LESSON-1

CORPORATE GOVERNANCE

STRUCTURE OUTLINE

1.1 Objectives

1.2 Introduction

1.3 Meaning And Definition Of Corporate Governance

1.4 Framework of Corporate Governance

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1.1 OBJECTIVES

After reading the lesson/unit, the learner will be able to:

- Understand the Corporate Governance
- Discuss its framework
- To get the idea of corporate practices followed
- Describe the Need & Significance of Corporate Governance
- Discuss the key actors of corporate Governance

1.2 INTRODUCTION

The field of corporate governance has at taken very prominent role all across the globe. Number of developments are taking place on the front of corporate governance. Like if we talk about the case of India, Companies Act, 2013 has brought lot many changes to it. One of the main developments that has been observed is that it intends to improve corporate governance by requiring disclosure of nature of concern or interest of every director, manager, any other key managerial personnel and relatives of such a director, manager or any other key managerial personnel and reduction in threshold of disclosure from 20% to 2%. But, interestingly, it is important to note that the concept of 'corporate governance' remained unknown until 1993. It came to the fore at that time because of a spate of corporate scandals that occurred during the aftermath of economic liberalization.

Whereas the 20th century might be viewed as the age of management, the early 21st century is predicted to be more focused on issues of governance. Although both terms refers to the control of corporations but governance demands an examination of underlying purpose and legitimacy.

1.3 MEANING AND DEFINITION OF CORPORATE GOVERNANCE

If in less than three decades, it has become of prime importance and getting more attention day by day, it will be quite interesting to learn about the concept of ***Corporate Governance***. Before going into the formal definitions, it will be useful for all of you to understand and well verse with the concept of Corporate Governance. What is Corporate Governance? Corporate governance is typically perceived as dealing with "problems that result from the separation of ownership and control." Hence, the focus of corporate governance includes the internal structure and rules of the board of directors (BOD); the creation of independent audit committees; rules for disclosure of information to shareholders and creditors; and, control of the management to name a few.

Corporate Governance comes into play only because of the ***separation of ownership and control***. In case of large corporation, there is a principle-agent relationship between shareholder (Actual owner) and manager (agent) as manager is appointed by shareholders to work on their behalf and with the best interest (same care with which he would have taken care of his/her own cash, property to name a few).

"The directors of companies, being the managers of other people's money rather than their own, cannot well be expected to watch over it with the same anxious vigilance with which (they) watch over their own. *Adam Smith, The Wealth of Nations, 1776*

Managers have to take decisions with regard to the best interest of shareholders. The supervisory role for overseeing the act of managers to act in the best interest of shareholders rests with Board of Directors (BOD). Hence, all governance issues in corporation arise because of divorce of management and shareholders which has actually given input to the development of separate, independent and full-fledged field of 'Corporate Governance'. Corporation Governance refers to the integrated framework whereby people formally organize themselves for a defined purpose in a corporation, and they apply systematic processes consistently to achieve predicted performance for sustainable development. To understand the same concept in detail, here are a few definitions which are compulsory to learn, and are taken from different sources as follows:

Corporate Governance refers to the system of rules, practices and processes by which a company is directed and controlled. The focus of Corporate Governance is to balance the interests of the various stakeholders- shareholders, management, customers, suppliers, financiers, government and the community-in a company. Since corporate governance also provides the framework for attaining a company's objectives, it encompasses practically every sphere of management, from action plans and internal controls to performance measurement and corporate disclosure.

According to Investopedia

"The framework of rules and practices by which a board of directors ensures accountability, fairness, and transparency in a company's relationship with its all stakeholders (financiers, customers, management, employees, government, and the community)."

Business Dictionary.com

"Corporate governance is a field in economics that investigates how to secure/ motivate efficient management of corporations by the use of incentive mechanisms, such as contracts, organizational designs and legislation. This is often limited to the question of improving financial performance, for example how the corporate owners can secure/ motivate that the corporate managers will deliver a competitive rate of return".

Mathiesen (2002)

“Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”.

Shleifer and Vishny (1997)

“Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance"

OECD, April 1999.

“Corporate Governance-which can he defined narrowly as the relationship of a company to its shareholders or, more broadly, as its relationship to society_____”

From an article in **Financial Times (1997)**

“Corporate governance is about promoting corporate fairness, transparency and accountability"

J Wolfensohn, **president of the World bank**, as quoted by an article in Financial Times, June 21, 1999.

“Corporate governance broadly refers to the mechanisms, processes and relations by which corporations are controlled and directed” **Wikipedia**

Some commentators take too narrow a view, and say it (corporate governance) is the fancy term for the way in which directors and auditors handle their responsibilities towards shareholders. Others use the expression as if' it were synonymous with shareholder democracy. Corporate Governance is a topic recently conceived, as yet, ill-defined, and consequently blurred at the edges.. Corporate Governance as a subject, as an otherwise, or as a regime to be followed for the good of shareholders, employees, customers, bankers and indeed for the reputation and standing of our nation and its economy"

Maw el al., 1994

Corporate governance includes the processes through which corporations' objectives are set and pursued in the context of the social, regulatory and market environment. Corporate governance is most often viewed as both the structure and the relationships which determine corporate direction and performance. Given with the responsibility of overseeing over the working of management, the board of directors is typically central to corporate governance. Hence, the relationship of board of director to the other primary participants-shareholders and management-is critical for the good governance. Except from the primary participants in context to corporate governance, 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. **James McRitchie, 1999**

Perspective of corporation

Corporate Governance is the relations between owners, management board and other stakeholders (Employees, customers, suppliers, investors and communities) where emphasis is given to the BOD to balance their interests to achieve long term sustained value.

Perspective of public policy

Corporate Governance refers to providing for the survival, growth, and development of the company, and at the same time, its accountability in the exercise of power and control over companies. The role of public policy is to discipline companies and simultaneously initiate minimization of differences between private and social interests.

World Bank

According to another experts, "**Corporate governance means doing everything better to improve relations between companies and their shareholders; to improve the quality of outside directors; to encourage people to think of long-term relations; information needs of all stakeholders are met and to ensure that executive management is monitored properly in the interest of shareholders**."

After analyzing the above written definition, you will come across the following issues which are focused as follows:

(i). Management accountability

(ii). Providing adequate investments to management

(iii). Disciplining and replacement of bad management

(iv). Enhancing corporate performance

(v). Transparency, Mutual Trust and Integrity

(vi). Shareholder Activism

(vii). Investor protection

(viii) Improving access to capital markets

(ix) Promoting long-term investment

(x) Encouraging innovation.

All these views reflect the necessity of corporate governance for improved performance of corporate themselves. However, in addition to these issues, there is a growing need for corporate excellence not only for the purpose of corporate but also for the economy as a whole. Good governance makes a reputation for the whole of the nation like Tata, Infosys etc which are actually the benchmarks in the corporate governance on the scale of transparency, integrity, ethics and disclosure to name a few.

1.4 FRAMEWORK OF CORPORATE GOVERNANCE

The corporate governance system surrounds of the following key areas:

(1).Various contracts-Explicit and implicit-mechanism between the company and its stakeholders so as to share roles, responsibilities, rights and rewards.

(2). Procedures for reconciling the conflicting interests of stakeholders, if any, in accordance with their duties, privileges and roles.

(3). Designing of procedure and systems for proper supervision, control, and information-flows so as to oversee the functions of managers.

For covering the above issues, a detailed framework of 4Ps-participants, Purpose, Process and performance- has been designed for the effective corporate governance as explained below:

Participants:

These are the participants for whom the corporation exists and similarly, participants are the important pillar of effective corporate governance. Participants include Investors, Employees, Suppliers, Customers, Lenders, Government and Society at large. The effectiveness of the participant's in corporate governance of the organization can be measured with the help of the parameters like equity, ethics and relationship etc. Equity refers to the equitable treatment to all whether minority shareholders, or foreign investors etc. Ethical practices of organizations refers to the adherence to the principles of integrity, transparency etc.

Relationship includes stakeholders' empowerment and engagement in management and decision making process, harmonious culture and effective communication so as to result in effective performance of the organization.

Purpose: Second 'P' of corporate governance is "Purpose". The Purpose for which the organization is there must be established, measurable, actionable and achievable. For this, the organization must communicate the purpose very clearly throughout the organization. The purpose is always derived from Vision-Mission and Strategy of the organization. The Vision and Mission are decided based on Unified and Shared Values of the Organization, Stakeholders' policies and Organization Commitment. The Strategy helps in furthering to achieve the set objectives.

Process: Third 'P' of the corporate governance is "Process". Process must be established, integrated, documented, automated, implemented and maintained. Process compliance, process management, process innovation, Proper Risk Management, crisis management are the key areas to be taken care of. Organizations have to comply with all the rules, regulations, and compliance requirements of state as well as central government.

Performance: The fourth ‘P’ of the corporate governance framework is “Performance”. Performance must be measured, analyzed and communicated so as to achieve the organizational objectives effectively. The objectives may be to increase the market share, to increase the net-worth, to expand in the new market or to diversify. The participants are rewarded according to their role, contribution and up to the extent of the realization of the objectives.

To work for the effective governance, these four Ps have to work in tandem. Any lack on the part of any participant or process or performance may hinder the good governance.

1.5 CORPORATE GOVERNANCE PRACTICES

A McKinsey & Company Report published in 2001 under the title "Giving New Life to the Corporate Governance Reform Agenda for Emerging Markets" suggests that by using a two-version "governance" chain model, we can highlight the governance practices followed throughout the world. There are two models-market and control-which are explained as follows:

Model 1 (Figure 1.1) in the first version of McKinsey's model has been named as "The Market Model" governance chain, and it assumes efficient and well-developed equity markets, and dispersed ownership. These characteristics are common in the developed industrial nations such as the US, UK, Canada and Australia.

Corporate governance means how companies deal fairly with problems that arise from "separation of ownership and effective control." This model points out the conditions and governance practices that are better understood and appreciated and as such highly valued by sophisticated global investors.

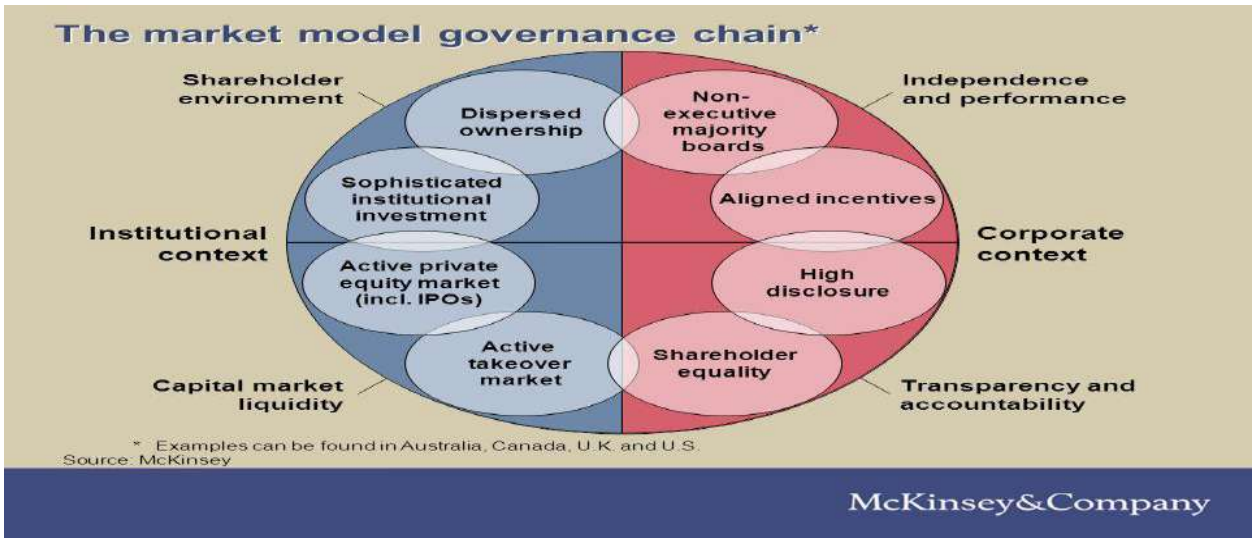

Figure 1.1: Market Model Governance Chain

Model 2 (as depicted in figure 1.2) has been named as the "The Control Model," governance chain. The control model is represented the characteristics like underdeveloped equity markets, concentrated (family) ownership, less shareholder transparency and inadequate protection of minority and foreign shareholders. These common characteristics are more prominent in Asia, Latin America and some east European nations. In such a scenario, transitional and developing countries, there is a need to build, nurture and grow supporting institutions such as a strong andefficient capital market regulator and judiciary to enforce contracts or protect property rights.

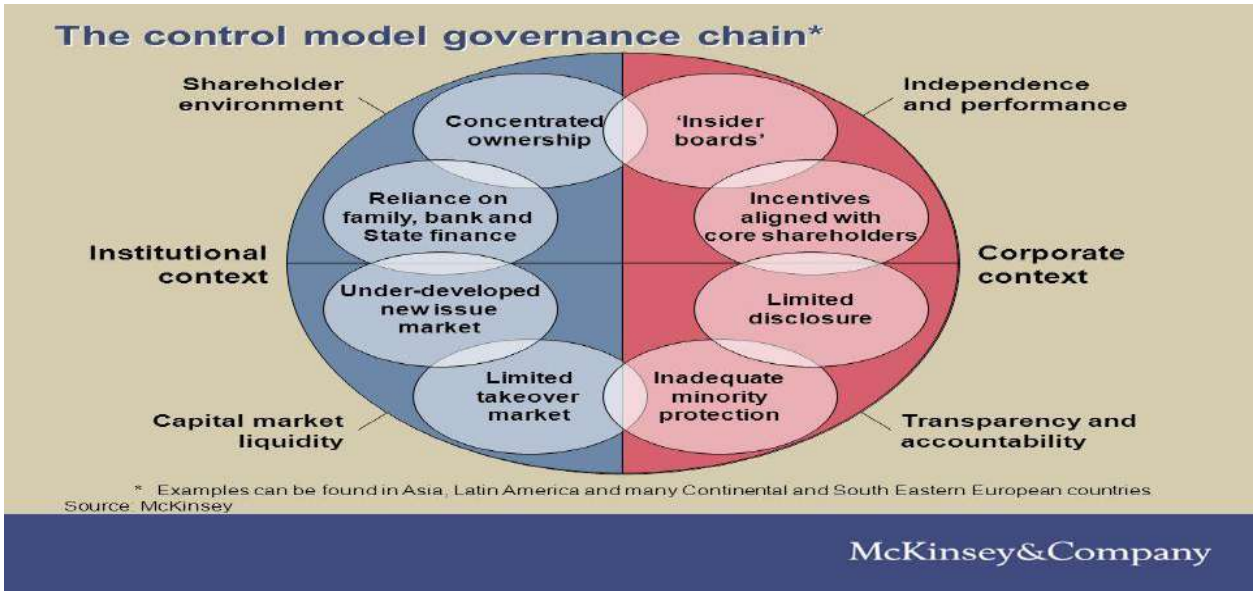

Figure 1.2: Control Model Governance Chain

1.6 KEY CORPORATE ACTORS OF CORPORATE GOVERNANCE

Principal actors involved in corporate governance include the regulator bodies, which has the capacity to govern the companies to adhere to the rules and regulations as framed by these governing bodies. This consists of external key actors and internal key actors. Internal key actors include Chief Executive Officer (CEO), Board of Directors (BOD), Management, Shareholders and Employees. The external key participants include Suppliers, Creditors, Investors, Lenders, Customers, Government and Society at large.

In corporations, because of separation of the control from the ownership, the principal (shareholder) delegates decision rights to the agent (manager) to act in the best interests of principal. Hence, corporate governance controls helps in assisting in aligning the incentives of managers with those of shareholders so as to oppose the opportunistic behavior of managers.

BOD plays a vital role in corporate governance as they are entrusted with the responsibility to formulate the organization's strategy, develop directional policy and ensure accountability of the organization to all direct and indirect stakeholders. For the same purpose, BOD appoint, supervise and remunerate senior executives so as to make them work effectively.

All key players have an interest, direct or indirect, in the effective performance of the organization. Different key actors have their role and contribution to the organization and in exchange for their contribution, they want their justified returns. This is only possible if every actor is playing his/her part very carefully in the organization set up.

A key factor in an individual's decision to participate in an organization is influenced by his/her trust that he/she will receive a fair share of the organizational returns for his contribution (Capital, expertise or labour). In case, some parties are receiving more than their fair return exorbitant, then other participants may choose not to continue participating, as a result of it, employees may leave the organization, customer may shift to another producer to name a few. ***Corporate governance is the key mechanism through which this trust is maintained across all stakeholders.***

ACTIVITY 1

Dear learners, the objective of the exercise is to make learning an entertaining experience.

Identify which is the company that is best from the view point of corporate governance and identify the various best practices of these companies.

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1.7 PRINCIPLES OF CORPORATE GOVERNANCE

These are the core principles which form the basis for the Corporate Governance as follows:

a. **Rights and equitable treatment of shareholders:** Organizations must adhere to equal treatment means it must respect the rights of shareholders and help shareholders to exercise these rights. They can help shareholders exercise their rights by openly and effectively communicating information and by encouraging shareholders to participate in general meetings. Moreover, there must be equal treatment for all whether a minority shareholder or a foreign investor or any.

b. **Interests of Other stakeholders:** It is of vital importance to mention that organizations should recognize that they have legal, contractual, social, and market driven obligations to other stakeholders in addition to shareholder. These other stakeholders include employees, investors, creditors, suppliers, local communities, customers, and policy makers to name a few.

c. **Role and Responsibilities of the board:** The board needs adequate and necessary skills, and understanding to review and challenge management performance. It also needs adequate size and appropriate levels of independence and commitment for its duty.

d. **Integrity and Ethical behavior:** Integrity must be maintained at every stage and at every place of organization. Organizations should develop a code of conduct for their directors and executives that reinforce ethical and responsible decision making.

e. **Disclosure and Transparency:** Organizations should clarify and roles and responsibilities of board and management must be made in public so as to reinforce accountability among all its stakeholders about their duties. Procedures to independently verify and safe guard the integrity of the company's financial reporting must be put at place. Disclosure of material matters concerning the organization should be timely and balanced to ensure that all investors have access to clear and factual information so as to make informed decisions.

f. **Mutual Trust:** Organizations is made up of human resources and it is the relationship among them which is of prime importance for promoting mutual trust. Hence, a culture of faith, belief and trust must be established so as to make right decisions from organizational point of view.

On the basis of above principles, an organization can achieve corporate excellence.

1.8 NEED OF CORPORATE GOVERNANCE

Many corporate are working at multiple countries so any type of work they do, it impacts citizens of number of counties. Moreover, corporate governance is needed to create a corporate culture of consciousness, transparency, integrity and openness. It will result in bringing satisfaction among the customers, satisfied society and government and more importantly, add long term value to the shareholders. Thus, it will help in satisfying all stakeholders.

It is important to mention here that there has been a fair number of researches both in Indian scenario and rest of the world regarding the impact of corporate governance on corporate performance. Several studies found positive relationship between these two variables. Although the relationship cannot be generalized because not all of the studies have established same positive results but there are a few studies have found either negative results or are not able to

establish a link between two variables. In case of example of Indian context, Infosys, Tata, Dr, Reddy are the forerunner in establishing higher standards of governance and because of the governance, they are able to improve their profitability too.

Investor while evaluating a company for the purpose of investment, they take the reference of governance standards for the purpose. If a poorly governed company is exhibiting the same financial performance as that of a good governed company, Investors prefer to invest in a good governed company vis-à-vis the poorly governed company.

1.9 SIGNIFICANCE OF CORPORATE GOVERNANCE

As pointed out in the above session while explaining the need of corporate governance, these are the potential benefits that are to be realized as explained below:

Benefits of the corporation

The potential benefits to corporation for adopting good governance practices are explained as below:

Access to global Capital Markets: Adopting good governance will help the organization to access the global capital markets so as to result in reduction of their cost of capital.

Enable a firm to perform by preventing Fraud and Malpractices: Creating and promoting a culture of ethical practices and code of conduct will help the organization in preventing fraud and malpractices in the system.

Providing protection to shareholder's interest: For the shareholders, it is important to have access to the relevant information related to the health of the company. Hence, by following a culture of good governance, disclosure and transparency are promoted so as to safe guard the interest of the shareholders.

Enhances the brand value: Following good governance practices by organization will improve the brand image of the organization as a whole.

Ensuring Compliance to laws and Regulation: As corporate governance practices focus mainly on adherence to the laws and regulations. Hence, a company ensures all the necessary laws and regulations by adopting good governance.

Benefits of the Society

These are the following benefits of corporate governance to the society:

More Liquid Markets: Research has proved that the countries with stronger corporate governance have much larger and liquid capital markets.

Necessity in weak markets: Especially in weak markets, there is need to adopt corporate standards. Because, in weak markets there are higher chances that shareholders don't have any mechanism to safe guard their rights as bounded by law.

Protection from Fraud, Malpractices and Corruption: By adopting high standards of disclosure, transparency and integrity, organization can succeed in preventing frauds, malpractices and corruption up to certain extent.

1.10 CORPORATE GOVERNANCE AT WIPRO

Company's Leadership and Philosophy

Azim Premji has led Wipro since the late 1960s, which was valued $2 million hydrogenated cooking fat manufacturing company. Today, Wipro is a $6 billion revenue IT, BPO and R&D services organization with operations in over 50 countries.

Azim Premji followed one basic idea of building an organization firmly committed to 'Values', and he deeply believed that success in business would be its eventual, inevitable outcome. Commitment to values continues to be one of the basic key elements of Wipro's organizational culture.

He strongly believes that it is the ordinary people who are capable of performing extraordinary things and that the key to this is creating highly energized teams. He has always taken a personal interest in developing teams and leaders and has also invested significant time as a faculty in the leadership development programs of Wipro. According to him, the Wipro's brand promise of

"Applying Thought" is the main driving force for delivering value to customers. This has lead to Wipro's pioneering efforts in Quality, culminating in the "Wipro Way," which integrates the methods and practices of Six Sigma and Lean etc. The philosophy also drives Wipro's focus on applying innovation for direct customer benefits-enhancing predictability and reliability and improving their time-to-market and cutting costs.

According to the Chairman of Wipro, Azim Premji, “In the building of a world class institution, five factors namely, vision, values, innovation, leadership and social commitment.

According to an article, Power of Ethical Leadership, “Azim Premji, chairman of Wipro, is a man of exemplary personal integrity deeply committed to ethical principles and practice. According to him, “To meet the challenges of the future we are prepared to change everything about ourselves, except our beliefs, as they alone guide, govern and bind us together as an organization. It is essential that we consciously internalize our beliefs and be fanatical about consistently practicing them. Our beliefs define our business philosophy of managing business and remain the spirit and essence of Wipro."

