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Module 37: Corporate Governance

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MHRD Govt. of India

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CORPORATE GOVERNANCE

Items	Description of Module
Subject Name	Management
Paper Name	Business Environment
Module Title	Corporate Governance
Module Id	Module No. 37
Pre- Requisites	Preliminary understanding of corporate governance
Objectives	To understand the corporate governance mechanisms and its importance
Keywords	Corporate Governance, Principles, Models

QUADRANT-I

Corporate Governance
1. Learning Outcome
2. Meaning of Corporate Governance
3. Definitions of Corporate Governance
4. Narrow vs. Broad Perceptions of Corporate Governance
5. Theories of Corporate Governance
6. Principles of Corporate Governance
7. Models of Corporate Governance
8. Corporate Governance Controls
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1. Objective

After reading this lesson, you should be able:

- To understand the manner in which the corporations are directed and controlled throughout the world
- To understand the basic principles, theories and models of corporate governance across the world.

2. Meaning of Corporate Governance-:

Corporate Governance, i.e. the system by which companies are directed and controlled, has become a key topic in today's globalised world **. Corporate governance** refers to the mechanisms and processes by which corporations are directed and controlled . Corporate governance includes the rules and regulations that focus towards the allocation of rights and responsibilities among different participants in the corporation (such as the board of directors, managers, shareholders, creditors, auditors, regulators, and other stakeholders) . It is a framework that forms the basis for decision making in the corporations. It acts as a torchlight in identifying the objectives of the corporations and pursuing them keeping into account the market, regulatory and social environment. The principal aim of corporate governance is to align the interests of the different stakeholders in the corporation for the overall benefit of all the stakeholders.

During the past two decades the world has witnessed an awful end to some of the leading corporations in the world like Enron, World Com, Tyco, etc. The major reason for such debacles was managerial greed, unethical practices and lack of suitable governance mechanisms. The last decade , therefore, has witnessed a continuous attempt to strengthen the corporate governance norms all over the world including India. This has greatly been influenced by the emergence of Sarbanes Oxley Act in the U.S.A. and the Cadbury Committee in the United Kingdom. .

3. Definitions of Corporate Governance

Shleifer and Vishny (1997) defined corporate governance as "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment"

"Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined." **(OECD 2004)**

F. Mayer (1997) opines that Corporate governance is concerned with ways of bringing the interests of investors and manager into line and ensuring that firms are run for the benefit of investors.

4. Narrow Vs. Broad Perceptions of Corporate Governance-:

There exists a vast amount of literature on corporate governance that gives innumerable definitions about the subject. To get a true and fair view on the subject it would be prudent to give a narrow as well as a broad definition of corporate governance.

In a narrow sense, corporate governance is defined as the relationship of a company to its shareholders .It involves a set of relationships amongst the company's management, its board of directors, its shareholders, its auditors and other stakeholders. These relationships provide the guidelines through which the objectives of the company are set, the path of attaining these objectives charted out and the ways of monitoring performance is determined. Thus, the key aspects of good corporate governance include transparency of corporate structures and operations; the accountability of managers and the boards to shareholders; and corporate responsibility towards stakeholders. While corporate governance in the narrow sense lays down the emphasis for creating long term trust between companies and the external providers of capital, it would be wrong to think that the importance of corporate governance lies solely in better access of finance. Managers around the world have realized that better corporate governance adds considerable value to their operational performance as well:

• It improves strategic thinking at the top by inducting independent directors who bring a wealth of experience, and a host of new ideas

• It rationalizes the management and monitoring of risk that a firm faces globally

• It limits the liability of top management and directors, by carefully articulating the decision making process

• It assures the integrity of financial reports

• It has long term reputational effects among key stakeholders, both internally and externally.

However in a broader sense, Corporate governance is not just about maintaining long term relationships with the suppliers of finance only. In fact it calls for a common path that would lead to attainment of the common objectives of all the stakeholders in the corporation and not just the shareholders. Good corporate governance is important for overall market confidence, the efficiency of capital allocation, the growth and development of countries industrial bases, and ultimately the nations' overall wealth and welfare. It is important to note that in both the narrow as well as in the broad definitions, the concepts of disclosure and transparency occupy centre-stage. In the first instance, they create trust at the firm level among the suppliers of finance. In the second instance, they create overall confidence at the aggregate economy level. In both cases, they result in efficient allocation of capital.

