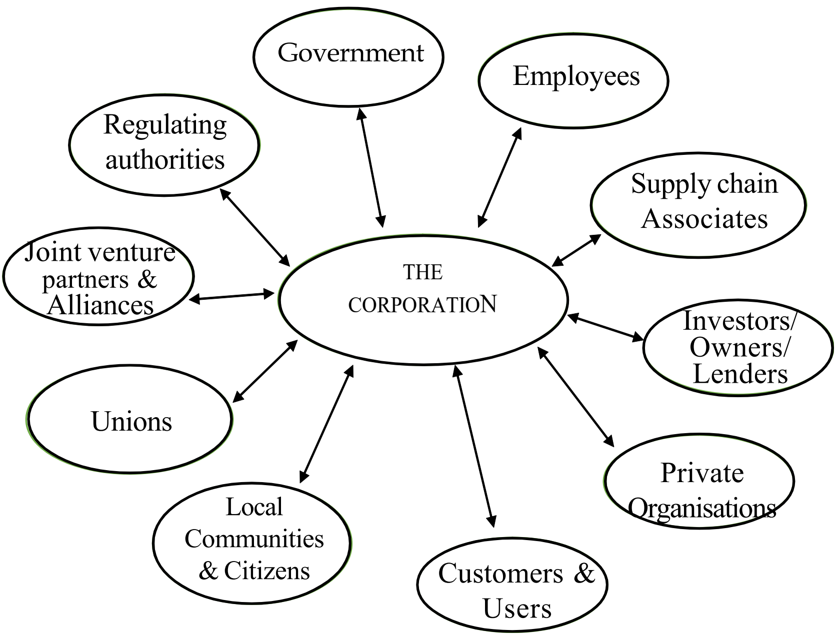

Figure – 1 – The Corporation and its Stakeholders

MEANING:

The word **governance** comes from the Latin word "**gubanare**" which means "**to steer**". The ordinary meaning of governance is "the manner of directing and controlling the actions and affairs of an entity". The corporate governance framework should recognize the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises. In simple words, governance is the exercise of powers and actions to achieve goals of an organizational entity.

Corporate governance is most often viewed as both the structure and the relationships which determine corporate direction and performance. The board of directors is typically central to corporate governance. Its relationship to the other primary participants, typically shareholders and management, is critical. Additional participants include employees, customers, suppliers, and creditors. The corporate governance framework also depends on the legal, regulatory, institutional and ethical environment of the community.

Corporate governance is the collection of mechanisms, processes and relations by which corporations are controlled and operated. Governance structures and principles identify the distribution of rights and responsibilities among different participants in the corporation (such as the board of directors, managers, shareholders, creditors, auditors, regulators, and other stakeholders) and include the rules and procedures for making decisions in corporate affairs. Corporate governance is necessary because of the possibility of conflicts of interests between stakeholders, primarily between shareholders and upper management or among shareholders.

Corporate governance includes the processes through which corporations' objectives are set and pursued in the context of the social, regulatory and market environment. These include monitoring the actions, policies, practices, and decisions of corporations, their agents, and affected stakeholders. Corporate governance practices can be seen as attempts to align the interests of stakeholders. In simple terms corporate governance means extent to which companies are run in an open and honest manner.

DEFINITIONS:

Corporate Governance is a multi-faceted subject and difficult to comprehend in a concise definition. The main theme of corporate governance is to integrate sound management policies in the corporate framework in such a manner to bring economic efficiency in the organization in order to achieve twin goals of profit maximization and shareholder welfare. Few comprehensive definitions on Corporate Governance are below.

The Cadbury Committee U.K, defined Corporate Governance as, "It is a system by which companies are directed & controlled".**Bruce Weber** defined Corporate Governance as, "accountability to providers of capital."According to **Shleifer and Vishny,** Corporate Governance means, "how investors get the managers to give them back their money"

Gabrielle O'Donovan defined Corporate Governance as, "An internal system encompassing policies, processes and people, which serves the needs of shareholders and other stakeholders, by directing and controlling management activities, with good business savvy, objectivity, accountability and integrity. Sound corporate governance is reliant on external market place commitment and legislation, plus a healthy board culture which safeguards policies and processes".

John L.Weinberg defined Corporate Governance as, " is the control of management in the best interests of the company, including accountability to shareholders who elect directors and auditors and vote on say on pay. How a company is governed influences rights and relationships among organizational stakeholders, and ultimately how an organization is managed, and whether it succeeds or fails".

According to **Goergen and Renneboog**, "Corporate Governance system is the combination of mechanisms which ensure that the management (the agent) runs the firm for the benefit of one or several stakeholders (principals). Such stakeholders may cover shareholders, creditors, suppliers, clients, employees and other parties with whom the firm conducts its business.”