In January 2011, Premji was honored with the Padma Vibhushana, which is one of the highest civilian awards in the country, by the Indian Government. Earlier in 2005 he was conferred with the Padma Bhushana. The Republic of France honored him with the "Legion of Honor" in 2011. Premji established the Azim Premji Foundation in the year 2001, a not-for-profit organization with a vision to work and contribute significantly towards the quality primary education for every child in India, in order to help in building an equitable, just, humane and sustainable society. Premji himself arranged for the financial resources for the organization. The Azim Premji Foundation has reached out to more than 20,000 schools and over 2.5 million children in across India. The Economic Times in October 2006 recognized the Foundation as the Corporate Citizen of the year. The Foundation is currently in the process of a very significant scale-up, including planning to set up a university and multiple field level institutions; all these efforts are focused on improving education in India and related issues of development.

Corporate Governance at Wipro

The relationship between the Board and the management is mostly characterized by sincerity; their relationship with employees is characterized by fairness; their relationship with the

communities in which they operate is characterized by good citizenship and their relationship with government is characterized by a commitment to adhere to various norm, rules and regulations.

The senior management is responsible for running the day-to-day operations of the corporation and properly informing the Board of the status of the operational activities. The management's responsibilities include strategic planning, financial reporting and risk management.

The Board of Directors has a very significant role of overseeing management performance on behalf of the stockholders. Stockholders necessarily have little voice in day-to-day management of corporate operations, but have the right to elect representatives (Directors) to look out for their interests and to receive the necessary information they need to make investment and voting decisions.

Over the last few years, the Board of Directors of Wipro have from time to time developed corporate governance practices to enable the Directors to effectively and efficiently discharge the following responsibilities:

- Fiduciary duties
- Oversight of the management
- Evaluation of the management performance
- Support and guidance in shaping company policies and business strategies

An attempt has been made here in these guidelines to capture and codify in one place these corporate governance practices.

Management's Responsibilities

The management is responsible for operating the company in an ethical, effective and legal manner designed to produce value for the company's stakeholders. The management is also responsible for enforcing and complying with mandatory provisions of the company's policies and standards. The senior management is responsible for understanding the company's income-producing activities and also the material risks being incurred by the company. It is also responsible for avoiding conflicts of interest with the company and its shareholders.

- **Financial Statements and Disclosures:** The management is responsible for producing financial statements that fairly present the financial condition, cash flows, results of operations and related risks in a clear and understandable way. This is done for making timely and complete disclosures to investors, and for keeping the Board and the appropriate Committees of the Board well-informed on all matters of significance.
- **Strategic Planning:** The Chairman/Chief Executive Officer and senior management are responsible for developing and by presenting to the Board, the company's strategic plans for implementing those plans as approved Board.
- **Annual Operating Plans and Budgets:** The Chief Executive Officer and senior management are responsible for developing and presenting to the Board, the company's annual operating plans and annual budgets and/or implementing those plans and budgets as approved by the Board.
- **Effective Management and Organizational Structure:** The Chief Executive Officer and senior management are responsible for selecting qualified members of management and for implementing and working within an effective organizational structure appropriate for the company's particular circumstances.
- **Setting a Strong Ethical "Tone at the Top":** Senior management and especially the Chief Executive Officer are responsible for setting a "Tone at the top" of integrity, ethics and compliance on the part of all persons associated with the company, with applicable legal requirements and with the company's policies and standards.

ACTIVITY 2

Can you name certain companies which are performing very well because of their corporate governance efforts? What type of relationship exists between the variables-corporate governance and performance?

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1.11 SUMMARY

Corporate governance is typically perceived as dealing with "problems that result from the separation of ownership and control." Hence, the focus of corporate governance includes the internal structure and rules of the board of directors (BOD); the creation of independent audit committees; rules for disclosure of information to shareholders and creditors; and, control of the management to name a few. Principal actors involved in corporate governance include the regulator bodies, which has the capacity to govern the companies to adhere to the rules and regulations as framed by these governing bodies. This consists of external key actors and internal key actors. Internal key actors include Chief Executive Officer (CEO), Board of Directors (BOD), Management, Shareholders and Employees. The external key participants include Suppliers, Creditors, Investors, Lenders, Customers, Government and Society at large. As far as the framework of Corporate Governance is concerned, It is based on the 4Ps-Particpants, Purpose, Process and performance-of the organization which are the vital part of the this governance system. For the effective implementation of Corporate Governance, the principles like Fairness, Equitable Treatment, Transparency, Disclosure, Mutual Trust etc are important which an organization must adhere to.

Good governance is critical not only for the success or failure of companies, but also for industries and economies as well. Besides, there is a need to extend the concept of governance to corporates of developing and transitional economies and standardise it to accommodate "well-entrenched" local and regional customs, traditions and business practices, which may be very different from what are obtained in advanced societies. Of late, corporate governance has become the cynosure of all issues connected with corporations. National business communities are gradually realising the fact that there is no substitute for getting the basic business and

management systems in place in order to be competitive in the global market and to attract investment.

Corporate governance is needed to create a corporate culture of consciousness, transparency, integrity and openness. It will result in bringing satisfaction among the customers, satisfied society and government and more importantly, add long term value to the shareholders. Thus, it will help in satisfying all stakeholders.

1.12 SELF –ASSESSMENT EXERCISE

Fill in the blanks for the following statements:

a). For elements of 4Ps framework of Corporate Governance System includes Participants, …….., Process and Performance.

b). Corporate governance is typically perceived as dealing with "problems that result from the separation of ……and control.

c). Acoorsing to Shleifer and Vishny (1997) “Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a……..”.

d). The board needs adequate and necessary skills, and understanding to review and ……..management performance.

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1.15 ANSWERS TO SELF –ASSESSMENT EXERCISE

The answers for the self-assessment exercise are explained as below:

a). Purpose

b). Ownership

c). Return on investment

d). Challenge

1.16 MODEL QUESTIONS

Q1). Define Corporate Governance. Explain its importance to business organizations.

Q2). Describe in detail the framework of Corporate Governance citing relevant example.

Q3). What do you understand by 4Ps framework of Corporate Governance? Elaborate.

Q4). "Corporate Governance comes into play because of the divorce of ownership and control". Do you agree or disagree with statement? Justify your position.

Q5). What is significance of Corporate Governance for emerging economy like India? Describe.

Q6). What are the key actors in Corporate Governance system? Discuss in detail.

Q7). Describe the case of any Indian organization which is setting benchmarks in Corporate Governance for other organizations.

Q8). What is meant by market and control model of governance chain? Describe.

Q9). Is there any link between corporate governance and financial performance? Can you justify it with some examples of Indian Corporate?

LESSON-2

THEORY OF CORPORATE GOVERNANCE

STRUCTURE OUTLINE

2.1 Objectives

2.2 Introduction

2.3 The Concept of Governance

2.4 Theoretical Basis of Corporate Governance

2.4.1 Agency theory

2.4.2 Stewardship theory

2.4.3 Sociological theory

2.4.4 Resource Dependence theory

2.4.5 Managerial and Class Hegemony

2.4.6 Psychological and Organizational Perspective

2.4.7 The Societal perspective: Stakeholder theory

2.4.8 System theory

Activity 1

2.5 Summary

2.6 Self –Assessment Exercise

2.7 Bibliography

2.8 Suggested Readings

2.9 Answers to Self –Assessment Exercise

2.10 Model Questions

2.1 OBJECTIVES

After reading the lesson/unit, the learner will be able to:

- Understand the concept of Governance
- Discuss the various theories of corporate governance
- Describe the criticism and applicability of various theories

2.2 INTRODUCTION

The lesson focuses on various theories that have been propounded by various authors since the incorporation was introduced in UK. These theories have emerged so as to make sense to focus on various corporate governance issues like what goes into the corporate so as to ensure that appropriate governance practices are followed. In the same regard various theories like agency, stewardship, stakeholder and sociological are presented and their criticism and the mechanism to ensure good governance practices are explained in detail.

2.3 THE CONCEPT OF GOVERNANCE

The concept of governance can be traced back to the time of emergence of human civilization. Simply put, governance means refers to the process of making and implementing decision-making. Governance is a big umbrella term and is used in several different contexts such as corporate governance, international governance, national governance and local governance.

As governance refers to “the process of decision-making and the process by which decisions are implemented across the unit in the context of which the governance has been talked of”, it is important to have an analysis about the key players-formal and informal-involved in decision-making, and implementing agencies and the structures- formal and informal-that have been set in place to arrive at and to implement the decision.

Irrespective of the context of term, Government is one of the major players in governance. The involvement of other key players in governance varies depending on the context and the level of government that we are talking of. Take the example of rural areas; other key players may include influential landlords, associations of peasant farmers, cooperatives, NGOs, research institutes, religious leaders, finance institutions, political parties, the police to name a few. But on the other side, the situation in urban areas is much more complex vis-à-vis rural areas, and includes the urban elite, decision-makers at various levels, both the government and the private sector media, elected representatives, government officers of various levels, the middle class, the urban poor, NGOs and interested groups, small scale entrepreneurs, trade unions to name a few. At the national level, in addition to the above players, media, lobbyists, international donors, multi-national corporations and similar other players play a key role in decision-making or in influencing the decision-making process. All players other than government and the military are grouped together and referred as the "civil society".

If we talk of the structures across the various units, formal government structures are one of the bases of making and implementing the various decisions. At the national level, informal decision-making structures, such as informal advisors may exist. In urban areas, organized crime syndicates such as the "land mafia" may influence decision-making e.g. take the case of various cases happened in Mumbai and think of the governance structure prevalent there. In some rural areas, local powerful families may influence decision-making.

2.4 THEORETICAL BASIS OF CORPORATE GOVERNANCE

There are four broad theories to explain and elucidate corporate governance. These theories are developed ever since the ‘corporation’ form of organizational set up came into existence. These are:

I. Agency theory
II. Stewardship theory
III. Sociological theory
IV. Resource Dependence theory
V. Managerial and Class Hegemony
VI. Psychological and Organizational Perspective
VII. The Societal perspective: Stakeholder theory
VIII. System theory

These theories are explained as below:

2.4.1 AGENCY THEORY

The concept of agency problems and agency cost has got more relevance in these days in all disciplines of management. The roots of the agency theory can be traced back to Adam Smith, who identified an agency problem in the joint stock company. The theory looks at the corporate governance practices through the agency dilemma. According to this theory, the fundamental basis of corporate governance is agency costs. The theory perceives the governance relationship as a contract between Shareholders (owners of any joint stock company) and the managers (agent). Mangers, being opportunistic, try to maximize their own personal benefits and hence

take only those actions which are advantageous for themselves and detrimental to the interest of shareholders.

By virtue of their ownership, the principals define the objectives of a company and the management (Agents) directly or indirectly selected by shareholders are there to pursue such objectives. While the principals generally assume that the agents would invariably carry out their objectives, it is often not so in all the cases. In many instances, the objectives of managers are at variance from those of the shareholders. Suppose, a chief executive may want to increase his managerial capabilities using the company's funds to finance an unrelated diversification, which could reduce long term shareholder value. The shareholders and other stakeholders of the company may be unaware of decisions because of inadequate disclosure or any. Such mismatch of objectives between the Principals and agents is termed as the agency problem and the cost inflicted by such dissonance is the agency cost.

The core of corporate governance is designing and putting in place a mechanism for disclosures, monitoring, oversight, corrective systems and incentivizing the agents using adequate compensation and other benefits such as employee stock options that can align the objectives of the principals and agents as closely as possible and, hence, minimize agency costs.

Essentially, trust involves an agreement between two parties with asymmetrical access to information as the managers know far more about the enterprise than the shareholders, who must trust them. This is the underpinning concept of the joint stock limited liability company. As it has been have seen, the shareholders trust the directors to be stewards of their funds. The agency theory of corporate governance takes a less sanguine view of directors' behaviour.

According to Jensen and Meckling (1976), "……. ***agency theory involves a contract under which one or more persons (the shareholders) engage another person (the directors) to perform some service on their behalf which includes delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers there is good reason to believe the agent will not always act in the best interests of the principal***."

Further, the same has been argued by Adam Smith in his book titled 'The Wealth of Nations' that "…….***company directors not likely to be as careful with other people's money as with their own***".

These are the following reasons found in the literature about the contractual hazards:

a). Opportunistic Behaviour

b) Moral Hazard

c). Information asymmetry.

d). Adverse selection

Opportunistic behaviour in this regard refers to the situation when agents grab the opportunity in case of having access to such an opportunity for some tangible or intangible benefits. Moral hazard also arises in a principal–agent contract, where agent usually has more information about his or her actions or intentions than the principal does, because the principal usually cannot completely monitor the agent. The agent may have an incentive to act inappropriately (from the viewpoint of the principal) if the interests of the agent and the principal are not aligned. A further agency problem is asymmetrical access to information. Principals (owners) always believe that agents are having access to information and are at information advantage. Mangers know far more about the corporate situation than the shareholders themselves. Indeed, shareholders have to rely on the mangers to decide what information they should have, over and above the minimum required by regulation and company law. Sometimes, because of the adverse selection of the agent, the interest of principal and agent might not align.

Managers may also take a different view to that of their shareholders on the matter of corporate risk. After all, it is not their money they are risking. Of course, successful managers involve taking controlled risks. But mangers might hazard corporate funds on riskier ventures, hostile takeover bid for example, than many of their shareholders would expect or want. Potential investors can only judge the ability of the board level decision makers and their risk profile from the company prospectus, reports, and past performance.

The evidence of such behaviour is not hard to find. There are a number of cases in which directors treat a listed public company as though it was their own property, exploiting their position, receiving unsanctioned benefits, and taking remuneration unrelated to their performance to the shareholders' detriment. Bob Monks (2008), a shareholder activist, pointed

out that trillions of dollars of shareholders' wealth have been wrongly extracted from US corporations over the years by directors abusing their power.

Hence, it is sure that in the modern corporation, in which share ownership is widely scattered, managerial actions depart from those required to maximize shareholder returns. In agency theory terms, there is an agency loss which is the extent to which returns to the owners fall below what they would be if the principals, the owners themselves, exercised direct control of the corporation. This gap between the expectation of the owners and what they actually realize is termed as the agency loss.

Agency theory specifies mechanisms which reduces agency loss. These include incentivizing managers in such a way that reward them financially for maximizing shareholder's interests. Such schemes typically include giving Employee Stock Options (ESOPs) so as to align financial interests of executives with those of shareholders. Other similar mechanism to handle agency problems is to link compensation of mangers and levels of benefits to the shareholders' returns and have part of their compensation deferred to the future to reward long-run value maximization of the corporation and deter short-run executive action which harms corporate value.

Problems with the Agency Theory

Total control of management is neither feasible nor desirable under this theory. The underlying assumption in the trade-off that shareholders do while employing agents is that they must accept a certain level of self-interested behavior (Opportunistic behaviour) in delegating responsibility to others. The objective of agency theory is to check any abuse in this trade-off. Because of it limited success and practicality, its utility as a theoretical model to promote corporate governance has been criticized.

In large organizations specially, shareholders must have access to correct and adequate information to wield effective control. Shareholder activism must be promoted so as to ensure that an orderly house is maintained.

There are two broad mechanisms that help reduce agency costs and hence, improve corporate performance through better governance. These are:

1. Fair and accurate financial disclosures: Appropriate disclosure norms related to financial as well as non-financial disclosures related to the company affairs must be there. Information disclosure may be related to the role of the independent directors, statutory auditors appointed by shareholders to audit a company's accounts so as to true and fair view of the financial health of the corporation. Indeed, the quality and independence of statutory auditors are fundamental to achieve the good governance practices. While the management is supposed to prepare the accounts of the company, it is the responsibility of the statutory auditors to scrutinize such accounts, raise queries and objections, if any, arrive at a true and fair view of the financial position of the company, and report their independent observation and findings to the board of directors.

The first step to achieve corporate excellence through good governance practices is to disclose up to the required standards. Improving the quality of financial and non-financial disclosures not only ensures corporate transparency among stakeholders, but also persuades companies to minimize value-destroying deviant behavior. This is the requirement of law too that insists the companies must prepare their audited annual accounts, and it must be provided to all shareholders and is to be deposited with the Registrar of companies. This is also in global corporate governance reforms, the major efforts are towards improving the quality and frequency of disclosures.

2. Efficient and independent board of directors: A joint-stock company is owned by the shareholders, who appoint directors to oversee management so as to ensure that it does all what is necessary by legal and ethical means to make the business grow and maximize long-term shareholder value. It is of prime importance to note that directors are fiduciaries of the shareholders, not of the management. Hence, they are accountable only to the shareholders. Presence of appropriate number of independent directors has become a critical issue in determining the composition of any board so as to ensure good corporate governance practices across the company.

Criticisms of Agency Theory

Some critics of agency theory cite its relatively narrow theoretical scope. To study the complex nature of corporate governance in terms of contracts between principals and agent, it is naïve

theory. There is big question mark on use of purely quantitative metrics such as board structure or compensation packages as a measure to improve the corporate performance.

Moreover, it has been pointed out by some critics that board behaviour does not consist of sets of contractual relationships, but is influenced by inter personal behaviour, group dynamics, and political intrigue. Such critics believe that the statistical methods will not explain the reality of the boardroom.

To add to it, other contemporary scholarship has observed that not only does increasing-governance conformance and compliance not necessarily add to corporate performance—it can actually detract. The authors challenged the findings of other agency theoretical research and established that boards with well connected, executive directors perform better vis-a-vis those that followed corporate governance codes on the use of independent directors (Muth and Donaldson, 1997).

Other critics have challenged the shareholder/director agency model as simplistic in practice. Where, for example, the ultimate beneficial owner has invested through a pension fund, which invests in a hedge fund, which invests in a private equity company, which places funds in the hands of a financial institution, which invests in the shares of a listed company but lends them as collateral for another transaction, who is agent for whom they ask? That is why; this agency theory cannot be justified in context to today's complex relationships because of various middlemen between investor and its company.

But there is another issue of assumption about the nature of man. The theory assumes that people are self-interested not altruistic. They cannot be expected to look after the interests of others. In other words, directors cannot be trusted. The legal concept of the corporation, and the basis of stewardship theory, as we shall see, takes the opposite view.

In summary, critics of agency theory argue that it has been erected on a single, questionable abstraction that governance involves a contract between two parties, and is based on a dubious hypothetical morality that people maximize their personal utility. Hence, it cannot acts a comprehensive theory to understand the various issues of corporate governance.

2.4.2 STEWARDSHIP THEORY

The stewardship theory of corporate governance discounts the possible conflicts between corporate management and owners and shows a preference for a board of directors (BOD) made up primarily of corporate insiders. This fundamental assumption of the theory is that managers are basically trustworthy and attach significant value to their own personal reputations. The market for managers with strong personal reputations serves as the primary mechanism to control behavior, with more reputable managers being offered higher compensation packages. Financial reporting, disclosure and auditing are still important mechanisms, but there is a fundamental presumption that these mechanisms are needed to confirm managements' inherent trustworthiness.

The nitty-gritty of Stewardship theory can be summarized by following basics:

- The theory assumes managers as stewards who are not motivated by individual goals, but rather their interests are aligned with the objectives of their principals.
- Given a choice between self-serving behavior (Opportunistic) and pro-organizational behavior (Organizational citizenship), a steward's behavior will not depart from the interests of his/her organization.
- Control can be potentially undermines the pro-organizational behavior of the steward by lowering his/her motivation.

This theory takes into account the legal view of corporation and the shareholders of the company nominate and appoint the directors so as to act as stewards for the investors. Ownership is the basis of power over the corporation. Directors have fiduciary duty to act as stewards of the shareholders' interest. Inherent in the concept of the company is the beliefs that directors can be trusted.

Stewardship theory reflects the classical ideas of corporate governance. The directors’ legal duty is towards their shareholders not to themselves, or to other interest groups. The mutual trust is the basis of this theory, and explains that directors do not always act in a way that maximizes their own personal interests: they can and do act responsibly with independence and integrity.

Stewardship exponents recognize that directors need to recognize the interests of various stakeholders like customers, employees, suppliers, and other legitimate stakeholders, but under

the law their first responsibility is towards the shareholders. They argue that conflicts of interest between stakeholder groups and the company should be met by competitive pressures in free markets, backed by legislation and legal controls to protect customers (monopoly and competition law), employees (employment law, health and safety law), consumers (product safety law, consumer protection law), suppliers (contract law, credit payment law) and society (environmental law, health and safety law, taxation law).

The underpinning disciplines in stewardship theory are legal and organizational studies. By reflecting the legal model, stewardship theory provides precise boundaries for the company, clearly identifying its assets and liabilities, its shareholders, and its directors.

This emphasis on the responsibility of the board to shareholders in the Anglo-Saxon model of corporate governance in terms of stewardship and trusteeship is nowhere better articulated than in the Canadian guidelines. It is stated therein: "Stewardship refers to the responsibility of the board to oversee the conduct of the business and to supervise management which is responsible for the day-to-day conduct of the business. In addition, as stewards of the business, the directors function to oversee so as to ensure no issue affecting the business and affairs of the company.

The greatest barrier, however, to the adoption of stewardship mechanisms of governance lies in the risk propensity of principals. Risk taking owners will assume that executives are pro-organization and favour stewardship governance mechanisms. Whereas executives, investors cannot afford to extend board power, agency costs are effective insurance against the self-interest behaviors of agents.

Of course, these concepts of stewardship and trusteeship are not new. If we refer to the scriptures of India, Gandhiji elaborated the concept trusteeship to make Indian industrialists better understand and appreciate their roles and responsibilities towards their employees.

Various researchers have proposed that the owners-managers relationship depends on the behavior adopted respectively by them. Managers choose to act as agents or as stewards according to certain personal characteristics and their own perceptions of particular situational factors. Principals choose to create a relationship of one type or the other depending on their perceptions of the same situational factors and of their managers' psychological mechanisms. The following tables set out these variables and the differences between the two theories.