5. Theories of Corporate Governance

5.1. Agency Theory : Agency theory was elaborated by Alchian and Demsetz (1972) and further developed by Jensen and Meckling (1976). It is defined as "the relationship between the principals, such as shareholders and agents such as the company executives and managers". According to this theory shareholders who are the owners or the principals appoints the managers or the agents to manage the business on their behalf. There are two factors that can influence the prominence of agency theory. First, the theory is conceptually and simple theory that reduces the corporation to two participants of managers and shareholders. Second, agency theory suggests that employees or managers in organizations can be self-interested. The agency theory shareholders expect the agents to act and make decisions in the principal's interest. On the contrary, the agent may not necessarily make decisions in the best interests of the principals. The agent may be succumbed to self-interest, opportunistic behavior and falling short of congruence between the aspirations of the principal and the agent's pursuits. .

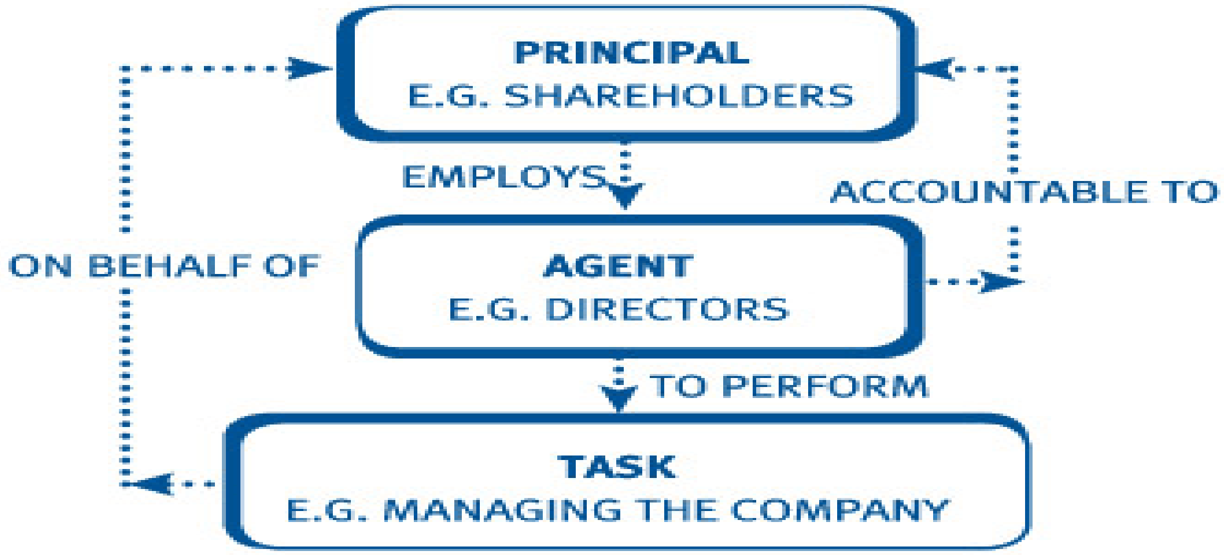


Figure 1: The Agency Model

5.2. Stewardship Theory: In contrast to agency theory, stewardship theory (see Figure 3) presents a different model of management, where managers are considered good stewards who will act in the best interest of the owners (Donaldson & Davis 1991). The fundamentals of stewardship theory are based on social psychology, which focuses on the behavior of executives. The steward's behavior is pro organizational and collectivists, and has higher utility than individualistic self-serving behavior and the steward's behavior will not depart from the interest of the organization because the steward seeks to attain the objectives of the organization. According to Smallman (2004) where shareholder wealth is maximized, the steward's utilities are maximized too, because organizational success will serve most requirements and the stewards will have a clear mission. He also states that, stewards balance tensions between different beneficiaries and other interest groups. Therefore stewardship theory is an argument put forward in firm performance that satisfies the requirements of the interested parties resulting in dynamic performance equilibrium for balanced governance.

In this perspective, stewards are company executives and managers working for the shareholders, protects and make profits for the shareholders. . The stewardship perspective suggests that stewards are satisfied and motivated when organizational success is attained.