According to **Monks and Minow**, Corporate Governance is the relationship among various participants [chief executive officer, management, shareholders, employees] in determining the direction and performance of corporations”

American Management Association defined Corporate Governance as, “is about how suppliers of capital get managers to return profits, make sure managers do not misuse the capital by investing in bad projects, and how shareholders and creditors monitor managers”.

International Chamber of Commerce defined Corporate Governance as, “…. is the relationship between corporate managers, directors and the providers of equity, people and institutions who save and invest their capital to earn a return? It ensures that the board of directors is accountable for the pursuit of corporate objectives and that the corporation itself conforms to the law and regulations.”

US Business Round Table defined Corporate Governance as, “Corporate governance is not an abstract goal, but exists to serve corporate purposes by providing a structure within which stockholders, directors and management can pursue most effectively the objectives of the corporation.”

Institute of Company Secretaries of India, defined Corporate Governance as, “Corporate Governance is the application of best Management Practices, Compliance of Laws in true letter and spirit and adherence to ethical standards for effective management and distribution of wealth and discharge of social responsibility for sustainable development of all stakeholders.”

Standard and Poor defined Corporate Governance as, “Corporate Governance is the way a company is organized and managed to ensure that all financial stakeholders receive a fair share of the company’s earnings and assets.”

From the above definitions we can understand Corporate Governance as “a system of law and sound approaches by which corporations are directed and controlled focusing on the internal and external corporate structures with the intention of monitoring the actions of management and directors and thereby, mitigating agency risks which may stem from the misdeeds of corporate officers."

EVOLUTION OF CORPORATE GOVERNANCE

Corporate Governance is a young discipline that has grown out of deep seated concerns raised by spectacular and well publicized corporate failures. The evolution of concept corporate governance may be studied on the basis of stages of development by taking into consideration a selected country specific approach in different countries as below:

UNITED STATES OF AMERICA (USA):

In 1920's and 1930's, a remarkable democratization of shareholding took place between the period of World War I and the end of World War II. The benefits of democratization and diversification depend on the depth of the stock market. Popular magazines on share ownership, and popular media coverage of Wall-Street celebrities brought Middle American wealth into the stock market, vastly deepening it and thus making the sacrifice of diversification for control more attractive than elsewhere. America's response to the Great Depression then razed much of what family capitalism remained. Two great pyramids, the Insull and Van Sweringen business groups, collapsed after the 1929 crash. These high profile collapses appear to have linked to the depression with highly concentrated corporate control in the public mind, justifying a barrage of progressive reforms.

A series of regulatory reforms governing banks, insurance companies, mutual funds and pension funds prevented any of these organizations from accumulating any serious corporate governance influence as per 1937 data on block holding in the top listed 200 US firms.The seed of modern concept of corporate Governance were probably sown by the Watergate scandal in the United States. As a result of subsequent investigation, US regulatory and legislative bodies were able to highlight control failures that had allowed several major corporations to make illegal political contributions and to bribe government officials. This led to the development of the Foreign and Corrupt Practices Act of 1977 in USA that contained specific provisions regarding the establishment, maintenance and review of system of internal control. This was followed by in 1979 by the Securities and Exchange Commission of USA's proposals for mandatory reporting on internal financial controls.In Around 1980 Smith and Zingles defined corporate governance as "allocation of ownership, capital structure, managerial incentive schemes, takeovers, board of directors, pressure from institutional investors, product market competition, labour market competition, organizational structure, etc., can all be thought of as institutions that affect the process through which quasi-rents are distributed. In 1985, following a series of high profile business failures in the USA, the most notable one of which being the savings and loan collapse, the Treadway Commission was formed. The Treadway report published in 1987 highlighted the need for a proper control environment, Independent audit committees and an objective Internal Audit function. It called for published reports on the effectiveness of internal control. It also requested the sponsoring organizations to develop an integrated set of internal control criteria to enable companies to improve their controls.

Although the hostile takeovers of the 1980s disrupted this arrangement for some forms, and some United States institutional investors were clearing their throats, this situation has kept most American firms free standing and 27 professionally run ever since. Since then, corporate governance has been implemented in most of the companies.Companies such as Polly Peck, British and Commonwealth, BCCI, and Robert Maxwell's Mirror Group News International in UK were all victims of the boo to bust decade of the 1980s. Such spectacular corporate failures arose primarily out of poorly managed business practices.

In the USA, no discernible interest existed in corporate governance before the 1990s except for some occasional activist institutional shareholders such as Calpers.The collapse of Enron, Arthur Anderson, World.com and others from the late 2001 to date, generated interest in corporate governance and a series of regulations and statutory provisions