THEORY	AGENCY	STEWARDSHIP
MANAGERS AS	Agents	Stewards
APPROACH TO GOVERNANCE	Economic	Sociological and psychological
MODEL OF MAN BEHAVIOR	Individualistic Opportunistic Self-serving	Collectivistic Pro-organizational Trustworthy
MANAGERS MOTIVATED BY	Their own objectives	Principal's objectives
MANAGER'S AND PRINCIPAL'S INTERESTS	Diverge	Converge
STRUCTURES THAT	Monitor and control	Facilitate and empower
OWNERS' ATTITUDE	Risk aversion	Risk propensity
PRINCIPAL-MANAGER RELATIONSHIP BASED ON	Control	Trust

Figure-2.1 (Behavioural Differences between Agency and Stewardship Theory)

It has been propounded that state that the owners-managers relationship depends on the behavior adopted respectively by them. Managers choose to act as agent or as steward according to certain personal characteristics and their own perceptions of particular situational factors. Principals choose to create a relationship of one type or the other depending on their perceptions of the same situational factors and of their managers' psychological mechanisms. The following tables set out these variables and the differences between the two theories (Davis, Schoorman and Donaldson, 1997)

PSYCHOLOGICAL MECHANISMS	AGENCY THEORY	STEWARDSHIP THEORY
MOTIVATION	Lower order needs Extrinsic needs	Higher order needs Intrinsic needs
SOCIAL COMPARISON	Other managers	Principal
IDENTIFICATION	Little value commitment	Great value commitment
POWER	Institutional	Personal

Figure-2.2 (Differences of Psychological Mechanisms between Agency and Stewardship Theory)

SITUATIONAL MECHANISMS	AGENCY THEORY	STEWARDSHIP THEORY
MANAGEMENT PHILOSOPHY	Control oriented	Involvement oriented
How to deal with increasing uncertainty and risk	Greater controls, more supervision	Training and empowering people. Redesigning jobs to be more challenging and motivating
Risk orientation	Control mechanisms	Trust
Time frame	Short term	Long term
Objective	Cost control	Performance enhancement
CULTURAL DIFFERENCES	Individualism Large power distance	Collectivism Small power distance

Figure-2.3 (Differences of Situational Mechanisms between Agency and Stewardship Theory)

MANAGER'S CHOICE	PRINCIPAL'S CHOICE	
	AGENT	STEWARD
AGENT	Mutual agency relationship Minimize potential costs	Agent acts opportunistically Principal feels angry and betrayed
STEWARD	Principal acts opportunistically Manager feels frustrated and betrayed	Mutual stewardship relationship Maximize potential performance

Figure-2.4 (Summary of the difference between Agency and Stewardship Theory)

Shareholder versus Stakeholder Approaches

While studying theories of corporate governance, it is common to distinguish between shareholder and stakeholder approaches. Shareholder approaches argue that corporations have a limited set of responsibilities, which primarily consist of obeying the law and maximizing shareholder wealth. The basic argument is that corporations, by focusing on shareholder interests maximize societal utility. The logic of this position goes back to the ability of the shareholder model to maximize utility, however, is tenuous in that it is based on the assumption of perfect competition. To the extent that the conditions of perfect competition are not in place, the

argument falters. More specifically, as deviations from the conditions of perfect competition increase (e.g. imperfect markets, incomplete contracts, information asymmetries), after a certain point, corporations will not be maximizing societal utility by merely pursuing shareholder interests. The shareholder approach is logically most compatible with the Anglo-American model of corporate governance. In contrast to shareholder approaches, stakeholder models of corporate governance argue that those responsible for the governance of the corporation have responsibilities to parties other than shareholders and that, any fiduciary obligations owed to shareholders to maximize profits might be subject to the constraint of respecting obligations owed to such stakeholders.

Criticisms of Stewardship Theory

Critics of this theory say that de facto situation in modern corporation is quite different from the 19th century model. They argue theory that the concept of a set of shareholders owning a single company and appointing its directors is naïve in modern circumstances. They argue that have in listed companies; shareholders have become remote form the company and do not nominate the directors. Financial reports are complicated to such an extent that they make sense only to experts. Complex corporations lack transparency and their directors are not really accountable to shareholders.

Other critics have highlighted that stewardship theory is normative as the theory is rooted in law, and is unable to show causal relationships between specific behaviours and corporate performance.

Critics of this approach point out that institutional investors such as pension funds are run by trustees whose accountability is not always apparent and seldom challenged, whose interests do not align with those of fund beneficiaries, and who may use investment funds to protect themselves from claims for negligence.

2.4.3 SOCIOLOGICAL THEORY

The sociological approach to the study of corporate governance has focused mostly on board composition and the implications for power and wealth distribution in society. Problems of interlocking directorships and the concentration of directorships in the hands of a privileged class

are viewed as major challenges to equity and social progress. Under this theory, board composition, financial reporting, disclosure and auditing are necessary mechanisms to promote equity and fairness in society.

2.4.4 RESOURCE DEPENDENCY THEORY

Resource dependency theory takes a strategic view of corporate governance. It sees the governing body of a corporate entity as the lynch pin between a company and the resources it needs to achieve its objectives. These resources could include, for example, links to relevant markets including potential customers and competitors, access to capital and other sources of finance, provision of know-how and technology, and relationships with business, political, and other societal networks and elites.

The directors are viewed as boundary-spanning nodes of networks able to connect the business to its strategic environment. Studies from this perspective focus on the interdependence of companies in a market and can serve to reduce uncertainty in corporate decisions. The theory finds its roots in organization theories. The theory of social networks recognizes that those involved in corporate governance processes are often linked through networks. Individuals at the nodes may have things in common including, perhaps, social standing, class, income, education, institutional or corporate links to name a few. Some individuals in the networks, such as the chairman or CEO, may be pivotal nodes in a number of networks, increasing their communication leverage. Such social networks can enhance or adversely interfere with independent and objective governance activities. Identifying such networks and monitoring their activities provides another insight into governance processes and powers.

2.4.5 MANAGERIAL AND CLASS HEGEMONY

This perspective on the governance of companies focuses on the view that directors have of themselves and its impact on their behaviour and corporate governance implications. Directors in some companies perceive themselves as an elite group. This self-perception encourages them to behave in elite way, dominating both the company and its external linkages. Managers and directors are appointed only if they sustain the dominance of the ruling group.

Class hegemony recognizes that directors' self-image can affect the board behaviour and performance. Further executive directors, with their own self-image bolstered by access to information, knowledge of ongoing operations, and decision making power, may dominate board decisions.

The theory is rooted in the socio-political disciples, but have used case research, allied with biographical analysis, to produce some penetrating insights into corporate governance. Es but Critics of the case approach to the study of corporate governance complain that the evidence is statistically irrelevant, largely anecdotal, and can be influenced by all sorts of personal prejudice, self-centred reporting, and biased insights. The counter-argument is that corporate governance involves a political process, with human beings expressing themselves—more art than a statistically controlled group activity.

2.4.6 PSYCOLOGICAL AND ORGANIZATIONAL PERSPCTIVES

Both agency and stewardship theories, view corporate governance at the Agent the firm, being concerned with relationships between owners and directors. Agency theory focuses on the shareholder/director relationship; stewardship theory focus on companies, their shareholders, external auditors, boards of directors. Resource dependency and class/managerial hegemony theories take a firm level focus.

Individual players, with their different mindsets, personalities do not appear in these theoretical paradigms. But practitioners recognize that knowing what goes on in the boardroom and during interactions between directors is vital to understanding Corporate Governance.

Corporate governance research from a psychological perspective seeks to understand how individual directors perceive their board level work and what they believe leads to effective performance. Although, not much research has been done in corporate governance from this perspective, Cognitive maps, produced by repertory grid techniques, can be used to chart directors' mindsets. Studies of cognition, perception, and thought processes can enable personal constructs and frames of reference to be identified. Core perceptual dimensions can be traced to find out how directors construe their board level activities. Deep-seated values that influence perceptions and affect decisions can be explored. Constructs of language, using the language of the director not words imposed by the re-searcher, can help to describe and interpret board level

experiences. If words such as involvement, leadership, participation, reputation, or teamwork, are used by the director, or moral values such as trust, harmony, and ethical standards mentioned, then these become the frame of reference for the researcher. In other words, attributes and roles identified by directors are used to understand their work and understand what they believe makes for an effective board.

Psychological theories have yet to make a significant impact in understanding ably be Organization theories have also been relatively slow to focus on issues at hoard level.

2.4.7 THE SOCIETAL PERSPECTIVE: STAKEHOLDER THEORY

Lastly, we turn to perspectives on corporate governance at a societal level, so-called stake-holder theory. This is concerned with values and beliefs about the appropriate relationships between the individual, the enterprise, and the state. It involves a discourse on the balance of responsibility, accountability, and power throughout society.

Consequently, this societal view of corporate governance is probably better thought of as a philosophy rather than a theory. Companies, stakeholder advocates argue, should recognize a responsibility to all those affected by companies' decisions, including customers, employees, and managers, partners in the supply chain, bankers, shareholders, the local community, broader societal interests for the environment and the state. Companies owe a duty to all those affected by their behaviour, they argue. Some advocates go further and call for directors to be accountable and responsible to a wide range of stakeholders far beyond companies' current company law responsibility to shareholders. Such responsible behaviour, the stakeholder advocates argue, should be the price society demands from companies for the privilege of incorporation, granting shareholders limited liability for the company's debts.

The stakeholder theory of corporate governance has a lengthy history that dates back to 1930s. The theory represents a synthesis of economics, behavioral science, business ethics and the stakeholder concept. The history and the range of disciplines that the theory draws upon have led to large and diverse literature on stakeholders. In essence, the theory considers the firm as an input-output model by explicitly adding all interest groups—employees, customers, dealers, government and the society at large—to the corporate mix.

The theory is grounded in many normative theoretical perspectives including the ethics of care, the ethics of fiduciary relationships, social contract thee theory of property rights, theory of the stakeholders as investors, critical theory etc.

Insofar as stakeholder approaches uphold responsibilities to non-shareholder groups, they tend to be in some tension with the Anglo-American model of corporate governance, which generally emphasizes the primacy of "fiduciary obligations" owed to shareholders over any stakeholder claims.

Criticisms of the Stakeholder Theory

The major problem with the Stakeholder Theory stems from the difficulty of defining the concept. Who really constitutes a genuine stakeholder? Some writers have suggested that any one negatively affected by corporate actions might reasonably be included as stakeholder, and across the world this might include political prisoners, abused children, minorities and the homeless. However, a more seriously conceived and yet contested list of stakeholders would generally include employees, customers, suppliers, the government, the community, assorted activist or pressure groups, and of course, shareholders.

2.4.8 SYSTEM THEORY

The two dominant contenders for theory i.e. agency and stewardship theories, are properly based on bounded models of reality-agency theory on an economic perspective and stewardship theory on a legal one. Inevitably each perspective is limited. Each theory sees the world through a different lens.

Some theories focus on the shareholders and the board as a whole with its standing-committees, perhaps including the external auditors; other theories focus on individual directors on the board and the interactions between them; yet other theories take the perspective of the stock markets, investors, and regulators; while at the highest level the political situation, the economic impact, and the cultural context come into view, along with legislatures, states, and international agencies. As yet there is not a single theory which takes into account the whole list of key players, their actions and relationships.

System theory takes a similar approach to understand situations. All phenomena can be perceived and classified as a hierarchy of systems. The classical criteria of systems use three criteria to identify a system as follows:

• The system's boundaries that is determining what is to be considered as within the system itself and what in the system's environment. Systems are man-made artefacts to help understand a situation.

• The system's level of abstraction, that is the level at which the system is perceived and the amount of detail treated within it

• The system's function that is what occurs between the system's inputs and outputs

So what are the boundaries of corporate governance? What should be in the system, what should be its boundaries? This is what the researcher must focus to explore.

ACTIVITY 1

Dear learners, the objective of the exercise is to make learning an effective exercise.

On the basis of above given theories, do a comparative analysis of these. Which theory you think is the best fit theories for the current corporate governance practices in Indian Corporate Sector?

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2.5 SUMMARY

There are various theories which are explained in this lesson. Each theory is having criticism by number of researchers. The main theories like agency, stewardship, and stakeholder are fundamental to the concept of corporate governance. Other theories like resource dependency theory, system theories are evolved with time and there has been not much research that has been done on these theories. Hence, there is need to have research on these theories so as to validate these for the current practices of corporate governance.

2.6 SELF –ASSESSMENT EXERCISE

Fill in the blanks for the following statements:

a). ……..is the process of decision-making and the process by which decisions are implemented across the unit in the context of which the governance has been talked of.

b). …….theory involves a contract under which one or more persons (the shareholders) engage another person (the directors) to perform some service on their behalf which includes delegating some decision making authority to the agent.

c). This fundamental assumption of the stewardship theory is that managers are basically ……and attach significant value to their own personal reputations.

d). The sociological approach to the study of corporate governance has focused mostly on ……and the implications for power and wealth distribution in society.

e). System theory assumes that all phenomena can be perceived and classified as a hierarchy of…….

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2.8 SUGGESTED READINGS

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2.9 ANSWERS TO SELF –ASSESSMENT EXERCISE

These are the answers for the self-assessment exercise as follows:

a). Governance

b). Agency

c). Trustworthy

d). Board composition

e). Systems

2.10 MODEL QUESTIONS

Q1). What is agency theory? How it is related to corporate governance? Describe.

Q2). Differentiate 'Stewardship Theory' from 'Agency Theory'.

Q3). Differentiate 'Shareholder approaches theories' from 'Stakeholder approaches theories'.

Q4). Describe 'Resource Dependency theory' in detail.

Q5). What are the critics of 'stewardship theory'? Elaborate

Q6). Describe system theory of corporate governance.

LESSON-3

CORPORATE GOVERNANCE IN INDIA

STRUCTURE OUTLINE

3.1 Objectives

3.2 Introduction

3.3 The emergence of Corporate Governance in India

3.4 Pioneers in Good Corporate Practices

3.4.1 Government Initiatives

3.4.2 Industry Initiatives
3.4.3 Corporate Initiatives
3.4.4 Individual Initiatives
3.4.5 Best Practices
3.5 Need for Accounting Standards
3.6 Future of Corporate Governance in India.
Activity 1
3.7 Summary
3.8 Self –Assessment Exercise
3.9 Bibliography
3.10 Suggested Readings
3.11 Answers to Self –Assessment Exercise
3.12 Model Questions

3.1 OBJECTIVES

After reading the lesson/unit, the learner will be able to:

- Understand the emergence of Corporate Governance in India
- Discuss the pioneers in good governance
- Describe the need for Accounting Standards
- Discuss the future of Corporate Governance in India.

3.2 INTRODUCTION

In India, Corporate governance has matured well and today we have the privilege of the New York Stock Exchange citing Infosys Technologies, an Indian company, as a role model regarding disclosure of information to shareholders. Good corporate governance practices affect the business performance positively. The answers to the boiling question that why we need corporate governance in India, the answer lies here is that it is essential for attracting foreign capital. Being developing country and not in a condition of self-reliant to a large extent, we need foreign capital to develop, sustain and grow.

It is well recognized concept and the importance of this concept has been well recognized all across the world over. The roots of Indian working ethos lie in values. India has never judged an

individual's esteem according to his wealth and power, but has always valued his virtue, learning and character. If we talk of the Indian scriptures, even Kautilya's Arthashastra holds opinion on corporate governance, wherein he states:

"Only if a king himself is energetically active, do his officers follow him energetically. If he is sluggish, they too remain sluggish. And besides, they eat up his works. His enemies thereby easily overpower him. Therefore, he should dedicate himself energetically to activity. The vow of the king is energetic activity; his sacrifice constituted of the discharge of his own administrative duties; his sacrificial fee (to the officiating priest) is his impartiality of attitude towards all; and his sacrificial consecration is his anointment as king". (Arthashastra 8.2)

It is a well established fact that the Indians used to believe in high moral and societal standards. ***In modem times Mahatma Gandhi gave the principle of 'Trusteeship'*** *which* is the ideal of corporate governance**.** Gandhi said that an entrepreneur is a trustee of the organization and of its employees and he should look after the organization and its employees as their trustees.

In the present scenario, if we talk of governance practices in India, there has been a big question mark on us being the citizens of our country. To start with, scams like Satyam, 2G Scam, Saradha financial scams shook the investors' confidence. Hence, there is pertinent need to have adequate standards on corporate governance practices. Also, the option of share buyback, big remunerations and perks enjoyed by top management, instances where most of the businesses where the Chairman and Managing Director is the same person, and in cases where the son becomes the CEO, there is an urgent need of ethical Corporate Governance to protect the rights and safeguard the interest of small shareholders and other stakeholders.

In purview of this situation, the government and the industry must need to be more accountable. Time and again, various rules and regulations are framed so as to build investors' confidence in Indian market. Various committees by the SEBI have been framed so as to make necessary changes in the system to protect investors' rights. Corporate governance initiatives in India began in 1998 with the Desirable Code of Corporate Governance (a voluntary code published by the CII), and the first formal, regulatory framework for listed companies specifically for corporate governance established by the SEBI. These rules and regulations has been revised time

and again as recent change has been done in various provisions of corporate governance through Companies Act, 2013.

Why is Corporate Governance Important?

Corporate governance is important for a society due to these following reasons as given below:

(i) It lays down the framework for creating long-term trust between companies and the external providers of capital.

(ii) It improves strategic thinking at the top by inducting independent directors who bring in a wealth of experience and a host of new ideas.

(iii) It rationalizes the management and monitoring of risks a firm faces globally.

(iv) It limits the liability of the top management and directors by carefully articulating the decision making process.

(v) It ensures the integrity of financial reports.

(vi) It helps to provide a degree of confidence that is necessary for the proper funding of a market economy.

The Need for Corporate Governance in India

If corporate governance has to take root in a country, basically, it will depend on the economic and business environment that has been created by public governance in the country. There cannot be good corporate governance if public governance is weak. The dramatic collapse of corporations like Enron has highlighted the reality of how companies, which were very prominent in the stock market and held up as models for vigorous and innovative growth, can ultimately fall like a pack of cards when fraud and dishonesty became their operational guide. Various critics raised a doubt about the credibility of even highly regarded global players. In the Indian context, the need corporate governance has been highlighted because of the series of scams that had become an annual feature ever since the government liberalized the economy in 1991. Since then, there had been the Harshad Mehta scam, Ketan Parikh scam, the UTI scam, Satyam and so on. In the Indian corporate scene, it is the important point to remember that unless

we induct global governance standards, the scope for scams may rise in the years to come. To reduce it to the minimum, there is an urgent need to improve corporate governance practices in the country.

There is no denial to the fact that the legal and administrative environment in India is providing greater scope for companies like Satyam to abuse the existing system. For more than five decades since independence, lack of transparency and financial disclosures, corruption and mismanagement have been accepted as a way of life and taken in a stride in an insulated, license ridden and non-competitive economic environment. As a result, unless a management is committed to be honest and observes the principles of propriety, the atmosphere is too tempting not to observe good corporate governance in practice. We should approach the issue of corporate governance in India not merely from the point of view of the Companies Act or the SEBI guidelines or the codes evolved out of recommendations of committees such as the Kumar Mangalam Birla Committee or Rahul Bajaj Committee, but look at the entire network of various rules and regulations impinging on business so that there is an integrated holistic system, created for ensuring that transparency and good corporate governance prevail.

3.3 THE EMERGENCE OF CORPORATE GOVERNANCE ISSUES IN INDIA

The Stock Exchange of London appointed, as discussed earlier, the famous Cadbury Committee which submitted its report in 1992 that included the "Code of Best Practices" to be practised by listed companies. Sir Cadbury Report was implemented by the London Stock Exchange as part of its Listing Agreement with its member companies. The Cadbury Report is generally considered to be the foundation stone of corporate governance.

In India, the real history of corporate governance dates back to the year 1992, following efforts made in number of countries all across the world to put in place a system suggested by the Cadbury Committee. The Confederation of Indian Industry framed a voluntary code of corporate governance for listed companies in 1998. This was followed by the recommendations of the Kumar Mangalam Birla set up in 1999 by SEBI culminating in the introduction of Clause 49 of the standard Listing Agreement to be complied with all the listed companies in stipulated phases. The Kumar Mangalam Birla Committee divided its recommendations into mandatory and non-mandatory. Mandatory recommendations included such issues as the composition of the board,

appointment and structures of audit committees, remuneration of directors, board procedures, additional information regarding management, discussion and analysis as a part of the annual report, disclosure of directors' interest, shareholders' rights and the compliance level of corporate governance in the annual report. Its non-mandatory recommendations included issues concerning the chairman of the board, setting up of remuneration committee, half yearly information to the shareholders, use of postal ballots for certain key decisions, appointment of nominee directors and obligations of institutional shareholders. As it has been pointed out above that, with time, it is evolving and various revisions have been made time and again so as to ensure good governance practices.

3.4 PIONEERS IN GOOD GOVERNANCE PRACTICES

Various initiatives to ensure good governance are categorized into government, industry, corporate and individual basis described as follows:

3.4.1 GOVERNMENT INITIATIVES

There are other initiatives at the Government level which helped in fostering corporate excellence as follows:

Initiatives of the Department of Company Affairs: In May 2000, the Department of Company Affairs invited a group of leading industrialists, professionals and academics to recommend measures to enhance corporate excellence in India. This Study group in turn set up a Task Force under the chairmanship of Dr. P. L. Sanjeev Reddy, which examined the subject of "Corporate Excellence Through Sound Corporate Governance, and submitted its report in November 2000. The Task Force in its recommendations identified two classifications, namely, essential and desirable, with the former to be introduced immediately by legislation and the latter to be left to the discretion of companies and their shareholders. Some of the recommendations of the Task Force include the following:

- Greater role and influence for non-executive, independent directors.
- Stringent punishment for executive directors for failing to comply with listing and other necessary requirements.
- Limitation on the nature and number of directorship of managing and full-time directors.

- Proper disclosure to the shareholders and investing community.
- Interested shareholders to abstain from voting on specified matters
- More meaningful and transparent accounting and reporting standards and practices.
- Tougher listing and compliance requirements through a centralized national listing authority.
- Highest and toughest standards of corporate governance for listed companies
- A code of public behaviour for public sector units.

Setting up of Centre for Corporate Excellence: The setting up of 'Centre for Corporate Excellence' is another feather in the cap of the Department of Company Affairs. The 'Centre for Corporate Excellence' has been established as an independent and autonomous body as recommended by the study group. The centre would undertake research or corporate governance; provide a mechanism to companies so as to rate themselves in terms of their corporate governance performance; promote corporate governance through certifying companies who practise acceptable standards of corporate governance and by instituting annual awards for outstanding performance in the same area. Government's initiative in promoting corporate excellence in the country by setting up such a centre is indeed a very important step in the right direction. It is likely to spread greater awareness among the corporate sector regarding matters relating to good corporate governance, motivating them to seek accreditation from this body. Cumulative effect of the companies achieving levels of corporate excellence would undoubtedly be visible in the form of much enhanced competitive strength of our country in the global market for goods and services.

National Award for Excellence in Corporate Governance : The national award for excellence in corporate governance, instituted in 1999 by the Ministry of Finance under the aegis of the Department of Company Affairs is sponsored by Unit Trust of India. For the very first year, the award was presented to Infosys Company. A panel chaired by Justice P. N. Bhagwati and comprising eminent persons unanimously selected Infosys Company for the award for the year 1999. Infosys was named as an ethical organization with fairness, honesty, transparency, and courtesy in place for all its constituents and society at large.

For the year 2000, a panel chaired by Justice M. N. Venkatachaliah and comprising eminent persons bestowed The Tata Iron and Steel Limited (TISCO) with this award. This prestigious award was given to the company's management for showing fairness, honesty, transparency and courtesy to all stakeholders and for its deep concern for the environment, pioneering social audit, taking good care of its employees and for driving change within the company in terms of knowledge management systems.