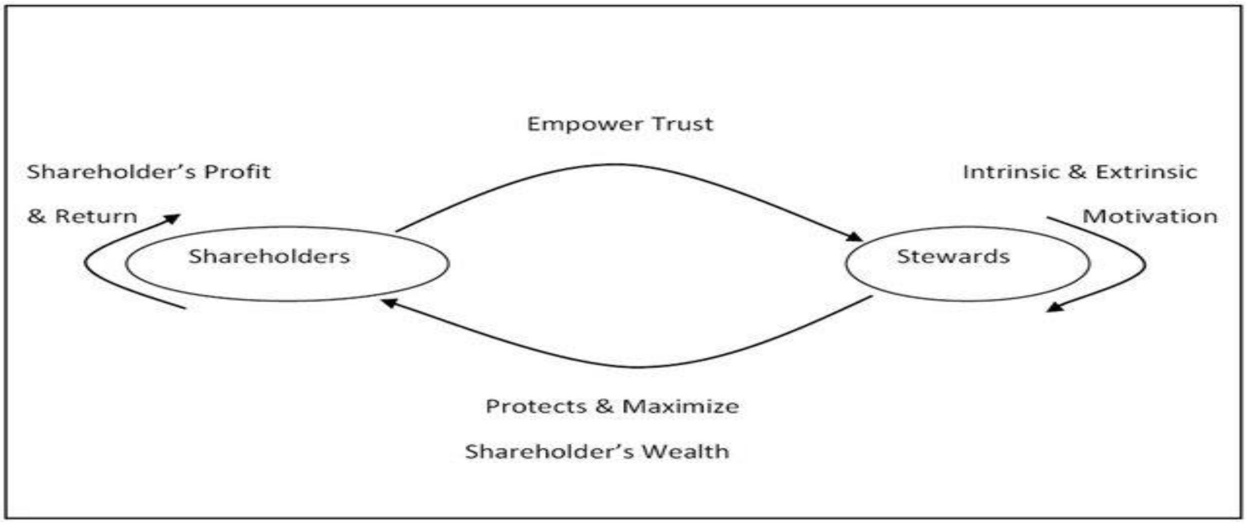


Figure 2:The Stewardship theory Adapted from Abdallah, H. (2009)

5.3. Stakeholder Theory: Stakeholder theory was embedded in the management discipline in 1970 and gradually developed by Freeman (1984) incorporating corporate accountability to a broad range of stakeholders. Wheeler et al, (2002) argued that stakeholder theory derived from a combination of the sociological and organizational disciplines. Indeed, stakeholder theory is less of a formal unified theory and more of a broad research tradition, incorporating philosophy, ethics, political theory, economics, law and organizational science. Stakeholder can be defined as “any group or individual who can affect or is affected by the achievement of the organization’s objectives”. Unlike agency theory in which the managers are working and serving for the shareholders, stakeholder theorists suggest that managers in organizations have a network of relationships to serve – this include the suppliers, employees and business partners. And it was argued that this group of network is important other than owner-manager-employee relationship as in agency theory .