Establishment of the National Foundation of Corporate Governance: In September 2003, The Indian government has taken a step forward in setting up the National Foundation for Corporate Governance (NFCG) with an objective to provide a platform to deliberate on issues relating to good corporate governance as key to sustainable wealth creation. The Union Cabinet had given its consent for setting up NFCG as a Trust. The Foundation has since been registered as a trust with the objective to promote good corporate governance practices in India. The trust is having a three-tier body comprising a governing council, a board of trustees and an Executive directorate. It will work in synergy with the Investor Protection and Education Fund (IE&PF), a corpus used for investor awareness programmes on issues such as capacity building. Promoting investor associations will be a common activity between the two bodies. Another task entrusted to NFCG is to provide research and training in the field of corporate governance. It also caters to the financial or any other assistance for activities aimed at promoting corporate governance, including research and training. Besides, the US-based Global Corporate Governance Forum will also be supporting the India-centric activities taken up by various agencies.

Establishment of the Serious Fraud Office: Department of Company Affairs has set up a Serious Fraud Office (SFO) so as to crack down on company fraud with an objective to improve corporate governance. The SFO investigates economic crimes such as bribery by companies to win lucrative deals. The SFO has the powers to prosecute the violating companies.

3.4.2 INDUSTRY INITIATIVES

Changing with the times, industry associations have taken the initiative to come up with guidelines for their member companies on the issues of governance. A formal effort was initiated by the Confederation of Indian Industry when it produced in 1998, a document titled "Corporate Governance—A Desirable Code" through a Task Force headed by Rahul Bajaj, which for the

first time formally recognized the obligation of listed corporations to create corporate wealth and distribute it among all their stakeholders. The need for transparency in reporting and the imperatives of having independent non-executive directors who could protect the interests of shareholders were initiated. A similar initiative was mounted by SEBI with the constitution of a committee under the chairmanship of Kumar Mangalam Birla. Its report recommending guidelines on corporate governance published in February 2000 is a detailed set of good practices so as to help corporate in moving towards good governance- practices. These recommendations that have been categorized as mandatory, have since been incorporated in the listing agreements of the stock exchanges and hence, for all of the company who are listed with stock exchange in India, it is mandatory to follow clasue-49 on the issues of corporate governance. To this extent, this initiative may be termed part-regulatory, part-voluntary.

As a service to the corporate sector, the CII is putting together a roaster of independent directors from which companies can choose their non-executives directors while constituting their boards. The CII will provide the necessary guidelines to choose good directors, screen them, and continue to monitor and rate them. This will help companies overcome the difficulties they face in identifying professionally competent and ethically sound non-executive directors.

The existing diversity and complexity in corporate governance will continue evolving and, very probably, improve with time. Further, the revisions/changes in governance regulations will be needed to improve the effectiveness of governance, to influence the healthy development of corporate regulation, and to understand the reality of the political processes by which companies are governed, rather than the structures and mechanisms through which governance is exercised. In any development, it will be important to avoid the polarities of governance based on vested interests of political system, and to develop towards convergence of corporate governance all across the world.

3.4.3 CORPORATE INITIATIVES

Several studies have confirmed that the movement to introduce corporate governance practices in the country has achieved commendable progress. In fact, the country has been successful in putting a system and structure of corporate governance in place that has been considered as one of the best among all developing countries. Unlike several other emerging markets, Indian

companies maintain their shareholding patterns, making it possible to identify the ownership affiliation of each firm easily. "It is by and large a hybrid of the 'outsiders' systems' and "insiders systems' of corporate governance."

The legal framework for all corporate activities including governance and administration of companies, disclosures, shareholders' rights, dividend announcements has been in place since the enactment of the Companies Act in 1956 and has been fairly stable. ***The listing agreements of stock exchanges have also been prescribing on-going conditions and continuous obligations to companies.***

India has a robust regulatory framework for more than four decades, which forms the foundation of the corporate governance system in India. Numerous initiatives have been taken by Securities and Exchange Board of India (SEBI) to enhance corporate governance practice, in fulfillment of the objectives: Investor protection and market development like streamlining of the disclosure, Investors' protection guidelines, book building, entry norms, listing agreement and preferential allotment disclosures to name a few. According to Khanna & Palepu, 2000, "Accounting system in India is well-established and accounting standards are similar to those followed in most of the advanced economies". According to a survey on corporate excellence carried out by Credit Lyonnais, three Indian companies—Infosys, Hindustan Lever Limited and Wipro are found amongst Asia's top ten corporations in terms of good governance practices. Likewise, ICICI, , HDFC, Ranbaxy, Dr. Reddy's Lab and Tata also share this honour and marking the best practices in corporate governance. Take the example of The Birla Group; company has already adopted good governance provisions, and Non-executive directors now dominate the group's company boards, and they have constituted nomination, remuneration and audit committees.

3.4.4 INDIVIDUAL INITIATIVES

There were some, outstanding, initiatives in India from individual personalities even before the concept of corporate governance gained importance. The one tycoon named as 'J. R. D. Tata', the time he took over the reins of the group till his death, ran the Tata Industrial Empire in a very professional way, unlike other family-run businesses. Under his guidance, the Tata Group produced some outstanding CEOs. His belief in keeping business and politics separate did give the group a great deal of credibility and brought him various laurels. He ensured that the Tata's

companies followed corporate governance practices in all its forms, both in the letter and spirit. Tata had always been to achieve corporate excellence by focusing on the dimensions of ethics, integrity and disclosure.

Keshub Mahindra is another industrialist who like J. R. D. Tata runs his empire professionally. He kept his near and dear out of the boardroom. He has ensured that it is Mahindra & Mahindra that is projected and not personalities. He has ensured that the business is separate from politics. He had created a code of corporate governance for the company.

N. R. Narayanamurthy is the name of business tycoon and undisputed king of the new economy. He shook the corporate world by giving his employees a stock option scheme (ESOPS) that saw many corporate taking a leaf out of Infosys' book. Even before corporate governance became the buzzword, Infosys showed the way by giving detailed information and guidance reports in its annual report. This is not the end of the story, to add to it, the SEC has been asking US companies to use the Infosys Annual Report as a model. The company has been maintaining the high standards of governance, and is able to get award for being the best-run company, best for maintaining investor relations, best employer and so on. The ultimate tribute to Murthy was the government of India bestowing on Infosys the National Award for Excellence in Corporate Governance.

Kumar Mangalam Birla who inherited a huge industrial empire challenged the conventional practices within the group companies when he took over in 1995. He has changed the culture of the group from being mainly a family-run enterprise of old-timers to one with professional ethos. His group companies have been making extensive disclosures. Impressed by this young Birla's initiative, the regulatory body, SEBI appointed him on a committee which is now known as the Kumar Mangalam Birla Committee on corporate governance to draft a code for corporate governance in India.

Similarly, there are number of other individuals who are pioneers in good governance practices.

3.4.5 BEST PRACTICES

The DCA has undertaken an ambitious programme to completely overhaul its services to the corporate sector by providing all necessary services on the Internet. This is being undertaken

with a view to reducing the time and resources spent by corporates. The offices of the Registrar of companies (ROC) curb malpractices that arise out of the situation and also tap the immense amount of economic data received through filing in ROC offices and through the cost audit branches in the DCA.

As mentioned earlier, Naresh Chandra Committee was set up to look into issues relating to auditor-company relationship such as rotation of auditors/ auditing partners, restrictions on non-audit work /fees, procedures for appointment of auditors, determination of audit fees, the role of independent directors and disciplinary procedures for accountants. The recommendations of the committee are expected to help improve the credibility of company accounts and the integrity of audit work. They would also help in strengthening the disciplinary mechanism against the malpractices in company's accounts.

3.5 NEED FOR ACCOUNTING STANDARDS

To improve the corporate governance in India, there is pertinent need to introduce internationally acceptable accounting standards like International Financial Reporting Standards (IFRS) so as to bring uniformity across the globe. There are some gaps in accounting standards, which need to be closed or narrowed down for greater transparency. One of the first and foremost demands of good corporate governance is to let investors know how their money has been used to further the interests of the company they have invested in. The question that assumes importance in this context is, how effectively the resources of the company are utilized to strengthen the organization. The only available source of information regarding the affairs of a company is its balance sheet. But, for many companies, the balance sheet had remained the most abused statement. What the company is disclosing may be significant, but what is hidden is vital. The common methods by which companies hide their wrongful practices, which are all too well known, are to use legal terminology and accounting parlance, non-disclosure and selective adoption of only those policies that are mandatory in nature. It is only a handful of qualified persons, primarily the chartered accountants and the other knowledgeable people, who can get to the real picture behind the scenes and disclose the actual from the portrayed picture. It is in this context that the adoption of the US Generally Accepted Accounting Principles (GAAP) and IFRS, which provides for rigorous accounting standards and disclosures, assumes relevance.

The Institute of Chartered Accountants of India has tried to cope with the issues like accounting standards regarding segmental reporting, related party transactions and a consolidated financial statement for the entire group to name a few. Companies Act, 2013 has made mandatory provisions for corporate social responsibilities for almost all the listed companies. Also, deferred tax payments have been made mandatory to be reflected the current financial statements.

As a result of the overall changes made by SEBI, the Department of Company Affairs and industry-based voluntary codes, Indian accounting and financial reporting standards are now at par with International standards, although the still significantly lag behind the generally accepted US accounting principle. There is need to bring more transparency and disclosure into the accounting practices in India. Issues like risk management practices adopted by companies are to be brought to the company's books.

With most organizations moving at an extremely fast pace to be recognized as responsible corporate citizens, those who do not will witness an erosion of their reputations with corporate governance standards continuously evolving, auditors all over the world are still unclear on what exactly they have to report. This is a great challenge since operating processes and internal audit functions have to be redefined to ensure compliance.

3.6 THE FUTURE OF CORPORATE GOVERNANCE IN INDIA

Although India has a long way to go to be ranked among the best in the world in corporate governance, the driver is exactly right. Most of companies have realized that their companies need financial and human capital in order to beat the international competition. They also understand that such capital will not be available in a non-transparent corporate regime as with evolution, very stringent international quality standards for disclosures and accountability are put up at place. It is precisely this realization which is driving the corporate governance movement in India and which, has greater chances of delivering substance rather than ticking mandated governance checklists.

It is important to note that there are still some lacunae in different aspects of corporate governance. These are as follows:

• India still has poor bankruptcy laws and procedures (legal and procedural barriers to good corporate governance).

• Indian accounting standards still lack in standards vis-à-vis International Accounting standards.

• Indian stock markets are still inefficiently run, and do have adequate depth or width to give shareholders greater comfort.

• Indian bond market is in its infancy. Pension funds need to invest much more in equity, and play an activist role.

Even so, it is necessary to recognize that corporate India has gone a long way in the business of governance.

Impetus for the Growth of Corporate Governance in India

Although corporate governance has been slow in making its mark in India, the next few years will see a flurry of activity. This will be driven by several factors:

1. **Competition-driven:** Most important is the force of competition. With the dismantling of licenses and controls, reduction of import tariffs and quotas, virtual elimination of public sector reservations, and a much more liberalized regime for foreign direct and portfolio investments, Indian companies have faced more competition in the second half of the 1990s than they did since independence. Competition has forced companies to drastically restructure their ways of doing business.

2. **Professionalism:** Many companies and business groups that were on the top of the pecking order in 1991 have been relegated to the bottom. Simultaneously, new aggressive companies have clawed their way to the top. Therefore, they are more than willing to have professional boards and voluntarily follow disclosure standards that measure up to the best in the world.

3. **Growth in market capitalization:** There has been a phenomenal growth in market capitalization. This growth has triggered a fundamental change in mindset from doing only necessary and mandatory requirements to the higher level of benchmarks.

4. **Shareholder's activism of foreign portfolio investors:** One cannot exaggerate the impact of well-focused, well-researched foreign portfolio investors. These investors have steadily the raised their demands for better corporate governance, more transparency and greater disclosure. Over the last few years, they have systematically increased their exposure in well-governed firms at the expense of poorly run ones. The loopholes in the books of Satyam Company were triggered and inquired by foreign institutional investors. ***Hence, activism of shareholders can force the market to work in a disciplined manner.***

5. **Media Influences:** India has a strong media having a strong influence. In the last few years, the media has forced and induced a level of disclosure that was inconceivable a decade ago. This will further ensure bringing more transparency not just in their financial statements but also in matters relating to internal governance.

6. **Influence of banks and financial institutions:** Despite serious lacunae in Indian bankruptcy provisions, neither banks nor financial institutions will continue to support managements irrespective of performance. Already, the more aggressive and market oriented Financial Institutions have started converting some of their outstanding debt to equity, and setting up merger and acquisition subsidiaries to sell their shares in under performing companies to more dynamic entrepreneurs and managerial groups. This will intensify over time, especially with the advent of universal banking.

7. **Realization among Indian corporate of the benefits of corporate governance:** Ultimately, Indian corporations have appreciated the fact that good corporate governance and internationally accepted standards of accounting and disclosure can help them access the US capital markets. There are more and more companies gearing up to issue US depository receipts, and all of them will get listed either at NYSE or at NASDAQ. This trend has had two major beneficial effects. First, it has shown that good governance pays off, and allows companies to access the world's largest capital market. It makes good business sense to be a transparent, well governed company, incorporating internally acceptable accounting standards.

8. **Impending full capital account convertibility will exert its own pressure:** Moreover, sooner than later India will move to full capital account convertibility. When that

happens, an Indian investor will seriously consider whether to put his funds in an Indian company or to place it with a foreign mutual or pension fund. That kind of freedom will be the ultimate weapon in favour of good corporate governance. Thus, it may not be wrong to predict that in another couple of years India might have the largest concentration of companies in South and Southeast Asia.

There are still a few questions which are remained unanswered as follows:

1). Should the Corporate Governance Practices be based on Rules or Principles only?

2). Should the Chairman also be an CEO?

3). Should a Retiring CEO ever become Chairman of the Board?

4). Can outside Independent Directors be genuinely independent?

5). Should shareholders be able to nominate Directors?

6). Should Institutional Investors exercise more power over listed companies?

7). Are external auditors really independent?

8). How should the directors' remuneration be decided?

These are the questions which we need to answer while deliberating the issues of corporate governance practices in India. There are sea changes that are expected as far as the future of corporate governance is concerned.

ACTIVITY 1

Read the corporate governance report of' Infosys' and 'Tata' companies. Write what type of mandatory and desirable requirements of corporate governance these are fulfilling?

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_____

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3.7 SUMMARY

In this lesson, corporate governance has been discussed at length and breadth in context to India. The various topics like the emergence of corporate governance; pioneers of good governance; and future of corporate governance has been explained in very detail. Although, India is on to the right path to achieve excellence in governance, but still, lot of lacunae in the system are necessary so as to accomplish the objective of corporate excellence in India. There are sea changes that are expected as far as the future of corporate governance is concerned. Time will teach us how to excel in corporate excellence.

3.8 SELF –ASSESSMENT EXERCISE

Fill in the blanks for the following statements:

a). Corporate governance initiatives in India began in year……. with the Desirable Code of Corporate Governance (a voluntary code published by the CII), and the first formal, regulatory framework for listed companies specifically for corporate governance established by the SEBI.

b). The recommendations of the Kumar Mangalam Birla set up in 1999 by SEBI has introduced the ……of the standard Listing Agreement to be complied with all the listed companies in stipulated phases.

c). The …….. undertake research or corporate governance; provide a mechanism to companies so as to rate themselves in terms of their corporate governance performance; promote corporate governance through certifying companies who practise acceptable standards of corporate governance and by instituting annual awards for outstanding performance in the same area.

d). For the very first year, the National award for corporate excellence was presented to ……Company.

e). ……has made mandatory provisions for corporate social responsibilities for almost all the listed companies.

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3.10 SUGGESTED READINGS

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3.11 ANSWERS TO SELF –ASSESSMENT EXERCISE

These are the answers for the self-assessment exercise as follows:

a). 1998

b). Clause 49

c). Centre of corporate excellence

d). Infosys

e). Companies Act, 2013

3.12 MODEL QUESTIONS

Q1). Elucidate the need for Corporate Governance in India.

Q2). Describe the evolution of Corporate Governance in India.

Q3). Describe the extent to which the efforts to ensure corporate governance in India has been effective?

Q4). Comment on the future of Corporate Governance in India.

Q5). Write a detailed note on 'Pioneers of good governance in India'.

Q6). ‘Shareholder activism can force the market to behave in a disciplined way’. Do you agree or disagree? Support your position.

LESSON-4

THE EXTERNAL AGENTS OF CORPORATE GOVERNANCE

STRUCTURE OUTLINE

4.1 Objectives

4.2 Introduction

4.3 The Concept of Corporation

4.4 The Purpose of Corporation

4.5 The Nature of Corporation

4.6 The Important Aspects of Corporation

4.7 The Characteristics of Corporation

4.8 Key External agents of Corporate Governance

4.8.1 Corporate governance and Employees

4.8.2 Corporate Governance and Customers

4.8.3 Corporate Governance and Creditors

4.8.4 Corporate Governance and the Community

4.8.5 Corporate Governance and the Government

4.9 Summary

4.10 Self –Assessment Exercise

4.11 Bibliography

4.12 Suggested Readings

4.13 Answers to Self –Assessment Exercise

4.14 Model Questions

4.1 OBJECTIVES

After reading the lesson/unit, the learner will be able to:

- Understand the concept of corporation
- Discuss the nature and purpose of corporation
- Describe the Characteristics of corporation

- Discuss the role of external agents (Stakeholders, Community and Government).

4.2 INTRODUCTION

As corporate governance refers to the relationship that exists between the different participants, and defining the direction and performance of a corporate firm. These participants/agents can be categorized into two categories namely, External and Internal. External agents are stakeholders, community at large and Government itself whereas internal agents include the shareholders, Board of Directors, mangers. These both types of the key agents are responsible for ensuring good governance practices in the company. In this lesson, external agents and their role have been discussed in detail and the internal agents will be discussed in next lesson.

4.3 THE CONCEPT OF CORPORATION

A corporation is a mechanism through which capital is acquired and used for the purpose of investment in assets which produce goods and services and help in distribution for the society. The purpose of every organization is to engage in such activities so as to contribute in raising profits of a corporation and also enhance the value of the shareholders who are the owners of the organization. Equity investors take their residual share in the profits of the corporation but they do not have the responsibility to run the operations of the business of the company. Management, on the other hand, runs the operations but they do not provide the equity. The responsibility to select the directors and fix their fiduciary duties rests with the shareholders. They also lay down the responsibilities of the management so as to protect shareholder's rights.

Corporations observe the basic responsibility towards the society. There are many stakeholders of a corporation and each has its own expectations from the corporate body. The law of the land sets the rule on corporate governance and corporates are aware of the norms to be observed on accountability.

4.4 THE PURPOSE OF CORPORATIONS

In the Indian context, the purpose of a corporation is enshrined in its Memorandum of Association. In the US, it is as per its charter vis-a-vis its declaration at the time of incorporation of the organization. The most common purposes of corporate governance may be outlined as below:

• To Provide Goods and Services for the Market.

• To protect the environment—Corporation define a policy which determines the appropriate quality of basic amenities like air, water they drink, besides the dwelling place where organization's staff live in the community.

• Satisfaction of human drives—corporations provide opportunities for the satisfaction of essential human needs—viz, growth of creative expression and competitiveness. A corporation focuses on development of individual's skills, knowledge. According to the utilization of the staff, they are rewarded for their contribution to the organization. Contribution refers to the value they add to the company. Corporations thus provide a platform where the ambitious, ingenious and the enterprising staff are allowed with ample growth opportunities.

• Corporation provides diversification to investors as option in investing in the equity of one corporation contain lot risk, and it can be spread over to other firms by buying ownerships. The risk may be significantly reduced through diversification of a portfolio of a corporation.

• Corporations create reservoirs of potential and talented staff and capital, which provides sufficient opportunities for the staff for creation of wealth and the posterity for themselves and for the corporation too.

• Corporations raise the purchasing power in the community living around the corporation by raising their standard of living. Moreover, the corporate contribute to the GDP of the economy.

• Corporations provide durable and continuing social structures which bind the people and make them devoted to the goals and objectives of the organization.

• History tells us that for centuries the social/religious structures were mainly devoted to goals which were not necessarily economic in nature. Through years, the power and authority to generate wealth through provision of goods and services as to determined by the demand of the society has taken its roots in corporations of huge global companies like the goods and services are determined by the demand of the Mobil Oil Company, Standard Oil, IBM, Microsoft, Coca Cola, etc.

• Corporations nurture talents in pursuit of higher efficiency and efficacy. They help the professionalism to grow, adequately compensate the staff and strengthen consumerism, which together contribute to overall economic prosperity of the economy.

• There is a great challenge before the corporations to fine-tune their forms to the needs of the society. In India, we have state undertakings /PSUs as model employers for whom profits are the secondary motive, but saving the society from exploitation was the main objective. But, over a period of time, the emerging competition and the shrinking budgets from the state, forced these bodies too to create wealth and earn profits. Some PSUs have been making good business and huge profits out of it. Because of their job security features, good working conditions and monetary and other non-monetary benefits, these PSUs are able to attract talents. Today, to recruit and maintain these professional have become very difficult as these have started moving to the private sector since they are offered high compensation at competitive rates. Government rules, regulations /procedures adopted in PSUs are models for private industry to emulate.

• Running the business efficiently and effectively has contributed to the success of the corporations. They are emerging as the cost-effective organizations and as the best manufacturers of quality goods and services for the society.

4.5 NATURE OF CORPORATIONS

Corporations exist along with the ***attendant power/authority and rights***. They have their own personalities. They are persons under the US Federal Constitution/Bill of Rights. They enjoy 'property protection' under the US laws. So, no one can take away their property without legal sanction. They enjoy freedom of speech and are reasonably entitled to contribute to political campaigns/ issues. Corporations are powerful as they play part in law making. They provide jobs to people. So, people depend upon corporations for livelihood and since people exercise power of their vote, firms derive political mileage to determine priority in investments, set the price of a product and nurture a work climate.

A corporation ***maintains its own identity*** not only as a producer of goods and services in the society but also as a corporate citizen. The social corporate responsibility of the corporations in India is enshrined in the firm's Memorandum of Association. Corporate lawyers opine that firms are entitled to have identical political rights, except, the right to vote, which are guaranteed to the

people under the constitution of the country. In 1986, the US Supreme Court had observed without any arguments in the court that the corporations are deemed persons in the context of the 14th amendment. Further, the corporate lawyers have been invoking the Bill of Rights as a measure of safeguarding their corporations from the Federal legislations. As corporations are claiming to be the citizens of the country in legal sense, they demand constitutional rights and immunity/protection.

If we take a corporation as a person under the law, it must also be a ***'Moral person' and act accordingly.*** A corporation should have a procedure for making decisions based on morals. The decision making process should exercise restriction/control mechanism, not only on obvious corporate activities but also on the rules and policies of the firm. The competency to use moral logic in decision making is inevitably a prerequisite to make a corporation more than a mere abstract body. Like human beings, a corporation is also liable to give explanation of its conduct, citing the moral reasoning which prompted it to indulge in the behaviour in question.

Can a business profit merely by doing good things? Will the business prosper if the cost of social responsibility is too high? Should the firm focus on acquiring higher share of the market for its products and services or on its social responsibility? Firms observe the ***basic responsibility towards the society***, for example, to provide the healthy and quality goods and services. But activities such as contributing to social causes may be impediment to generating higher profits. Basically, corporations exist for economic reasons, making profits to the maximum. This is the reason for their existence and so they need to be competitive to survive in the market. Profits guarantee longevity to the firm, and such businesses survive. Today's market dynamics are very complex, and the market determines the price and the consumers pay for what they buy. If the firm is not able to produce goods and services at the price the consumer is willing to pay, the business cannot survive long.

Corporations are ***flexible*** in nature. A corporation may be incorporated/chartered in one country at one place and operated from another place in the world. It has thus flexible boundaries. A corporation's activities last longer than its key executives and equity owners. It can be transferred by a change in its legal and capital structure. A corporation's executives/directors may close the business outfit and restart a fresh one without much difficulty and relocate the equity in the most economical/profitable venture.

A corporation has its entity as a person but it ***cannot be put behind bars***. The corporate form/structure transfers the corporation's liabilities to the total society. By virtue of the fact that corporates create employment and growth opportunities to the society, they are approached by the states in the country and offered concessions to open outfits in the underdeveloped regions. For instance, Hindustan Lever, ITC and IBM have agreed to tap the benefits of fresh investments in Uttaranchal state in India. Likewise, in response to Uttar Pradesh state's attractive offer, Reliance Industries and others have agreed to make fresh investments in the power sector in U.P. state. The fresh investments in the regional areas meet the purpose of the corporations, viz., to expand business, grow its market size and also help social and economic growth of the concerned states.

4.6 THE IMPORTANT ASPECTS OF CORPORTION

The present legal framework provides ample flexibility to corporate managers to determine their own governance and capital structure. It allows free competition and provides scope for the shareholders to choose the best alternative. A shareholder has the right to choose the company where he wants to invest. After making investment is one company, a shareholder's power to influence that company is only nominal. So, managers and investors perform respective roles with full knowledge of their power and limits.

Over the years, individual ownership has taken different models and forms of collective corporate body. The corporate structure has remained the best fit legal structure -in the business world. Corporate bodies have a number of attractive characteristics-they have the ability to hire management cadre of experts and acquire capital through different financial sources, control over inefficient and ineffective business ventures and they have the power to transfer the share holdings. In addition, there are some significant driving forces of the organization of corporate form, as follows:

(a) With the emergence of the financial markets, issue and transfer of shares is easy. Partnership became more difficult for the same purpose.

(b) Investors are able to decide the type and quality of managerial hierarchy they want mangers to follow. Moreover, they can bring changes in case it is necessary. But, partnership form of business is inflexible vis-à-vis the corporate form.

(c) If the corporate body was a trust, the common law is applicable which is difficult to understand and determine, and hard to predict as compared to the statute.

(d) The most significant and attractive feature of the corporate model is the limited liability that the owners enjoy, limited to the extent of their invested amount or subscription. The 'limited liability' implies that investors are able to take huge risks and liabilities, and this does not threaten the owners' personal resources. This is a great protection to the investors of corporate bodies. In the absence of this protection, investors will not be ready to risk their resources in such ventures as are deemed to be risky. This way, investors invest in multiple ventures which, in turn, helps in the formation of capital needed for growth of innovation, R&D activities and in technological advancements. However, the impact of failures in business and trade is bear across by the government and community at large. It means that the price of failure of a business is paid by the society and not by the investors. In this way, the corporate bodies externalize the cost of their failures and the society bears the brunt.

(e) Although the corporate form limits the liabilities, the risks are not limited. However, the limited liability together with the advantages of diversified investments and growth of technological innovations, have resulted in the growth and expansion of corporations.

(f) Contemporary corporations today are unlimited in the scope in terms of business, size of the capital, life and the operations at national level.

(g) Corporations are able to influence the society where they operate. They have the resources to influence elections, the law making and its interpretation as well as administration. This is already happening in almost all of the economies across the world. It is important to point out that the cost of all these activities is passed on to the shareholder and the customer.

Corporates are able to participate in the process of setting the legal provisions. And, all this is done by persons/owners as individuals (with limited liability). The corporation is able to fight legal battle. Those who manage business and those who own, i.e., the shareholders/owners, are able to appropriate the profit and loss account of the business. They safely pass on the cost of these activities to the society. This way, the corporates are able to externalize their costs of the operations and the related activities. To sum up, ownership in corporations is a one-way activity and the society bears the brunt of corporate decisions.

4.7 CHARACTERISTICS OF CORPORATIONS

Although there are various characteristics of corportations, but these are the four critical characteristics of corporates as follows:

The Liability Aspect: It is a known fact that a corporation is distinct from its owners and staff. What a corporation owes is not the liability of the group of persons who comprise the corporation. And, the liability of the group of persons is not the liability of the individuals who make the corporation. Therefore, in the event of a corporation going bankrupt, individually, the members of the corporation do not carry any liability if they are sued by its creditors for any debt. As pointed out above that a corporation is to be regarded as a person. In case of partnership when a number of persons collaborate and pool their resources/fund and enter into a partnership business, they are subject to the risk of losing their stakes plus all that they may possess. Liability of the members of a corporation is limited and the authority to control is also limited. Whereas in partnership, partners share the liability and they have high level of control over the activities of their partnership activities which is compatible with that of high degree of liability.

Stock Transferability: In corporations, the stockholding can be transferred to another person because stocks are liquid like cash and are there is ready secondary market for transferring the stocks. Once the stock price goes down, the shareholder can sell it and save the loss in value. In case of partnership, this is not possible because it is difficult to assess the value. There is no stock exchange so that the stocks can be traded like in the case of stocks owned by the investors in corporations. In a company, a shareholder may put his stock at risk with limited power to control the respective organization in as much as he controls the risks through his own decision to sell the same at anytime; he finds he is losing in value.

Life of a Corporation and Partnership: A partnership becomes non-existent the moment one partner decides to quit. This happens when there is no clear contract in existence. A corporation exists so long as it has the necessary capital to run it. Corporations have a legal entity which bestows a lot of benefits upon the corporation. For example, when a corporation has a legal entity, it can copyright own property, even in real estate, other assets, etc. A corporation may use its investors' equity, whether agreed/disagreed by the investors on purposes like promotion of an

agenda related to politics. Legal entity/existence to the corporation permits the corporation to own, act and to continue to exist till it has the capital.

Management Control: A partnership is managed on the basis of majority voting or consensus unless it is agreed to be explicitly otherwise. Every partner is equally important and has equal authority in the business. In case of a corporation, the Chairman and the directors have the authority and responsibility to give direction to the organization. The power is thus centralized in the hands of the board of directors and the managers are delegated the powers to control and manage the day-to-day functions of the business. The shareholders do not keep authority but pass it down to the management for most effective operation of the business.

With the change in the legal system, a dramatic change in the relationship between the corporation and the state and the corporation and the shareholders could be perceived. With the rising size of corporations and their longevity, in corporations, there is an increasing separation of ownership from the professional management. The rising market is providing the needed total liquidity in no time.

Earlier, the directors were also the shareholders. So, when they sat in the meetings, they represented the interests of the shareholders. And, with growth in the size of the corporation, managing was getting too complex. So, the law had to intervene to define the standards of performance for the directors.

A corporation has many stakeholders, namely, the employer and the employees, shareholders, customers, suppliers, creditors, state, etc. An employee wants the corporation to provide safe workplace and pollution free environment to grow and prosper, besides looking for opportunities which meet the individual aspirations/expectations for creativity, etc. One is proud to work for a firm that pays well, and looks after its people, and meets all the staff needs. Employees also evaluate the effectiveness of the firm's profit making capabilities, market share and the social responsibilities that it attends to.

The law of the land provides protection to the corporation against any odd competition from mighty overseas MNCs or cartel monopolistic policies of the firms at home. It is important to remember that state serves the role of a protector in times of crisis and also influences the corporation in its policies. Corporations draft their policies which make them responsible

players. Corporations also influence the state on all their policies on social and economic issues. In India, too, we have open-door policy at the national level to invite the corporate players and the general public to know their views and suggestions on economic and other issues before finalizing the policies. There are committees consisting of experts from all walks of life to advise the government on policy matters.

To summarize, corporates will continue to grow and expand business all over the globe. The need therefore is to define a more coherent and consistent approach. At the state level, there is a need for integration of the laws considering the realities of the economic considerations, so that all the incentives and concessions promote satisfaction among all the stakeholders.

4.8 KEY EXTERNAL AGENTS OF CORPORATE GOVERNANCE

It is a well-accepted principle nowadays that corporation exist not only for the benefit of its part-owners called shareholders, but also to serve the interests of other stakeholders in society,: come other stakeholders in society. It is fallacious to argue any concern of a company is exclusively towards shareholders and other stakeholders are only of a peripheral importance to it. A corporate does not exist by itself and it does not operate in a vacuum. Its work is organized and facilitated with the help and co-operation of all constituents of the society in which it functions. Hence, it is obviously natural that corporates are expected to reciprocate and contribute in a fair measure to the well-being of all stakeholders. Besides, if a corporate is interested in establishing long term shareholder value itself, it is vitally necessary to earn the goodwill of other stakeholders such as employees, customers, institutional investors, creditors, community at large, and the government, by serving their interests and being useful to them as much as possible.

4.8.1 CORPORATE GOVERNANCE AND EMPLOYEES

There is no denial to the fact that the better and ethically acceptable corporate governance has been critically important ever since the start of modern corporations, in which owners and managers of companies are separated. When owners directly manage their own company, governance issues may not be that important. The recent downfall of Enron, WorldCom, and other large corporations, partly due to the failure of their boards of directors, has resurrected governance as a significant corporate necessity. Employees are also one of the stakeholders of

the organization; by increasing their participation in the organization, one could ensure better corporate governance.

An organization needs capital and labour to create wealth. Earlier, the most important need for an organization to be a success was capital; as long as they had capital, the organization was able to be successful. But today, the need has extended beyond capital and includes labour. The conventional model was the "shareholder primacy" model, which left out the role of the employees in the creation of wealth. The Western reform advocates have promoted the concept of "shareholder capitalism" where the sole emphasis is on strengthening the rights of, and the protection for, financial investors. Today, the growing recognition that human capital is a source of competitive advantage has led to the understanding that labour is equally important as capital. Today, many organizations increasingly understand that people and the knowledge they create are often the most valuable assets in a corporation. They regard it as the knowledge capital, which is considered as an invaluable value asset of the organization. There are number of ways by which the interest of employees can be represented in an organization. There is a need to realize that shareholders' inertest are probably well-served by including employees in corporate governance.

4.8.2 CORPORTAE GOVERNANCE AND CUSTOMERS

From economics point of view, customer is thought of as a king. A few consider customer as the sole purpose for which an enterprise exists and therefore should be treated with respect in reality. Good corporate governance should treat customers at the center stage.

However, while good corporate governance is, undoubtedly, of considerable value to those who have invested their money in firms that adhere to its tenet there is no justification to conclude that it is sufficient in itself. The fact is that companies that practise good governance are of interest because the investors believe that these companies will perform well so as to result in increase in share price apart from paying handsome dividends. Good corporate governance is linked directly to the long-term enhanced potential of a company.

4.8.3 CORPORATE GOVERNANCE AND CREDITORS

Both financial sector reform and private sector development have received considerable attention in developing and transitional economies in recent years. But the critical nexus between banks and firms—not only for financing but also for efficiency and ultimate survival has been underemphasized. Banks and other creditors have an extremely important role to play in fostering efficiencies in the organizations. Creditors, in turn, rely for their debt repayment by their borrowers. Without dependable debt collection, no amount of supervision or competition can make banks run efficiently.

Debt appears to be slowly emerging as a device for exerting control over medium and large enterprises in some transitional economies. The powers and incentives of creditors in these countries are still weak, however, compared to their economies. Strong creditors are as critical to the efficient functioning of the enterprise.

4.8.4 CORPORATE GOVERNANCE AND THE COMMUNITY

The corporation has grown up with the time. Only the corporation has been able to combine for economic value creation financial capital, new technologies, and human resources. Sole proprietorship and partnerships were too small to achieve the scale of research and production that corporations could. Corporations will continue to create much of the wealth of society in future and open up new possibilities for humanity.

However, a corporation is a set of relationships among different stakeholders. Each stakeholder plays some role in the success of the corporation. Without capital and stockholders, there can be no corporate entity. Without banks and other debt investors, the corporation cannot maximize its ability to earn a return on its equity capital. But without customers, there will be no business for the corporation to do. Without employees, the corporation will be unable to do its business. Quality and cost efficient suppliers are necessary for the success of any business. And, if the community turns against a company, losing confidence in its good faith, then that corporation will lose its business legitimacy, sometimes very rapidly as we have seen in several cases around the globe. The corporation must also have concern for the physical and social environments in which it does business and must take care not to take unfair advantage of its competitors.

By aligning and attending to the needs of these stakeholders, the corporation fulfils its duty to society to promote modernization and a better life for all in a sustainable way. A modern

corporation is under fire from many directions. It has duties and obligations to different stakeholders when these duties and obligations often seem to conflict with one another. How is a corporation to decide what to do? That is the role of governance. Corporate governance is the mechanism by which the values, principles, management policies and procedures of a corporation are worked out in the real world.

The fundamental basis of corporate governance and responsibility in the value system of the corporation includes the followings:

- Its human resource principles—respect and dignity for all.
- Its dedication to accurate and transparent accounting and financial standard
- Its concern for the environment, for good business ethics and conduct, for social advancement.
- Its over-riding passion to serve customers and to guarantee its products and services.
- Its insistence on fair treatment of suppliers—and competitors.
- Its uncompromising commitment to comply with government laws and regulations in all countries in which it operates.
- Its desire to work with others to lead society to a better economic standard and quality of life.

The managerial skill lies in accomplishing all these things at the same time. A good structure of corporate governance satisfies these needs and interests of different stakeholders in a way that provides for long-term growth in the value of the company and its contribution to society. Its reputation and goodwill are enhanced, it commands success in the market for its products or services, its employees are productive and loyal, its equity owners are rewarded with good dividends and a rising price for their stock, and its growth is not impeded by external forces.

Corporate governance is there to ensure that managers act as agents and fiduciaries, guiding their corporations to successful accomplishment of their corporate and societal responsibilities. Thus it is obvious that good corporate governance aligns with the interests of management, shareholders and other stakeholders.

4.8.5 CORPORATE GOVERNANCE AND THE GOVERNMENT

Government plays a key role in corporate governance by defining the legal environment and sometimes by directly influencing managerial decisions. The ability to write and then enforce contracts, to oblige management to provide accurate and comprehensive information before shareholders, votes on important issues, to enforce the obligations of the boards of directors, to specify and have managerial incentive contracts enforced, and to have confidence in the full range of contractual arrangements that define the firm in modern corporations-these issues determine the extent to which equity and bond holders can exert corporate governance. Moreover, political economy forces that produce the laws, enforcement mechanisms, bankruptcy processes, and the ability of powerful managers to influence legislation will profoundly shape corporate governance. Beyond defining the rules of the game, the government may directly influence corporate governance. At one extreme, the government owns the firm, so that the government is charged with monitoring managerial decisions and limiting the ability of managers to maximize private benefits at the cost of society. At a less extreme level, governments regulate the corporations. Specifically, the Government is entrusted to regulate activities and asset allocations of corporations and may even insure corporate liabilities in favoured industries.

In theory, governments regulate to maximize social welfare, limit adverse externalities and exploit positive ones, deal with monopoly power, and directly prohibit managers from undertaking socially adverse actions.

The government in every country exercises a certain amount of control over operations of the organization and the government could use this to steer the organization towards the path of good corporate governance.

4.9 SUMMARY

A corporation is a body through which capital is acquired, for the purpose of investing in production of goods and services and distribution. A corporation is an invisible, intangible and artificial body which exists in the eyes of the law. It has such properties, expressed or implied as defined in the charter which creates it. Law regards the corporation as an entity whose life and existence are broader and longer than the individuals who constituted it. Some experts define a

corporation as a system or mechanism in which so many persons/parties may collaborate and contribute efforts, expertise and capital so that profits may accrue to them. As an independent entity, a corporation has a network of relationships with large body of shareholders and other actors, such as, directors, staff, suppliers, customers, state, as also the community where the corporation is located. Each of these relationships is significant and multi-faceted. Corporations observe the basic responsibility towards the society by providing healthy and quality goods and services. Corporations are flexible and as such, are incorporated in one country and operate from another country. It has flexible boundaries. It designs its own structure according to its own operational needs, and the changing needs of the environment. The law of the land sets the rule on corporate governance and the corporation has the responsibility towards all the stakeholders like employees, creditors, customers, community and government.

4.10 SELF –ASSESSMENT EXERCISE

Fill in the blanks for the following statements:

a). Corporate governance refers to the relationship that exists between the different participants, and defining the ……..and performance of a corporate firm.

b). Corporations provide durable and continuing ……..which bind the people and make them devoted to the goals and objectives of the organization.

c). A corporation maintains its own identity not only as a producer of goods and services in the society but also as a……..

d). The corporate form/structure transfers the corporation's liabilities to the …….

e). A corporation exists so long as it has the necessary ……to run it.

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4.13 ANSWERS TO SELF –ASSESSMENT EXERCISE

These are the answers for the self-assessment exercise as follows:

a). Direction

b). Social structures

c). Corporate citizen

d). Total society.

e). Capital

4.14 MODEL QUESTIONS

Q1). Elucidate the characteristic of Corporation in detail.

Q2). Describe the nature and purpose of Corporation.

Q3). Describe the extent to which the efforts to ensure corporate governance in India has been effective?

Q4). Describe the role of stakeholders in Corporate Governance.

Q5). Write a detailed note “the Role of Society in Corporate Governance”.

Q6). Describe the role of Government in ensuring Corporate Governance in India.

LESSON-5

THE INTERNAL AGENTS OF CORPORATE GOVERNANCE

STRUCTURE OUTLINE

5.1 Objectives

5.2 Introduction
5.3 Internal Agents of Corporation
5.4 Role of BOD in Corporate Governance
    5.4.1 Boards and their Fiduciary Duties
5.5 Role of Managers in Corporate Governance
5.6 Dilemma about the Roles of Board and Management
5.7 Role of Shareholders in Corporate Governance
5.8 International Corporate Governance Network
5.9 Summary
5.10 Self –Assessment Exercise
5.11 Bibliography
5.12 Suggested Readings
5.13 Answers to Self –Assessment Exercise
5.14 Model Questions

5.1 OBJECTIVES

After reading the lesson/unit, the learner will be able to:

- To know about the internal agents of corporate governance
- Discuss the role of Board of Directors in corporate governance
- Describe the role of Managers in corporate governance
- Discuss the role of shareholders in ensuring corporate governance

5.2 INTRODUCTION

The success of modern enterprises depends on the adoption and implementation of good management practices that inter alia seek to protect the interests of stakeholders. Sound corporate governance practices help companies to improve their performance and attract investment while enabling them to realize their corporate objectives, protect shareholder rights, meet legal requirements, and demonstrate to a wider public how they are conducting their business. These practices have become critical to worldwide efforts to stabilize and strengthen global capital markets and protect investors.

As corporate governance refers to the relationship that exists between the different participants, and defining the direction and performance of a corporate firm. These participants/agents can be categorized into two categories namely, External and Internal. External agents are stakeholders, community at large and Government itself whereas internal agents include the shareholders, Board of Directors, mangers. Although, there is no denial to the fact that shareholders are the backbone of the corporation as without the capital no corporation can survive, but same is the importance of employees and customers. Without the customers and employees, no organization can exist because according to Mahatma Gandhi, "Customers are the sole purpose for which the corporation exists' and without employees, it is very difficult to run organization. As in today's business environment where people are the repository of knowledge and these are working on the machine, and hence there is impertinent role of these external as well as internal agents of corporate governance. These both types of the key agents are responsible for ensuring good governance practices in the company. The corporation has to achieve its objective in such a way that all the stakeholders are satisfied. Hence, while achieving the objective of long-term wealth maximization of shareholders, the other stakeholders' requirements must be taken care of. In this lesson, internal agents and their role have been discussed in detail and the external agents have been discussed in the last lesson.

5.3 INTERNAL AGENTS OF CORPORATION

According to the definition of corporate governance, "Corporate Governance is umbrella term that includes specific issues arising from interactions among senior management, shareholders, boards of directors and other stakeholders" (Tricker 2001).

According to another definition, " Corporate Governance deals with appropriate board structures, processes, and values to cope up with rapidly changing demands of both shareholders and stakeholders in an around enterprise (Garratt, 2003).

From the above definitions, it is clear that main key agents of the corporate governance are the either shareholders or stakeholders. The shareholders term means somebody who is having ownership in that particular corporation, whereas the term stakeholder includes employees, customers, suppliers, creditors to name a few. But, BOD and mangers are another set of agents of corporate governance and play an important role in ensuring corporate governance. Mangers are the agents of shareholder, and are there in the organization for working on behalf of shareholders. BOD are the directors who oversee the functions of management so as to ensure

that the objectives of shareholders are aligned with that of mangers. The directors as a legal body draw enormous power because of the very nature of joint stock companies that gives the corporation the status of a separate legal entity.

A major issue in the management and governance of a corporate entity is of the wealth of a corporation is divorced from ownership. With the dispersion of ownership, no shareholder had effective control over the firm. It is the genesis of directors and board of directors, who had the fiduciary responsibility accorded to them by the shareholder to control the firm on behalf of the shareholders.

Berle and Means (1932) describe the legal position of the board and management. According to the authors, ‘management may be defined as the body of men who, in law, have formally assumed the duties of exercising domination over the corporate business and assets. It drives its position from a legal title of some sort universally. Under the American system of law, mangers commonly secure its legal title to office thorough election by the stockholders or those of them who, under the corporate charter, are accorded a vote. Whereas, board of directors is considered to be the body representing the shareholders through the fiduciary responsibility assigned on them.’ But Berle and Means assert a very important aspect: ‘The law holds management to certain standards of conduct. This is the legal link between ownership and management.’ According to authors, 'the three main rules of conduct which the law has developed are:

1). A decent amount of attention to business.

2). fidelity to the interests of the corporation.

3). At least reasonable business prudence.

The law sums up the three rules mentioned above by describing that management stands in a “fiduciary” capacity towards the corporation. Thus the BOD in effect become the "fiduciary" top of the corporation on behalf of shareholders. An ethical behaviour is expected from them. BOD must protect the interests of the shareholders, but for that they should not act against the company while protecting the interests of shareholders.