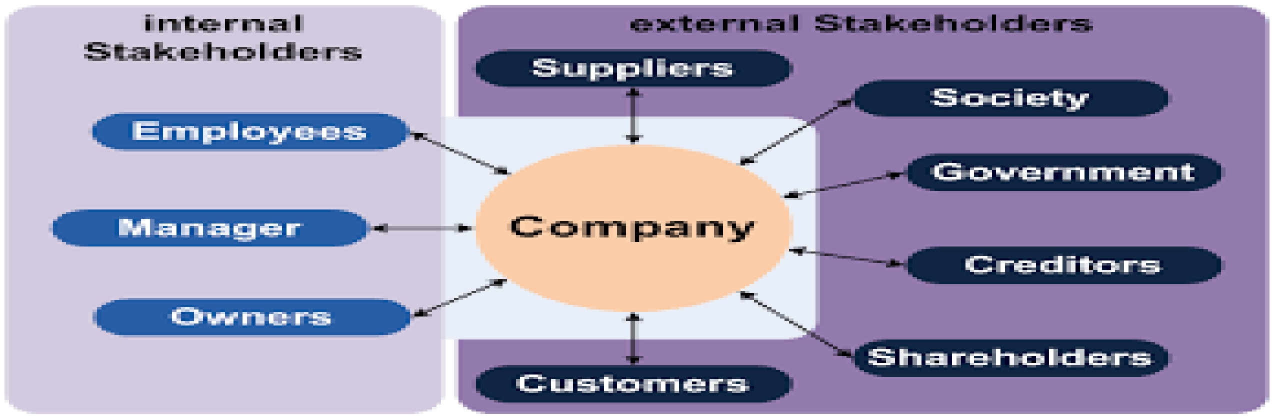


Figure 3: Different stakeholders in a corporation

5.4. Resource Dependency Theory : Whilst, the stakeholder theory focuses on relationships with many groups for individual benefits, resource dependency theory concentrates on the role of board directors in providing access to resources needed by the firm. It focuses on the role that directors play in providing or securing essential resources to an organization through their linkages to the external environment. According to Hillman, Canella and Paetzold (2000) directors bring resources to the firm, such as information, skills, access to key constituents such as suppliers, buyers, public policy makers, social groups as well as legitimacy. Directors can be classified into four categories of insiders, business experts, support specialists and community influentials. First, the insiders are current and former executives of the firm and they provide expertise in specific areas such as finance and law on the firm itself as well as general strategy and direction. Second, the business experts are current, former senior executives and directors of other large for-profit firms and they provide expertise on business strategy, decision making and problem solving. Third, the support specialists are the lawyers, bankers, insurance company representatives and public relations experts and these specialists provide support in their individual specialized field. Finally, the community influentials are the political leaders, university faculty, members of clergy, leaders of social or community organizations.

5.5. Political Theory : Political theory brings the approach of developing voting support from shareholders, rather by purchasing voting power. Hence having a political influence in corporate governance may direct corporate governance within the organization. Public interest is much reserved as the government participates in corporate decision making, taking into consideration cultural challenges (Pound, 1993). The political model highlights the allocation of corporate power, profits and privileges are determined via the governments' favor. The political model of corporate governance can have an immense influence on governance developments. Over the last decades, the government of a country has been seen to have a strong political influence on firms. As a result, there is an entrance of politics into the governance structure or firms' mechanism (Hawley and Williams, 1996).

6. Principles of Corporate Governance

The Organisation for Economic Co-operation and Development (OECD) published its 'Principles of Corporate Governance' in 2004. These are:

• **Rights of shareholders:** The corporate governance framework should protect shareholders and facilitate their rights in the company. Companies should generate investment returns for the risk capital put up by the shareholders.

• **Equitable treatment of shareholders:** All shareholders should be treated equitably (fairly), including those who constitute a minority, individuals and foreign shareholders. Shareholders should have redress when their rights are contravened or where an individual shareholder or group of shareholders is oppressed by the majority.

• **Stakeholders:** The corporate governance framework should recognise the legal rights of stakeholders and facilitate cooperation with them in order to create wealth, employment and sustainable enterprises.

• Disclosure and transparency: Companies should make relevant, timely disclosures on matters affecting financial performance, management and ownership of the business.

• Board of directors: The board of directors should set the direction of the company and monitor management in order that the company will achieve its objectives. The corporate governance framework should underpin the board's accountability to the company and its members.

7. Different Models of Corporate Governance

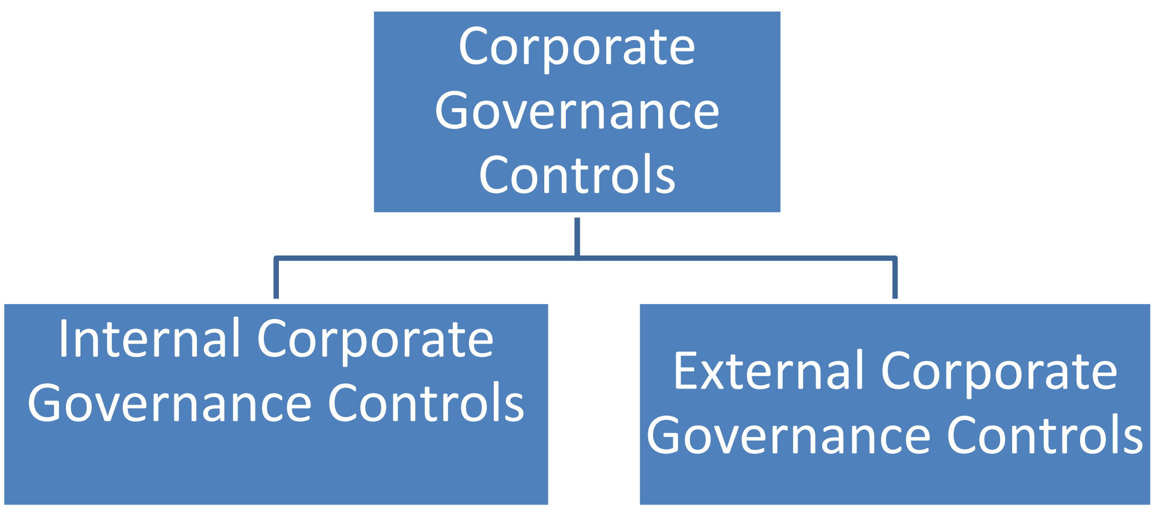
1. **The Anglo American Model-:** The Anglo-US model is characterized by share ownership of individual, and increasingly institutional investors not affiliated with the corporation (known as outside shareholders or “outsiders”); a well-developed legal framework defining the rights and responsibilities of three key players, namely management, directors and shareholders; and a comparatively uncomplicated procedure for interaction between shareholder and corporation as well as among shareholders during or outside the AGM. Equity financing is a common method of raising capital for corporations in the United Kingdom (UK) and the US. There is a causal relationship between the importance of equity financing, the size of the capital market and the development of a corporate governance system. The US is both the world’s largest capital market and the home of the world’s most-developed system of proxy voting and shareholder activism by institutional investors. Institutional investors also play an important role in both the capital market and corporate governance in the UK.