Shareholders as owners of the corporation have rights over the corporation and its assets. While at individual shareholder level rarely does a possibility arise for action directed at exercising their rights, the shareholders still have their rights given by the laws and conventions. Wallace and Zinkin (2005) in their study found that companies can choose to be like democracies and dictatorship. Democracies refer to the granting great powers to the voters whereas in case of

dictatorship, they can choose to be like dictatorships protecting the management from being accountable to the voters. Further, it was confirmed that ‘Democracies’ appear to have outperformed the ‘Dictatorships'.

5.4 ROLE OF BOD IN CORPORATE GOVERNANCE

Although BOD members are responsible and have been given legal powers to ensure corporate governance, before that in this section let’s see what goes into the bodies of ‘Fiduciary Duties’ as entrusted to BOD. These are explained as below:

5.4.1 BOARDS AND THEIR FIDUCIARY DUTIES

According to Garratt (2003), the fiduciary duty of the directors is ‘to hold the company in trust for the future' which seems to be the most appropriate explanation for fiduciary duty. According to Phan, 2000 the fiduciary duty of directors essentially consists of two sub-duties namely, the duty of loyalty, and the duty of care. The duty of loyalty is a direct result of the agency theory of corporate governance. The second sub-duty, the duty of care, is related to the first, the duty of loyalty, and the duty of loyalty necessitates that a 'fiduciary shall not engage in practices that directly or indirectly harm the interests of his principal.’ The duty of loyalty enables us to address issues related to conflicts of interest and those related to personal gains. The duty of care of directors demands that they act in ways to protect and enhance the principal's position. Thus, boards and directors have to not only obey and act according to legal requirements but also have to develop much more beyond the minimum to ensure that they make the best decision. Society may ‘impose additional duty to the directors, for example to protect the environment, human rights, gender rights, etc. These are known as statutory duties' (Phan, 2000).

Garratt (2003) observed that post-Enron the three values of corporate governance namely accountability, probity, and ethics are receiving the righteous attention from the public. The Commonwealth Association of Corporate Governance (CACG) has suggested various duties for directors. These duties require the board and the directors to behave within the following legal and ethical bounds as follows:

The duty of legitimacy: It emphasizes the importance of working within the ambit of national and international laws. While for a layman including this duty may look naive, the fact remains that many directors are ignorant of many aspects of company law and laws relating to capital

markets in their country and international capital market regulations if they have chosen to raise capital internationally. Knowing about laws and regulations is not enough. The BOD also derive lot of power from basic documents of the company namely, the articles of association (A0A) and the Memorandum of Association (MOA). These will define how the company is going to be regulated internally, subject to the external laws that are applicable to every company. Another important document is the shareholders' agreement, if it exists. Such an agreement may be prevalent in the case of closely held companies and are intended for owners specifying their roles and responsibilities. It should be noted that ignorance is not acceptable in the legal perspective. The directors have to be careful about the company and its affairs.

The duty of upholding the three values of corporate governance: The three fundamental values generally accepted by everybody concerned with good governance are

I. Accountability
II. Openness
III. Probity

In context to corporate governance, accountability refers to the accountability towards the shareholders as it is the basic premise of fiduciary duty of the directors.

Each director must have confidence in their colleagues. Also, there shall be a clear understanding among the directors that nobody shall indulge in any activity that is targets at personal gain from his membership of the board. The board should have a stringent code of conduct for all of the members. The issue of integrity and honesty by the board has to do with obeying all the laws and regulations of the land that are applicable and being transparent to outside stakeholders. The best example in this context can be of Infosys Chairman, N.R. Narayana Murthy has set a dictum for the company: 'When in doubt, disclose.' Openness in the context of corporate governance refers to the situation where any information that is of importance to any stakeholders must be disclosed at right time. Even though all the stringent norms have been adhered to, shareholders may still complain about transparency. Shareholders would like to know the process of decision-making used by the board and the consequences of those decisions.

The duty of trust: Directors are required by law to hold their company 'in trust' for the future. This is another fundamental premise of the fiduciary duty that directors are responsible for. It must be noted that the directors have a duty to the company to hold it in trust than to the

shareholders. While trying to execute this duty to the company, the directors might at times act against the narrow interests of the shareholders to protect the larger interests of the company. There have been a number of instances where certain shareholder(s) try to further or protect their interests at the expense of the company's overall interests.

The duty of upholding the primary loyalty of a director: The moment one gets the duty of director; his primary loyalty must be to the company as a legal entity rather than the shareholders, who appointed them. The shareholders will always expect that the directors elected by them will act in their interests. But, the directors have to choose a view that what is good for company over a long-term must be good for the shareholders too. Directors must concentrate on the current as well as on the future health of the company as an economic entity. They have to exercise their power of will in times of difficulty by arriving at harsh decisions.

The duty of care: The directors and the board as a body has to be caring for the company dick-take their decisions as parents of a child. The board has a duty to protect the company from different threats, or risks, identify its weakness, make good use of its strengths to exploit the opportunities that come by in order to sustain and grow. To be careful, directors need to observe the following:

- ✓ Be fully involved and committed to the company rather than attending board meetings and vote for or against resolutions just for the sake of it.
- ✓ Prepare themselves for their active and full participation in the hoard meetings.
- ✓ Be properly inducted, trained to gain competence and appraised on a regular basis.
- ✓ Reduce the number of directorships in order to be fully committed to wherever one is a director.
- ✓ Continuously monitor the environment-internal and external-so as to make suitable changes in their strategies, processes, people, and even businesses.

The duty of critical review and independent thought: According to law, all directors on the board are equal. A chairman is elected from the directors to enable the board to conduct well. Hence, 'each director is expected to be sufficiently self-aware and mature to be able to make their own judgment on the best direction and prudent control systems for the best of the company' (Garratt 2003). While directors are expected to be applying independence of

thought and indulging in critical review, they might be running a risk of being isolated in the short run and not getting re-elected in the long run. Many of the colleagues on the hoard, especially the promoters and their nominees, expect other directors to toe their line. But, in today's environment, while harmony is encouraged to co-exist with diverse opinions and even dissent, many think that the dissenting director is a nuisance and forget that he/she might be expressing his/ her dissent or concern for the good of the company, which is the dusty for which he is there. The other board members should discuss threadbare the reasons for the dissenting directors' concerns and address them before taking further decisive actions.

The duty of delivering the primary roles and tasks of the board: This role of director can be explained better by considering the four `interlinked directoral dilemmas' as follows:

I. Driving the enterprise forward, while keeping it under prudent control
II. Being required to be sufficiently aware of the workings of the business to be responsible for its actions, while having time to develop a longer-term more objective view of developments outside the business
III. Being sensitive to short-term local demands, while balancing these against broader regional, national, and international trends
IV. Being focused on the commercial needs of the business, while acting responsibly to other stakeholders in your society

The board has to subdivide the broader roles into board tasks so as to take effective decisions in dilemmas like above.

The duty of protecting minority owners' interests: The position of minority shareholders is precarious in most of the countries. While developed countries have tried to protect the interests of minority shareholders by stringent regulatory measures, in developing and underdeveloped countries this is still a major issue. The directors owe their positions to the owners or the CEO who is a nominee of the owners and hence will try to protect the interests of the -who nominated them than performing and executing the duties of a 'director'. Sometimes MOA and the AOA may specifically mention the company's intention to protect the minority interests. The directors must not forget that they represent the entire shareholding community and their allegiance is not only to the large shareholders.

The duty of corporate social responsibility: It is extremely difficult for any board to take a balanced and pragmatic approach with respect to corporate social responsibility. Primarily, business enterprises are profit-driven and they do everything within the frontiers of law to maximize profit. This is underscored by the free market regime which is the touchstone of capitalism. On the one side, we have proponents of free markets where any action to further profit was legitimate. On the other extreme, we have anti-capitalist groups crying for an equitable distribution of wealth, protecting environments, protecting human rights, and even development of local economies rather than international development and creation of economic power blocks. But according to Peter Drucker, 1970 the companies had clearly set objectives in the area of public responsibility while identifying areas where management had to invariably set objectives. Drucker included it under the three intangible areas but warned that 'to neglect them is to risk not only business incompetence but... public restriction on business provoked by irresponsible business conduct.'

The concept of the triple bottom got prominence, and this refers to not only the financial performance but also of environmental performance and performance on the corporate social responsibility targets. Hence standards are set for all the three bottomlines and all the three outputs have independent, external auditors appointed who report back as part of the annual auditing process. Tata Steel took has taken leadership in implementing a social audit process. Stock markets have also started encouraging companies with concerns for society.

The duty of learning, developing, and communicating: Many directors assumed that the reward of a directorship is simply the acknowledgement of a long and successful executive or professional career, not the beginning of a new one. This wrong belief had led them to believe that there was no need for them to learn anything new. But today, with the corporate governance being the cynosure of attention, accepting directorship is not an easy option anymore. Directors have to look at the directorship as the start of a new and challenging career. While certain parts of managerial learning might be useful, directors' learning has to be different and broader than those of the managers.

5.5 ROLE OF MANAGERS IN CORPORATE GOVERNANCE

In the context of India, the need for good corporate governance assumes a more significant dimension given the corporate culture, recent lot many corporate scams, and the fact that an overwhelming number of companies are family owned business. The need for reasonable representation in corporate decision-making process for all stakeholders of a company thus assumes a striking significance in the scheme of corporate governance in country like India. The board of directors in a company has the overall responsibility for management and direction of its affairs. In this regard, the directors should exercise strategic oversight of business operations while directly monitoring, measuring and rewarding management's performance. The mangers being the agents of their principals (Shareholders) must act in the best interest of their shareholders. The mangers must align the objectives of shareholders and theirs too so as to minimize the agency problem.

The board should also ensure the integrity of accounting and financial reporting systems and oversee the process of disclosure and communications. The board's responsibilities inherently demand the exercise of judgment. Guiding business strategy, determining an appropriate corporate appetite for risk or selecting a chief executive from a pool of candidates involves decision-making that cannot be reduced to a mechanical series of steps. Monitoring and supervisory functions may comprise a range of reasonable approaches. In the end, healthy corporate profits do not guarantee that directors performed well, nor losses prove that directors were careless or incompetent. The board of directors has the responsibility to ensure that corporate behaviour conforms to best governance practices. For this, directors need to exhibit certain behavioral norms, including:

(a) Informed and deliberative decision-making

(b) Division of authority

(c) Effective monitoring of management

(d) Evenhanded performance of duties owed to the company and to shareholders as a class.

In closely held companies, a single family or group appoints the entire board of directors, and it aggravates the problem of governance. The governance of such companies often relies on private, informal decision making, deference to authority, and also based on long-term personal relationships; in such cases, even if legal norms clearly fix directors' duties, human nature and cultural patterns can lead to divided loyalties. Behavioral norms also affect shareholders and regulators. For both cultural and practical reasons, many shareholders often prove reluctant to

litigate or to assert formally their legal rights. This reluctance places greater pressure on regulators and raises capacity and infrastructural challenges for corporate governance frameworks all across world.

5.6 DILEMMA ABOUT THE ROLES OF BOARD AND MANAGEMENT

Although, there is a clear distinction between different roles of managing and directing, but it has been found by various researchers that poor governance of most of the corporations is as a result of failure to distinguish between the two roles-the role of a manager and the role of a director. The same happened in case of Satyam Company where Mr Ramaliga Raju and his brother failed to perform their duties as directors but they continued to perform their roles as managers of Satyam. They was no question on the part of their competency as they both have taken the efforts to make Satyam from small beginner to the third biggest IT service provider from India over a period of about 20 years. According to Garratt, 2003, "It is an open secret that the vast majority of directors are not fully competent." That does that they are all therefore incompetent, but rather that most of them have not been able to distinguish between managing a business and directing one. They tend to be over-trained as executives and under-trained as direction givers. Their many rewards have come from being effective managers, not from giving strategic direction.'

According to Harper, 2005 directing the company means 'focusing on providing overall leadership and judgment in order to make those decisions that are central to protecting and enhancing the interests of the company including all the stakeholders over time. This is not possible if the BOD is bogged down with day-to-day matters that are the proper concerns of management. It is the prime responsibility of the chairman to maintain this focus. But again there can be issue as in case of number of companies in India when the chairman is full time and hence a part of management. To quote with example, here is the case of Mr. Deepak Parekh as full time chairman of HDFC even with an MD under him. Similar is the case of Mr. Rahul Bajaj who had been working as the full time chairman with his son as MD of the Bajaj Conglomerate. Second issue that arises is when the chairman even though part time is a member of family which also has nominee as CEO/MD. Hence, it is the duty of every individual director to understand about his/her role with lot of clarity otherwise governance will be at stake. But, wherever the Chairman is independent, he/she should encourage the directors to consider directorship as responsible profession that need meticulous attention, knowledge and willingness to learn, courage to express truth and challenge, where is it necessary , professional behaviour and attitude,

commitment and involvement. The whole-time or executive directors need to be extremely cautious in exercising their role as the director on the board. According to Harper, 2005 that most of the appointments of executive directors are will have been made principally on the strength of success as a manger. Many such directors will regard their directorship as a further endorsement of that success in the operational field, rather than taking a completely separate attitude. The management role demands to achieve results in the domain in their specialized area. In contrast, their director role requires an essentially thoughtful, reflective approach of thinking things through' in conjunction with their hoard colleagues. They must take action sufficient time to devote to critical thinking while acting as director.

Garratt, 1996 has identified the key task of the board of in order to create a balance among the following four opposing forces:

I. **Organizational Effectiveness:** Perception in customers' minds of all the products or services as desirable and good value for money
II. **Organizational Efficiency:** The internal activities aimed at cost reduction and efficiency improvements without affecting the value perception by customers
III. **Board Performance:** The hoard's external focus on various environments affecting the company and also about the competitive positioning and broad resource allocation in relation to the policies set by it.
IV. **Board Conformance:** The board's internal focus of achieving business performance goals while being accountable towards stakeholders.

While the role of directing is different from managing, it is necessary for the board to support and bolster management (Shultz 2001). According to the author Shultz, “Strategic boards validate good decisions. A board is there to help the CEO succeed as well as to provide policy input”.

Only the necessary clarity is achieved regarding the different roles of managing and directing, many of the ownership related issues of governance can be resolved.

5.7 ROLE OF SHAREHOLDERS IN CORPORATE GOVERNANCE

It has been found by the McKinsey Quarterly that institutional investors in emerging markets would be willing to pay as much as 30 percent more for shares in companies with good

governance. That is why it is important to study the role of shareholders in ensuring good governance practices in the companies.

According to the principles drawn up by International Corporate Governance Network (ICGN), there are five factors to be addressed while considering the rights of shareholders as follows:

I. Shareholders are entitled to be consulted before any major change is made to the corporation's strategic direction, as this will affect the risk profile of the business, and shareholders entitled to have their risk profiles respected. In addition, the shareholders should approve anything that is likely to dilute shareholder equity or erode shareholder economic interests, before it is undertaken.

II. Shareholders must have adequate access to be able to exercise the right to vote, and the ICGN goes so far as to suggest the adoption of secure telecommunication and electronic methods of voting to achieve this.

III. Voting results should be disclosed in a timely manner for each resolution and there should be no difference between votes cast in person or in absentia.

IV. Divergences from a 'one share, one vote' are undesirable because they give certain shareholders disproportionate power, and any such divergence should be disclosed and justified.

V. The duty to vote is a fiduciary obligation for institutional shareholders, subject to the co of exercising a vote.

While shareholders have definite rights accorded by the law, the widely dispersed nature of the shareholders, the ignorance of shareholders of their rights, the lower level of activism, lack of interest in exercising create a scenario where companies becomes inert to the possibility of shareholders exercising their rights for improving corporate governance.

Although, shareholders activism can force the management and BOD for greater accountability, but they don't do. The one of reasons behind such an attitude is that shareholders are so fragmented that the only one viable and convenient option for them is to sell the shares.

The same shareholders have definite expectations from boards having fiduciary duties and expect them to exercise the powers bestowed on them so as to meet the expectations of shareholders.

Investor's protection

Strong investor protection is associated with effective corporate governance. In fact, corporate governance has been advocated by everyone interested in the long term shareholder value, which

in turn promotes orderly development of industries and economies. When an investor places his hard-earned money in the securities of a corporation, he does so with certain expectations of its performance, the corporate benefits that may accrue to him, and above all, the prospects of income from, and the possibilities of capital growth of the securities he holds in the firm. At the same time, while he makes an investment decision the investor would have obviously taken note of and evaluated the attendant risks that go with such expectations, especially the possibility of the risk that the income and/ or capital growth may not materialize. This mismatch between the expectations of the investors and the unexpected future outcome in terms of income and/or capital growth arises mainly because their hard earned money is entrusted to managers in a corporation whose investment decisions, apart from carrying certain risk of their own, may not match those of the investors.

Why is Investor Protection Needed?

An appropriate definition of investor protection is very much needed to relate to the corporate governance and to establish the correlation between As stated earlier, when investors finance companies, they take a risk that could land them in a situation in which the returns on their investments would forthcoming because the managers or those whom they appointed to represent not be present them on the board may keep them or expropriate them either covertly or overtly. This kind of betrayal of the investors by the managers or board of directors of the company may shake their confidence, which in the long run would have a deleterious impact on the overall investment climate with serious repercussions on the economic development of the country. The economic parameters of a nation such as output, employment, income, expenditure, and above all, overall economic growth will be badly jeopardized due to declining investment. Therefore, there is a very strong reason to maintain the investors' morale, protect their interests and restore their confidence as and when there is a tendency for investors to lose confidence in the system or when their investments are at stake. Research findings also indicate that when the law and its agencies fail to protect investors, corporate governance and external finance do not fare well. If there is no investor protection, the insiders can easily steal the firm's profits, while when it is good they will find it very difficult to do it.

Relationship between Investor Protection and the Corporate Governance

Various recent research studies have found that an essential feature of good corporate governance is strong investor protection. According to Rafael La Porta et al., 1999 "corporate

governance to a large extent is a set of mechanisms through which outside investors protect themselves against expropriation by the insiders". Expropriation is possible because of the agency problems that are inherent in the formation and structure of corporations. Shareholders or investors of a firm are numerous and scattered and therefore cannot manage it. Hence, they entrust the management of the firm to managers who include the board of directors and senior executives such as the CEO and the CFO. However, managerial actions depart from those required to maximize shareholder returns. Such mismatch of objectives results in the agency problem. Investors do realize and accept to a certain level of opportunistic behaviour in managers. But when such self-indulgence by managers exceeds reasonable limits, principles of corporate governance come in to check such abuses and malpractices. The main premise of corporate governance lies in designing and putting in place, mechanisms such as disclosures, monitoring, oversight and corrective system that we can align with the objectives of the two sets of players (investors and mangers) as closely as possible and minimize the agency problems.

Conflict between Large and Minority Shareholders

In companies where a large shareholding is concentrated in the hands of one or a few shareholders, with the balance dispersed widely among a large number, usually there arise conflicts of interests between the controlling holders and the minority ones. The conflicting interest usually arises from the diversion of earnings to the advantage of the controlling shareholder. While arguments are in favour of large investors so as to influence the managers to improve the efficiencies and force them to distribute more profits among shareholders as widely dispersed shareholders may not be able to do the same, this can lead to conflicts of interest and even to costs for the minority shareholders. In companies where large owners are also in the management, such substantial owners could exploit minority shareholders b warding themselves with higher salaries and benefits like commissions which can result in lesser distributable profits and consequently lesser distribution by way of dividend. Same is the case with many of the Indian companies. And going by rule of ‘One share, one vote’, the minority holders will not be able to make the decisions in their favour. Even if there are major shareholders outside the promoters numbers, like institutional investors, they again might not be able to force many decision because their holding will still be smaller compared to those of the promoter-managers or they might be more keen to protect their own interests. The only avenue open to the minority holder is resort to laws and regulations.

5.8 INTERNATIONAL CORPORATE GOVERNANCE NETWORK

The International Corporate Governance Network CGN in its working kit in Annexure 3.3 has given the detailed framework to achieve good governance as follows:

These are following five assumptions on which the ICGN approach rests.

About shareholder rights :

These are the following five factors that need to be addressed as far as the shareholders are concerned:

I. Shareholders are entitled to be consulted before any major change is implemented to the company's strategic direction as this right affects the risk profile of the business, and shareholders have rights to have their risk profiles respected. Also, the approval of shareholders should be taken before the corporate indulges in anything that is likely to dilute the shareholder equity or erode shareholder economic interests.

II. Shareholder must be provided with adequate access to he able to exercise their right to vote and corporate must provide secure methods to enable the shareholders' voting.

III. The results of voting should be disclosed resolution-wise in a timely manner and votes cast in person or through post or proxy shall he treated alike.

IV. Care should be taken to see that no shareholder enjoys power disproportionate to his/her holding or the 'one share, one vote' system be followed.

V. Institutional shareholders must exercise their vote, subject to the costs, as it is a fiduciary responsibility.

Equitable treatment of shareholders: ICGN recognizes the 'one share, one vote' principle as the best way to enable the capital markets to grow and hence agree that markets that do not recognize this principle will be disadvantaged. 'One share, one vote' prevents any differential treatment of shareholders, especially the minority and foreign shareholders.

The role of stakeholders: ICGN assumes that boards are accountable to shareholders and are responsible to interact with all stakeholders in their pursuit of creating wealth, employment and financially sustainable companies over a period of time. ICGN also assumes that there is a need to align both shareholder and stakeholder interests and is enabled to a very large extent by performance enhancing mechanisms like employee share ownership plans and profit sharing plans.

Disclosure and transparency: While disclosure of financial and operating results, risk factors, stakeholder issues, and governance structure and procedures are necessary, disclosure of information such as major shareholders, special voting rights, shareholder agreements, dominant shareholders cross-holdings if any, guarantees provided by the company, related party transactions etc. must also be provided. Also, details of the directors, their remunerations, any transaction with the company other than that as a board member, etc., shall be disclosed details of auditors and the fees paid and also, whether they have been paid fees for any non-audit related work must be disclosed.

The board responsibility: ICGN emphasizes the fiduciary responsibilities of the board and hence expects the board as an entity and the directors as individuals being accountable to the shareholders as a whole. The board must have enough independent components with appropriate competencies and should contribute to the strategy and performance of the management, and also be responsible for constituting key committees with the right kind of skills and talents. ICGN endorses the OECD Principles fully on the independence aspect. It also suggests that committees should he composed wholly or predominantly of independent, non executive directors.

Criticism about the ICGN's approach is that it does not provide for any directives for chairpersons, CEOs and other directors to handle their jobs effectively.

5.9 SUMMARY

The success of modern enterprises depends on the adoption and implementation of good management practices that inter alia seek to protect the interests of stakeholders. Sound corporate governance practices help companies to improve their performance and attract investment while enabling them to realize their corporate objectives, protect shareholder rights, meet legal requirements, and demonstrate to a wider public how they are conducting their business. Observing the importance of corporate governance, it is important to identify key agents-external as well as internal-so as to make all of them to ensure the corporate governance at place.

5.10 SELF –ASSESSMENT EXERCISE

Fill in the blanks for the following statements:

a). Sound …….practices help companies to improve their performance and attract investment while enabling them to realize their corporate objectives

b). According to Mahatma Gandhi, "…….are the sole purpose for which the corporation exists'

c). A major issue in the management and governance of a corporate entity is of the wealth of a corporation is ……..from ownership.

d). In context to corporate governance, accountability refers to the accountability towards the shareholders as it is the basic premise of ……duty of the directors.

e). According to the author Shultz, "Strategic boards validate good decisions and a board is there to help the CEO succeed as well as to provide……".

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5.13 ANSWERS TO SELF –ASSESSMENT EXERCISE

These are the answers for the self-assessment exercise as follows:

a). Corporate governance

b). Customers

c). Divorced

d). Fiduciary

e). Policy input

5.14 MODEL QUESTIONS

Q1). "Shareholders are the backbone of any corporation". What is there role in effective governance practices? Describe.

Q2). Critically analyze the role of external agents in ensuring corporate governance at place.

Q3). Who are the internal agents of corporation? What is there role in Corporate Governance? Describe.

Q4). Describe the role of shareholders in ensuring good governance practices.

Q5). “Directors have the important role in ensuring Corporate Governance”. Do you agree or not? Support your position.

Q6). To what extent the managers are able to ensure Corporate Governance in India? Describe.

Q7). “Board has fiduciary duties towards its company and its shareholders”? What kind of duties these are? Explain in detail.

Q8). What is the dilemma between the role of mangers and role of director? Describe citing relevant examples.

LESSON-6

CORPORATE SOCIAL RESPONSIBILITY

STRUCTURE OUTLINE

6.1 Objectives

6.2 Introduction

6.3 CSR as a Concept

6.4 Meaning and Definition of Corporate Social Responsibility

6.5 Drivers of CSR in India

6.6 The Principles of CSR

6.7 Scope of CSR

6.8 Justification of CSR

6.9 What Corporates should follow CSR?

6.10 Private Sector needs Goodwill of The Society

6.11 Social Responsibility and Indian Corporations

6.12 Summary

6.13 Self –Assessment Exercise

6.14 Bibliography

6.15 Suggested Readings

6.16 Answers to Self –Assessment Exercise

6.17 Model Questions

6.1 OBJECTIVES

After reading the lesson/unit, the learner will be able to:

- To know about the meaning of Corporate Social Responsibility
- Discuss the significance of Corporate Social Responsibility
- Describe the relationship of Corporate Social Responsibility (CSR) with corporate governance.
- To get the idea about the scope and principles of CSR.
- Understand the provisions of Companies Act, 2013 regarding CSR.
- To know the status of Indian Corportaes and CSR initiatives.

6.2 INTRODUCTION

In academic debates and business environments hundreds of concepts and definitions have been proposed referring to a more humane, more ethical, more transparent way of doing business. This point in time is an important if not critical moment in the development process of new generation business frameworks facilitating sustainable growth. Corporate social responsibility had been a voluntary activity in which corporates like ITC, Wipro, House of Tatas group of companies as well as many others hale on their own invested for social development of the community/local areas before the Companies Act, 2013 but afterwards, Corporate Social Responsibility (CSR) has been made mandatory living the scope of doing it voluntarily. It is important to mention that India is the only country where CSR code has been mandatory, and it has found that in its debut, top 100 companies like Reliance, Tata have spent around 5240 crore in FY 2015 on CSR activities. (Top 100 cos spent Rs 5,240 crore on CSR activities in FY15: Study). These are the some Indian Corporates as mentioned above which are giving something back to the society while continuing with their business.

CSR is based on the assumption that it is a productive activity, it pays dividend in the form of good employees and management relationship, high output and workers belongingness to the company. Companies are doing CSR with active support of their shareholders and the board of

directors' decision. So, CSR involves the overall organization that includes every stakeholders of the organization.

While talking this CSR, it is important to point out that CSR is not divorced from corporate governance. Both, CSR and corporate governance are part and parcel of organizational functioning. CSR and corporate governance are inter-linked with each other. When business organizations exploit the natural resources, it is only natural to expect that the business organization will, in return, give good governance to the society.

Effective CSR results in satisfaction in all stakeholders of the business operations. This fact has been established on the basis of experiences of reputable Indian enterprises which have invested in CSR. In case of employees, good quality of life brings high productivity. When the employer is committed to ethical values, it inculcates ethical values in all its operational activities. Every staff member is also committed towards such ethical practices. Satisfied staff will contribute best performance which is reflected in high output on continuous basis. In totality, the good governance is reflected in high dividend to the shareholders of the company. The commitment of business organizations towards CSR gives a clear indication to the all stakeholders, that in all the decisions on business operations the company takes into consideration its social responsibilities towards the society. The stakeholder term is an umbrella term which includes the employees, suppliers, consumers, customers, investors, shareholders, creditors, regulators as well as the society at large. By investing in CSR, business enterprises are actually investing in long term success.

6.3 CSR AS A CONCEPT

Some researchers view CSR as a concept. But, it is not a mere concept, but, it is a subject of practical relevance to business organizations. This is why; so many organizations are investing in CSR as it impacts the business performance. It is interlinked and integrated with a company's corporate governance practices. According to Gobbels (2002), Votaw and Sethi (1973) considered social responsibility a brilliant term: "it means something, but not always the same thing to everybody". Too often, CSR is regarded as the panacea which will solve the global poverty gap, social exclusion and environmental degradation. Employers' associations emphasize the voluntary commitment of CSR. Also various management disciplines have

recognized that CSR fit their purposes, such as quality management, marketing, communication, finance, HRM, and reporting.

According to Quazi and O'Brien, 2000, "the social responsibility of business is to increase its profits" (Friedman, 1962). The shareholder, in pursuit of profit maximization, is the focal point of the company and socially responsible activities don't belong to the domain of organizations but are a major task of governments. This approach can also be interpreted as business enterprises being concerned with CSR "only to the extent that it contributes to the aim of business, which is the creation of long-term value for the owners of the business" (Foley, 2000).

The stakeholder approach indicates that organizations are not only accountable to its shareholders but should also balance a multiplicity of stakeholders' interests that can affect or are affected by the achievement of an organization's objectives (Freeman, 1984).

According to the societal approach, companies are responsible to society as a whole, of which they are an integral part. They operate by public consent (license to operate) in order to "serve constructively the needs of society – to the satisfaction of society".

In India, ever since around the mid twentieth century, large corporate bodies well as the PSUs have been giving due importance to CSR on the ground that since their business exists in a community environment and the business derives the benefits of natural resources in the place of their location, so they owe their existence to the society where the operations exist. Hence, these organizations compensate this duty by doing certain kinds of CSR activities.

Earlier economists like Adam Smith as well as Milton Friedman thought that the purpose of business was to produce goods and services efficiently for the society and earn profits. In their opinion social aspects were the responsibility of other institutions. This was a materialistic view and has been contradicted by thinkers like Paul Samuelson, Robert Dahl and Talcott Parson, who thought that social responsibility was inherent and integral part of business of modern society. Business is a part and parcel of the society to the extent that it is the primary purpose to serve the interests of the society. The government alone also cannot be supposed to be responsible for promoting the welfare measures of the masses. It is therefore, the responsibility of the corporate to assume the responsibility of social development of the areas they are located. When factories harness the natural resources of the environment where they are located it is their responsibility

to give to the society what they ought to, they cannot expect to harness the natural resources on on-going basis and without giving something back towards the development of the society.

To quote the case of Union Carbide located in Bhopal, Madhya Pradesh which just failed and has suffered losses to the extent of closure of the business because the company failed to honor its responsibility to maintain safe working conditions in the factory. Gas leak caused havoc in the plant and around Bhopal city. Lakhs of staff members and other local people suffered for their whole life due to the poisonous air coming out of the factory. The CEO faced legal consequences against the Union Carbide both in India and in the USA for violating its basic responsibility to provide safety and security of life of its employees, besides causing serious damages to the environment. The company has lost its name all across the world. The multinational company has lost its goodwill and brand image among all its stakeholders.

6.4 MEANING AND DEFINITION OF CORPORATE SOCIAL RESPONSIBILITY

The broadest definition of corporate social responsibility is concerned with focuses on the relationship between global corporations, governments of countries and individual citizens. More specific and locally the definition is concerned with the relationship between a corporation and the local society in which it resides or operates. Another definition is concerned with the relationship between a corporation and its stakeholders.

According to Lord Holme and Richard Watts, “corporate social responsibility can be defined as a continuous ownership/commitment by a business enterprise to observe ethical practices in all their dealings in the course of the business and also contribute to develop the society where it is located, and thereby it is committed to improve the quality of life of all their staff/workers and their family, including the local community where it carries on its business operations”.

This definition is extensive and covers all sort of stakeholder of a company as well as the environment where a business operation takes place.

According to the definition of ***world business council for sustainable development***, "Corporate Social Responsibility is the continuing commitment by business to contribute to economic development while improving the quality of life of the workforce and their families as well as of the community and society at large."

CSR "analyses economic, legal, moral, social and physical aspects of environment" (***Barnard, 1938***).

CSR has been defined as "the obligations of business to pursue those policies, to make those decisions or to follow those lines of action which are desirable in terms of the objectives and values of our society ***(Bowen, 1953)***."

According to the EU Commission, 2002 "CSR is a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis."

CSR refers to conduct the affairs of the enterprise to maintain an equitable and workable balance among the claims of the various directly interested groups, a harmonious balance among stockholders, employees, customers, and the public at large ***(Frederick, 2006***).

This can be observed from the definitions that CSR focuses on the social responsibility of business towards its all the stakeholders, and it is integral and pertinent for the business operation.

6.5 DRIVERS OF CSR IN INDIA

There are several factors which have provided incentive for CSR to have prospered in Indian context. These factors are explained as below:

- Expectations of different stakeholders of organizations have forced industrial organizations to invest on CSR activities.
- Change in the social criteria for investments by the domestic as well as foreign investors.
- Emerging concern to save the environment.
- Revolution created by information technology and telecommunication platform for discussing such issues.
- Concern of employers to create goodwill and brand image with the customers and the public/community at large.

- Deeper understanding among investors that CSR is contributory to high output and satisfaction of staff.

- International committees on corporate governance require companies to publish in their annual reports, details of the measures taken by the company for prevention of pollution as well as protection of the environment. Many organizations have defined their policy on protection of environment.

- Emergence of new learning among entrepreneurs that promoting resource preservation through reduction of waste and maximization of resources for improving profits ought to be the goal.

- The concern to maintain good relationship with local community as well as the regulatory authorities.

- Rising awareness among managers for observing the environmental issues.

Although when it has been made mandatory for the companies to spend for CSR activities, there is no need to discuss about the incentives that are motivating the Indian companies to invest in CSR. But, there are number of companies like Infosys, Tata and others which are doing more than the requirement. For them, CSR is indispensable and integral part of business. For companies like them, the above discussed are the incentives for the corporate for CSR activities.

6.6 THE PRINCIPLES OF CSR

Because of the uncertainty surrounding the nature of CSR activity, it is therefore imperative to be able to identify the basic principles which together comprise all CSR activity. These are:

- Sustainability
- Accountability
- Transparency

These are explained as below:

Sustainability

This is concerned with the effect which action taken in the present has upon the options available in the future, and it is the ability to survive in the future. If resources are utilized in the present then they are no longer available for use in the future, and this is of particular concern if the resources are finite in quantity. Thus raw materials of an extractive nature, such as coal, iron or oil, are limited and once used are not available for future use. At some point in the future therefore alternatives will be needed to fulfill the functions currently provided by these resources. This may be at some point in the relatively distant future but of more immediate concern is the fact that as resources become depleted then the cost of acquiring the remaining resources tends to increase, and hence the operational costs of organizations tend to increase.

Viewing an organization as part of a wider social and economic system implies that these effects must be taken into account, not just for the measurement of costs and value created in the present but also for the future of the business itself. Measures of sustainability would consider the rate at which resources are consumed by the organization in relation to the rate at which resources can be regenerated. Unsustainable operations can be accommodated for either by developing sustainable operations or by planning for a future lacking in resources currently required. In practice organizations mostly tend to aim towards less unsustainability by increasing efficiency in the way in which resources are utilized.

Accountability

This is concerned with an organization recognizing that its actions affect the external environment, and therefore assuming responsibility for the effects of its actions. This concept therefore implies a quantification of the effects of actions taken, both internal to the organization and externally. More specifically the concept implies a reporting of those quantifications to all parties affected by those actions. This implies a reporting to external stakeholders of the effects of actions taken by the organization and how they are affecting those stakeholders.

This concept therefore implies that the organization is part of a wider societal network and has responsibilities to that all external agents rather than just to the owners of the organization. Moreover, it must be accepted well that the external stakeholders have the power to affect the way in which the actions of the organization are taken and a role in deciding whether or not such actions can be justified, and if so at what cost to the organization and to other stakeholders.

Accountability therefore necessitates the development of appropriate measures of environmental performance and the reporting of the actions of the firm. This necessitates costs on the part of the organization in developing, recording and reporting such performance and to be of value the benefits must exceed the costs. Benefits must be determined by the usefulness of the measures selected to the decision-making process and by the way in which they facilitate resource allocation, both within the organization and between it and other stakeholders. Such reporting needs to be based upon the following characteristics:

- Understandability to all parties concerned
- Relevance to the users of the information provided
- Reliability in terms of accuracy of measurement, representation of impact and freedom from bias
- Comparability, which implies consistency, both over time and between different organizations.

Inevitably however such reporting will involve qualitative facts and judgments as well as quantifications. This qualitative measurement will inhibit comparability over time and will tend to mean that such impacts are assessed differently by different users of the information, reflecting their individual values and priorities.

A lack of precise understanding of effects, coupled with the necessarily judgmental nature of relative impacts, means that few standard measures exist. This in itself restricts the inter-organization comparison of such information. Although this limitation is problematic for the development of environmental accounting it is in fact useful to the managers of organizations as this limitation of comparability alleviates the need to demonstrate good performance as anything other than a semiotic.

Transparency

Transparency, as a principle, means that the external impact of the actions of the organization can be ascertained from that organization's reporting and pertinent facts are not disguised within that reporting. Thus all the effects of the actions of the organization, including external impacts, should be apparent to all from using the information provided by the organization's reporting mechanisms. Transparency is of particular importance to external users of such information as

these users lack the background details and knowledge available to internal users of such information. Transparency therefore can be seen to follow from the other two principles and equally can be seen to be a part of the process of recognition of responsibility on the part of the organization for the external effects of its actions and equally part of the process of transferring power to external stakeholders.

6.7 SCOPE OF CSR

Although CSR pertains to whole set of external elements of environment, the scope of CSR extends to the following areas as explained below:

- To maintain ecological balance.
- Protection of interest of the human capital.
- Address the social issues of the community living in the area.
- Promote peoples' welfare programmes, including education and learning programmes for children and adults-both female and male.
- Engage in philanthropic activities.
- Women empowerment and activities related to it.
- Eradicating hunger, poverty and malnutrition
- Promoting preventive healthcare, promoting education and promoting gender equality
- Setting up homes for women, orphans and the senior citizens
- Measures for reducing inequalities faced by socially and economically backward groups
- Ensuring environmental sustainability and ecological balance,
- Animal welfare, protection of national heritage and art and culture,
- Measures for the benefit of armed forces veterans, war widows and their dependents,
- Training to promote rural, nationally recognized, Paralympic or Olympic sports,

- Contribution to the prime minister's national relief fund or any other fund set up by the Central Government for socio economic development and relief and welfare of SC, ST, OBCs, minorities and women, contributions or funds provided to technology incubators located within academic institutions approved by the Central Government and rural development projects.
- Provide social services.
- Promotion and protection of interest of all stakeholders.
- Comply with rules and regulations as good corporate citizens.
- Provide good governance in the company.
- Support governmental initiatives/provisions efficiently to make the organization a strictly law abiding enterprise.

According to Companies Act, 2013, determining CSR activities to be undertaken, preference must be given to local areas and the areas around where the company operates. To formulate and monitor the CSR policy of a company, a CSR Committee of the Board needs to be constituted. Section 135 of the 2013 Act requires the CSR Committee to consist of at least three directors, including an independent director. However, CSR Rules exempts unlisted public companies and private companies that are not required to appoint an independent director from having an independent director as a part of their CSR Committee and stipulates that the Committee for a private company and a foreign company need have a minimum of only 2 members.

A company can undertake its CSR activities through a registered trust or society, a company established by its holding, subsidiary or associate company or otherwise, provided that the company has specified the activities to be undertaken, the modalities for utilization of funds as well as the reporting and monitoring mechanism. If the entity through which the CSR activities are being undertaken is not established by the company or its holding, subsidiary or associate company, such entity would need to have an established track record of three years undertaking similar activities.

Companies can also collaborate with each other for jointly undertaking CSR activities; provided that each of the companies is able individually report on such projects.

Many global multinational business enterprises such as, General Motors, Ford Motors, General Electric, Microsoft, McDonalds have sponsored many philanthropic activities and social welfare programmes. Bill Gates is one of the few billionaires who have invested heavily in India on education and health related progarmmes in the state of Bihar. Indian companies, such as, TISCO, TELCO, BHEL, Infosys, ITC are also doing commendable work in this field.

6.8 JUSTIFICATION OF CSR

Social scientists have formulated several theories that justify the importance of corporates engaged in promoting social welfare of the society in which they operate. These theories are given below.

Trusteeship Model

The Trusteeship Model adopts a realistic and descriptive perspective in viewing the current governing situation of a publicly held corporation as a social institution with a corporate personality.

The authors established that a public corporation is not the creation of a private contract and thus not owned by any individual (Kay and Silberston, 1995). Ownership is by definition where the owner has exclusive rights of possession, use, gain and legal disposition of a material object. ***Though shareholders own their shares in a company and trade their shares with others in the stock market, they do not have rights to possess and use the assets of the company to make decision about the direction of the company and to transfer the assets of the company to others.*** The residual claims of the shareholders are determined by the company and if the company's performance does not satisfy the shareholders' requirements, the shareholders are left with a single option of "exit" rather than “voice” as shareholders in general are in no way ably to monitor the management effectively and neither are they interested in running corporate business. In this sense, the assumption that the corporation is owned by the shareholders is in fact no a valid one. It has been observed that ownership rights are not important to business. Many

public institutions such as museums, universities, and libraries perform well without clear owners.

Indeed, Company Law does not explicitly grant shareholders ownership rights because the corporation is regarded as an independent legal person separate from its members, and shareholders are merely the "residual claimants" of the corporation. The company has its own assets, rights and duties, and has own its will and capacity to act and is responsible for its own actions. Therefore, the argument- that managers are the agents of shareholders-is not a valid one. Instead, they suggest that ***managers are trustees of the corporation***.

The trusteeship model differs from the agency model in two ways: First, the fiduciary duty of the trustees is to sustain the corporation's assets, including not only the shareholder's wealth, but also broader stakeholders' value such as the skills of employees, the expectations of customers and suppliers, and the company's reputation in the community. ***Managers as trustees are to promote the broader interests of the corporation as a whole, not solely the financial interest of its shareholders.*** Second, managers have to balance the conflicting interests of current and future stakeholders and to develop the company's capacities in a long-term perspective rather than focus on short-term shareholder gains.

The Social Entity Theory

The social entity theory has, in recent years, been promoted by three major social thinkers-the democratic political theorist, Robert Dahl (1985) using economic democracy, Paul Hirst (1994) using associationalism, and Jonathan Boswell (1990) using communication notion of property. The social entity conception of the corporation regards the company not as a private association united by individual property rights, but as a public association constituted through political and legal processes and as a social entity for pursuing collective goals with public objections. The theory views the corporation as a social institution in society based on the grounds of fundamental and moral values. With the fundamental value of human rights and standard of a corporation's usefulness is not whether it creates individual dignity and promoting over all welfare." The corporation identity and executives are representatives and guardians of all corporate stakeholders' interests (Hall, 1989).

The Pluralistic Model

The pluralistic model supports the idea of multiple interests of stakeholders, rather than shareholder interest alone. It argues that the corporation should serve and accommodate wider stakeholder interests in order to make the corporation more efficient and legitimate.

It suggests that corporate governance should not move away from ownership rights, but that such rights should not be solely claimed by, and thus concentrated in, shareholders; ownership rights can also be claimed by all other stakeholders like employees, creditors, consumers and suppliers to name a few. Stakeholders who make firm specific investments and contributions and bear risks in the corporation should have residual claims and should participate in the corporate decision making to enhance corporate efficiency.

It has been observed that if corporations practice stakeholder management, their performance such as profitability, stability and growth will be more successful.

6.9 WHAT CORPORATES SHOULD FOLLOW CSR?

In support of the view that corporates have a moral and social obligation towards society, some economists argue that corporates depend on society for a number of facilities they enjoy such as developed infrastructure, peace and tranquility in the work place and a trained workforce. They also depend on society for the maintenance of law and order, without which they cannot carry on their productive or distributive activities, and also for reaching to their customers through mass media. Consumers of products, without whom they have no reason for existence, are all drawn from society. If a business body draws so much from society, it has to make its own contribution to the welfare of the latter. It has a debt to pay in the first place. It has to behave as a good citizen to the extent that it has to pay its taxes in full and on time, observe the laws of the land and, going beyond it, ensure a clean and healthy environment, standards of operational and product safety and help in energy and resource conservation.

The corporations among the business community also have a moral responsibility to take a long and hard look at their values, practices and assumptions. They have to ensure that the country's fair name and its image is not compromised abroad during their deals, either as exporters or importers. They have to ensure maintenance of the quality of their products, keeping up to the delivery schedule, etc. In the Indian context, socially responsible corporates are expected to create employment opportunities directly and set up ancillaries for the disadvantaged persons; provide financial resources in several ways such as financing customer related marketing; by

sharing skills in marketing, technical and management areas in many ways; make available marketing support both by purchasing products and services from disadvantaged communities; and by sharing, company facilities of ,donating company's products and services.

6.10 PRIVATE SECTOR NEEDS GOODWILL OF THE SOCIETY

Private enterprise is not favoured much in countries like ours because its owners accumulate wealth for their own exclusive benefit at the expense of the public and are not generally seen to contribute to the common good. Corporates should, for their own good, come forward to erase such perception in the minds of the common public. In an era of intense competition, accentuated by the advent of MNCs, it is necessary for them to generate and sustain “goodwill” among their clients and the general public. Active participation in social welfare projects will definitely improve their visibility and place them on a pedestal of public esteem. They should understand the fact that economic goals and social responsibility objectives need not be contradictory to each other and that these could be achieved simultaneously. They should donate generously towards public causes and must get themselves directly involved in social welfare programmes, if they have to create goodwill among the public and to avoid being branded as profiteers and self-seekers.

6.11 SOCIAL RESPONSIBILITY AND INDIAN CORPORATIONS

The corporates are now reaching out to the community not only in India but all across the globe. The Philanthropy is no longer limited to signing cheques for social causes and welfare activities. The commitment is getting much deeper as a large section of employees, including the members of the top management, are now doing something for the causes close to their heart.