2. **The Japanese Model-:** The Japanese model is characterized by a high level of stock ownership by affiliated banks and companies; a banking system characterized by strong, long-term links between bank and corporation; a legal, public policy and industrial policy framework designed to support and promote “keiretsu” (industrial groups linked by trading relationships as well as cross-shareholdings of debt and equity); boards of directors composed almost solely of insiders; and a comparatively low (in some corporations, non-existent) level of input of outside shareholders, caused and exacerbated by complicated procedures for exercising shareholders’ votes. Equity financing is important for Japanese corporations. However, insiders and their affiliates are the major shareholders in most Japanese corporations. Consequently, they play a major role in individual corporations and in the system as a whole. Conversely, the interests of outside shareholders are marginal.

3. **The German Model-:** The German model governs German and Austrian corporations. Some elements of the model also apply in the Netherlands and Scandinavia. Furthermore, some corporations in France and Belgium have recently introduced some elements of the

German model. The German corporate governance model differs significantly from both the Anglo-US and the Japanese model, although some of its elements resemble the Japanese model. Banks hold long-term stakes in German corporations , and, as in Japan, bank representatives are elected to German boards. However, this representation is constant, unlike the situation in Japan where bank representatives were elected to a corporate board only in times of financial distress. The German model differs from other two models. First, German corporations have a two-tiered board structure consisting of a management board (composed entirely of insiders, that is, executives of the corporation) and a supervisory board (composed of labor/employee representatives and shareholder representatives). Second, the size of the supervisory board is set by law and cannot be changed by shareholders. Third, in Germany and other countries following this model, voting right restrictions are legal; these limit a shareholder to voting a certain percentage of the corporation's total share capital, regardless of share ownership position.

8. Corporate Governance Controls



8.1 Internal corporate governance controls

These are the control mechanisms within the organization that monitor activities and then take corrective action to accomplish the corporations goals. Some of the examples of internal control mechanisms-:

1. **Monitoring by the Board of Directors**: The Board of Directors are the top personnel's in the organization that have the main responsibility of safeguarding the invested capital. The executive and non-executive directors both examine the business processes continuously so as to ensure effective governance within the organization. The kind of Board Structure varies from firm to firm. The Board of Directors also keeps an eye on the functions of the executives. Executive directors have access to superior knowledge of the decision-making process and therefore evaluate top management based on insights from such information.

2. **Internal Control Mechanisms**: Internal control procedures are the steps undertaken by an entity's board of directors, audit committee, management, and other personnel to assure that the entity is conforming to all the rules and regulations related to adequate disclosure through appropriate financial statements and other statements related to disclosure, operating efficiency, and conformation to different appropriate laws and regulations. Internal auditors are the employees in the organization that test the implementation aspect of the organizations internal control systems.

3. **Mechanism of Separation of Power**: In order to ensure proper functioning in the organization one of the internal corporate governance control measures is the separation of power. There should be separation of power in such a manner that there exists a system of checks and balances. This application of separation of power should ensure separate work for separate divisions and there exists a system of check and balance on each other's actions. There may be a group that proposes company-wide administrative changes, some other group may review and can veto the changes, and one another group may check that the interests of people of the larger population are being met.

4. **Performance Based Compensation**: Nowadays, a major chunk of the compensation structure of the employees in the organization is based on their performance . It may be in the form of cash or non-cash payments such as employee stock option schemes. However such a compensation structure may induce the managers to act taking into consideration the short run performance. It may encourage the managers to have a myopic view about the goals of the organization

5. **Monitoring by majority shareholders/by banks /large creditors**: The proportion of investment of a major shareholder is very large in the organization. Therefore they have the power to monitor and control the functioning of the government. This will help in reducing the agency problem between the owners and the managers of an organization.

8.2 External Corporate Governance Controls

External Corporate Governance Control Mechanisms include the control measures adopted by external stakeholders such as

- Competitors of the business
- Lenders of the business.
- Government Regulations.
- Labour Market Controls
- Analysts