According to Sunil Rajshekhar of Times Foundation, "Corporate contribution earlier was limited to financial donations. This is giving way to more holistic approach as employees are now getting involved and companies like GE, Tata, and Infosys etc. encourage their employees to give back to communities who sustain their business".

More companies are joining hands with NGOs to set up labs, adopt schools and even villages, educate kids and women in slums, and start welfare programmes for cancer and AIDS patients. At GE, for instance, the initiative runs right from the top, and he finds satisfaction in his

endeavour to develop confidence among young school drop-outs and help restart their education and help them gain skills for employment. According to CEO of GE, "About 60 of our employees are involved in voluntary programmes and at least 30 of these are very active. GE has implemented many such initiatives globally".

Indian industry is also equally aggressive in its drive to being socially responsible. North Delhi Power Ltd. (NDPL), a joint-venture of Tata Group and the Delhi government, has joined hands to help out AIDS patients and improve awareness in industrial areas of Naraina.

The attempt to pay back the communities who sustain one's businesses are proving to be an effective HR measure too. Hewlett Packard's subsidiary, Agilent, boasts of an attrition level of about 8 compared to over 30 seen by competitors and attributes it to their employees' satisfaction level achieved from social causes. According to Managing Director, Agilent India, "People really feel good about it. It's easy for people to donate money and clothes, but actually working for society shows how we can make a difference. It might sound tough initially but soon becomes more like a habit and slowly takes the shape of a movement."

A large number of Indian companies discharge their social responsibilities quite satisfactorily. There are many companies which have excelled in such activities but when seen in the light of the country's vast needs, the achievements fall short of requirements. The money spent for social causes by companies is generally an insignificant proportion of their turnover. These are the highlights of the different social responsibility functions that Indian companies typically perform:

- ✓ BHEL has contributed to the development of the quality of life in rural areas, health care and family welfare, adult education etc.
- ✓ Asian Paints funded a large-scale community development project to enable farmers to use local resources effectively.
- ✓ Brooke Bond has been interested in animal welfare, providing veterinary services and improvements in animal breeding.
- ✓ Colgate Palmolive did pioneering work in the promotion of sports, dental health and small industry development.

- ✓ Escorts Ltd. has worked for farm mechanization, agricultural development, health care, etc.
- ✓ Infosys Technologies has helped through its Infosys Foundation schools in rural areas acquire classrooms, libraries and buildings. It has also helped higher education and research. It has promoted several public health programmes too.
- ✓ ITC Ltd. is socially active in the areas of agriculture, culture, sports and pollution control.
- ✓ SAIL contributes to the sectors of agriculture, industry, education, health care, dairy, poultry, fisheries, and drinking water supply.
- ✓ Tata Steel has been a pioneer in discharging social responsibility and has made several contributions in areas such as community development, social welfare, tribal area development, agriculture and related activities, rural industrialization etc.

Although there is no end to the story of CSR activities and It is the only country-India-that has initiated to make mandatory provisions regarding CSR activities.

6.12 SUMMARY

CSR has become the byword of the socially conscious corporate world. Only an infinitesimally small number of companies remain untouched by the ever-increasing importance of CSR. Even those corporations that are overwhelmingly guided by the profit motive have now realized that if they do not appear to give hack to society whit they have received from it in terms of trained manpower, material and other physical resources, they cannot justify their existence and future growth. This is a strong enough reason and justification as to why an ever-increasing number of corporations are investing both its human and material resources in various CSR activities. Moreover, this appreciation has also prompted many of them to integrate their CSR activities into their business practices. CSR is no more a stand-alone philanthropy, but a part and parcel of business strategy. As far the initiatives from the regulatory authorities are concerned, Companies Act, 2013 has made mandatory provisions regarding CSR activities.

6.13 SELF –ASSESSMENT EXERCISE

Fill in the blanks for the following statements:

a). When business organizations exploit the natural resources, it is only natural to expect that the business organization will, in return, give ……..to the society.

b). Many organizations are investing in CSR as it impacts the business…….

c). The stakeholder approach indicates that organizations are not only accountable to its shareholders but should also balance a multiplicity of ……that can affect or are affected by the achievement of an organization's objectives.

d). Transparency is of particular importance to external users of such information as these users lack the background details and knowledge available to ……..of such information.

e). Active participation in social welfare projects will definitely improve their …….and place them on a pedestal of public esteem.

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6.16 ANSWERS TO SELF –ASSESSMENT EXERCISE

These are the answers for the self-assessment exercise as follows:

a). Good governance

b). Performance

c). Stakeholders' interests

d). Internal users

e). Visibility

6.17 MODEL QUESTIONS

Q1). What is corporate social responsibility? Explain why there are conflicting perspectives on the subject.

Q2). If CSR is an essential feature of modern businesses, why do economists like Milton Friedman think otherwise?

Q3). Explain the Trusteeship Model of CSR.

Q4). For long, CSR was equated with the concept of corporate philanthropy. How and why do modern thinkers differ from this view?

Q5). Discuss the scope of CSR with suitable illustrations.

Q6). To what extent is CSR being practised in India? Give examples. Do you think Indian corporates adequately give back to society compared to what they have received from it?

Q7). Describe the principles of corporate social responsibility.

Q8). To what extent, Indian Corportaes are engaged in CSR activities? Describe.

Q9). What are the provisions of Companies Act, 2013 for CSR activities? Describe.

LESSON-7

ACCOUNTABILITY OF MANAGERS AND STOCKHOLDERS

STRUCTURE OUTLINE

7.1 Objectives

7.2 Introduction

7.3 Duties of Managers

7.4 Enforcing Managers' Duties

7.5 Mechanism to Enforce Stockholders' Accountability

7.6 Summary
7.7 Self –Assessment Exercise
7.8 Bibliography
7.9 Suggested Readings
7.10 Answers to Self –Assessment Exercise
7.11 Model Questions

7.1 OBJECTIVES

After reading the lesson/unit, the learner will be able to:

- To know about to define the duties of mangers in promoting Corporate Governance
- To describe how mangers can be enforced towards their duties.
- Discuss how stockholders' accountability can be enforced in enforcing corporate Governance practices.

7.2 INTRODUCTION

All stakeholders to corporate governance have an interest, whether direct or indirect, in the financial performance of the corporation. Directors, workers and management receive salaries, benefits and reputation, while investors expect to receive financial returns. For lenders, it is specified interest payments, while returns to equity investors arise from dividend distributions or capital gains on their stock. Customers are concerned with the certainty of the provision of goods and services of an appropriate quality; suppliers are concerned with compensation for their goods or services, and possible continued trading relationships. These stakeholders provide value to the corporation in the form of financial, physical, human and other forms of capital. Many parties may also be concerned with corporate social performance.

A key factor in a party's decision to participate in or engage with a corporation is their confidence that the corporation will deliver the expected outcomes of different stakeholders. When stakeholders do not have sufficient confidence that a corporation is being controlled and directed in a manner consistent with their desired outcomes, they are less likely to engage with the corporation. When this becomes an endemic system feature, the loss of confidence and participation in markets may affect many other stakeholders, and increases the likelihood of political action. There is substantial interest in how external systems and institutions, including markets, influence corporate governance.

It has been explained in detail that corporate governance deals with the set of rules by which the company is governed. Although, it the matter of conscience for the company's Board of directors, Managers and Employees to promote the corporate governance at place, but regulators, Government, Rating Agencies, Media and Press also force the company to act in a very disciplined manner. In this lesson, mechanism to enforce these managers and stockholders towards their duties has been discussed in detail.

7.3 DUTIES OF MANAGERS

Senior management with CEO runs the corporation's day-to-day business operations. Hence, it is the responsibility of senior managers under the CEO's direction, to operate the corporation in an effective and ethical manner.

- The managers should be aware of the major risks and issues that the corporation faces and is responsible for supervising the corporation's financial reporting processes. For example, the managers are responsible for providing stockholders and others with the necessary information that the managers believe is important to understanding the corporation's business. Of course, the managers necessarily rely on the expert advice of others on technical questions and legal requirements.
- As part of its operational responsibility, senior management is charged with:
  - **Operating the corporation:** The CEO and senior management run the corporation's day-to-day business operations. With a thorough understanding of how the corporation operates and earns its income, they carry out the corporation's strategic objectives within the annual operating plans and budgets reviewed by the board.
  - **Strategic planning:** The CEO and senior management generally take the lead in strategic planning. They identify and develop strategic plans for the corporation; present those plans to the board; implement the plans once board review is completed; and recommend and carry out changes to the plans as necessary.
  - **Annual operating plans and budgets:** With the corporation's overall strategic plans in mind, senior management develops annual operating plans and annual budgets for the corporation, and the CEO presents those plans and budgets to the board. Once board review is completed, the management team implements the annual operating plans and budgets.

- **Selecting qualified management and establishing an effective Organizational structure:** Senior management is responsible for selecting qualified management and for implementing an organizational structure that is efficient and appropriate for the corporation's particular circumstances.
- **Identifying and managing risks:** Senior management identifies and manages the risks that the corporation undertakes in the course of carrying out its business. It also manages the corporation's overall risk profile.
- **Good financial reporting**: Senior management is responsible for the integrity of the corporation's financial reporting system. It is senior management's responsibility to put in place and supervise the operation of systems that allow the corporation to produce financial statements that fairly present the corporation's financial condition and thus permit investors to understand the business and financial soundness and risks of the corporation.

- The CEO and senior management are responsible for operating the corporation in an ethical manner. They should never put individual, personal interests before those of the corporation or its stockholders.

7.4 ENFORCING MANAGERS' DUTIES

As defined and explained in previous lessons, the articulation of a 'fiduciary' duty is necessary for investors to be secure that their rights will be protected. It must be taken care by law or any other mechanism. The 'fiduciary' duty concept is a critical tool for courts, or whoever adjudicates matters relating to investor protection. Any country seeking to assure investors that their rights will be protected must have some form of 'fiduciary duty' embodied in its enforcement system. The fiduciary duty is the foundation stone by which to adjudicate manager and director actions that impact investors- actions that often fall within the gaps and ambiguities of incomplete law. If a country's legal and regulatory system doesn't yet articulate that duty, either explicitly or implicitly, it should do so, or its system is truly incomplete.

Fiduciary duties embody the notion of how and in whose interest managers and directors are supposed to act, set the standard by which director and managers actions are to be judged so as to provide a basis for the enforcement of investor rights under any system of law.

Fiduciary duties only gain meaning when shareholders can hold directors and managers who breach these duties responsible. And holding directors and managers responsible requires that there be a forum in which investors can enforce those rights.

The second most important dimension in this regard is 'enforcement'. In many developing countries, effective institutions for the enforcement of shareholder rights don't exist. If those countries seek global capital, they require effective legal institutions capable of enforcing investor rights, wherever they do not exist.

Given the need for capital in developing economies, what can be done in the meantime? How can companies in developing countries assure investors that their rights will be protected, especially where law, regulators, and related institutions are absent or weak? Unfortunately, there is no easy answer, and there is no one shot solution. So, alternative mechanism must be explored by which countries and companies can fill the gaps in their enforcement of investor rights. Obviously there should be some official governmental body to enforce a system so as to protect shareholders' rights. No regulatory body can possibly reach all directors and managers who improperly impinge on shareholder rights-regulators don't have the resources to do so. And further, in the U.S. breaches of fiduciary duties-care, loyalty, candor and good faith-all are matters which are generally enforced through derivative and class action law suits by investors who have been harmed. Thus, not only securities and company law, but the enforcement of that law-whether by regulators, courts or otherwise-is often incomplete.

7.5 MECHANISM TO ENFORCE STOCKHOLDERS' ACCOUNTABILITY

Many publicly traded companies have a large controlling shareholder. While the presence of a controlling shareholder can reduce the agency problem by closer monitoring of management, weaknesses in the legal and regulatory framework may lead to the abuse of other shareholders in the company. The potential for abuse is marked where the legal system allows, and the market accepts, controlling shareholders to exercise a level of control which does not correspond to the level of risk that they assume as owners through exploiting legal devices to separate ownership from control, such as pyramid structures or multiple voting rights. Such abuse may be carried out in various ways, including the extraction of direct private benefits via high pay and bonuses for employed family members and associates, inappropriate related party transactions, systematic

bias in business decisions and changes in the capital structure through special issuance of shares favouring the controlling shareholder. In addition to disclosure, a key to protecting minority shareholders is a clearly articulated duty of loyalty by board members to the company and to all shareholders. Indeed, abuse of minority shareholders is most pronounced in those countries where the legal and regulatory framework is weak in this regard. A particular issue arises in some jurisdictions where groups of companies are prevalent and where the duty of loyalty of a board member might be ambiguous and even interpreted as to the group. In these cases, some countries are now moving to control negative effects by specifying that a transaction in favour of another group company must be offset by receiving a corresponding benefit from other companies of the group.

Other common provisions to protect minority shareholders, which have proven effective, include pre-emptive rights in relation to share issues, qualified majorities for certain shareholder decisions and the possibility to use cumulative voting in electing members of the board. Under certain circumstances, some jurisdictions require or permit controlling shareholders to buy-out the remaining shareholders at a share-price that is established through an independent appraisal. This is particularly important when controlling shareholders decide to de-list an enterprise. Other means of improving minority shareholder rights include derivative and class action law suits. With the common aim of improving market credibility, the choice and ultimate design of different provisions to protect minority shareholders necessarily depends on the overall regulatory framework and the national legal system. These mechanisms are explained in detail as follows:

Class Actions

When shareholders suffer damages from the corporations in which they hold shares, they can pursue one of two legal remedies. The shareholders can bring a class-action suit, in which multiple plaintiffs belonging to a defined ‘class’ join in a suit against defendants seeking compensation for similar damages. They can also bring a shareholder derivative lawsuit, in which shareholders sue company management on behalf of all shareholders. The main objective of class-action lawsuits is to allow a group of individuals who have shared a common damage to pursue claims for damages, even when their individual claims would be redundant or insignificant. Class-action lawsuits also serve to eliminate redundancy in the judicial system and

to bring efficiency to litigation. For example, when New York law firm Kurzon Strauss, now known as Kurzon LLP, filed class-action lawsuits against two New York law schools for allegedly providing inaccurate post-graduate job data, they brought claims on behalf of dozens of students at these schools.

According to Federal Rule of Civil Procedure 23(a), there are four requirements necessary for class-action lawsuits. A major requirement is that the number of parties, either plaintiffs, defendants or both, must be so numerous it would be impractical for each plaintiff to pursue an individual claim. Another requirement is that a common question of law or fact must exist to make it more efficient to hear all the claims at once. A third requirement is that each case must have a common issue, such as product liability. The last requirement is that the class representatives must represent the entire class, rather than individual plaintiffs.

Shareholder Derivative Lawsuits

The main purpose of shareholder derivative lawsuits is to allow shareholders to pursue claims against the corporation in which they hold shares. While class-action lawsuits allow a specific group of shareholders to sue the corporation for example, shareholders who purchased stock in a particular time period, and a shareholder derivative lawsuit encompasses the interests of all the shareholders. Shareholders frequently bring derivative lawsuits against their corporation as a means of settling disputes between shareholders and corporate management, especially in matters concerning corporate governance and allegations of mismanagement.

Before shareholders can file a shareholder derivative lawsuit, they must first petition the corporation's management to rectify the behavior that prompted the suit. If the management refuses to comply, the shareholders must show that the corporate management's actions were sufficient to hurt their positions and that the corporation refuses remedy the situation. Shareholder derivative lawsuits can also serve to expose potential conflicts of interest within corporate management during the discovery process and show how this behavior damaged the stock value.

Stockholders’ Accountability through Voting Rights

Voting is the mechanism by which shareholders can force the management to behave in a disciplined way. If the shareholders are not agreeing with a particular issue, they can vote against such issues so as to protect their own interest.

Confidential Voting rights, on account of conflicting interests and political reasons, assume greater significance for the shareholders. Conflicts arise in all cases when the management counts the votes which are non-confidential. Majority of companies experience this kind of situation. The management knows who has voted and how and when the vote is cast. When shareholders enjoy intimate relationship with their corporation, a lot of pressure is brought to bear upon them for their support, since new proxies can be made on any occasion till the votes are being counted. The management calls and persuades the dissident shareholders for changing their votes to support them. However, for the participants of the pension plan and/or the investors of mutual funds, there is no means of tracing out how, on their behalf, the votes are cast. In this context, it may be noted that the institutional investors are more easily liable to accept the pressure for voting along with the management.

Most corporate bodies have formulated a policy on confidential voting because this is not expensive and is preferred by the activist shareholders. But, many of these policies are too narrowly defined and are inapplicable in cases of proxy contest. But, in reality, the advocates of confidential voting are in favour of a policy to deal with the cases of proxy contest.

Proxy

An attempt to gain control of a firm by soliciting a sufficient number of stockholder votes to replace the current board of directors is called a Proxy Contest. The acquirer will persuade existing shareholders to vote out company management so that the company will be easier to takeover. This is another mechanism for dissatisfied shareholders of the company to force the management to behave in a disciplined manner.

Takeover Mechanism

Connected to shareholders voting rights is the takeover mechanism that is another means of controlling the management of the company. According to Jensen & Ruback (1983), ‘Stock

market as a means of discipline company management through the takeover mechanism. If the shareholders are dissatisfied with company's management structure, they can vote in favour of takeover. The threat of takeover is per se a disciplining force on mangers, as they are unlikely to lose their job. Similarly the threat of divestment can force the mangers to act in a disciplined manner. Unsolicited takeover bid poses a serious conflict of interest between mangers and shareholders as in case deal goes forward, shareholders get substantial premium for their shares while incumbent directors and mangers bears the risk of losing their jobs.

These are the anti-takeover mechanism discussed in detail as below:

Anti-Takeover Devices

The period of 1980s, which is marked by threats of takeover bids, gave a feeling that the corporate control is rather theoretical. Both the management and the board of directors combined for thwarting the threats of hostile takeover efforts by the raiders, but the combined efforts resulted in the board and the management being kept away from the shareholders. By the end of 1980, majority of the corporations had designed their own strategies, known as 'shark repellents'. But, the new strategies were not effective because the board and the management became less accountable than previously. In reality, these protective strategies, explained below are considered main reasons for the rise of shareholders activism which we have discussed earlier. So, shareholders activism was a reaction to the protective devices. The protective strategies are explained in detail as below:

Poison Pills: The poison pill came into existence with the judgment Of the Delaware Supreme Court In November, 1985 which upheld the rights of a corporation to adopt the plans of shareholders. These plans are also known as poison pills. A poison pill is a strategy by a corporation to discourage a hostile takeover by attempting to make the firm's stock much too unattractive to the potential acquirer. The court granted permission for a pill to be created even without the approval of shareholders. By and large, the shareholder plan is in the shape of rights/ warrants which are issued to the shareholders but have no value in the absence of any effort for hostile takeover bid. The pills enable the shareholder to purchase or sell shares to target company (flip-in pill), i.e., the potential rider/acquirer. This is done when the plans are triggered by the

acquirer. The pill hedges a corporation against hostile takeover. It also saves the shareholder from coercive practices like two-tier tactical offers.

In practice, the flipover plan accords the targeted shareholders, right to acquire the shares of the given potential acquirer's common stock at deep discount of 50%. This occurs when the acquirer makes efforts for second stage merger which may not have been approved by the board of the target corporation.

In the process, the discount is built in the common stock and this phenomenon motivates the entire body of targeted shareholders to exerts their rights so that they buy they buy shares from the raider. In this process, the potential raider's shareholders are prohibited from participating in the purchase of the shares. In consequence, the already existing shareholders of the raider, experience that their equity interests are largely diminished when the pill is initiated and the rights are exercised. This is what is termed as the 'poison in the pill'.

A poison pill confers upon the board, veto power over bid for the corporation, irrespective of whether it is advantageous to the shareholders. In case the board of the corporation is not in favour of takeover bid, it just awaits triggering of the pill. Normally, at this time, the raider may have acquired 15% or 20% stake. And, when the board approves an acquisition, it just redeems the pill. The board does not need approval of the shareholders for creation or redeeming the pill.

No doubt, shareholders have the fundamental right to sell their stock to whomever they wish. But, in case of poison pills, shareholders are allowed to sell only to those persons who bear approval of the board.

Studies have been carried out on the effect of poison pills on stocks of corporations. Reports are conflicting. By the end of 1980s more than 1000 corporations had effected poison pills.

Crown Jewel: In this strategy, the target company sells, or alternatively, locks up its core business. The raider is faced with expensive bid for taking over which turns out to be a fir too less valuable deal. The strategy is a hedge against takeover but it is at the cost of division of the target corporation.

Fair Price Provision: This strategy involves a raider who wants control of a corporation, has to shell out the same price for all the stocks purchased in place of paying premium for large number of stocks.

White Knight: A white knight strategy is friendly but it is a third-party approach. This involves the third party being in agreement to acquire a sizeable part of the shares to help it against bid of the raider to control the company. This approach was adopted in Polaroid and Carter Hawley Hale Corporations. An identical device is used which means creation of a fresh class of shareholders having unequal rights to vote. Shares are issued to the management shareholders and they are allowed more power to vote than is applicable on common stocks. In this way, friendly interests are in control of the few stocks.

Pac Man: This involves the target corporation making a bid for the raider/acquirer. The approach implies 'I will eat you before you eat me'. This approach was used in the takeover war between Martin Marietta and Bendix. In 1982, Bendix declared its plan to takeover Martin Marietta. In response, Martin Marietta offered a tender to purchase Bendix stocks. Later, United Technologies entered the battle of takeover and purchased Bendix at a price higher than the offer of Marietta. Later on, both the companies were purchased by Allied Corporation.

Greenmail: This is another method used as an escape from takeover bid. This approach obliged the stockholders to share the consequences of incumbency of the management of the corporation. Greenmail is very much akin to extortion. A person invests in large stocks in a corporation and starts making his presence felt. He makes noise that he is going to takeover the corporation. The corporate management may not like him/his approach, so they may purchase his stake at higher price than the market price. A raider may obtain huge profits even without bidding for the corporation. Managers are safe. But, in this case, the other stockholders are content with the trading market price which is subject to going down due to huge cash paid to win over a potential dissenting person. Greenmail is a reflection of negligence on the part of the board of directors. The board must not allow managers to shell out huge amounts of shareholders' equity merely to evade possible loss of control.

Jewish Dentist: This is the most odd example of an anti-takeover approach which was used in 1975 by a leading legal professional, by name Joe Flom. Sterndent was a manufacturing outfit

which made dental equipment. The company was facing threat of takeover by Magus Corporation, an overseas conglomerate. Flom saw that 10% of Magus share was held by Kuwait Investment Company. Sterndent sold its products mostly to dentists who were Jewish. Flom opined that the take-over financed by an Arab financier will adversely impact the business of Sterndent because its customers will turn to shop elsewhere. Flom found a white knight for Sterndent and Magus withdrew.

Many thinkers opine that the takeover era was highly unproductive for corporate America. Some think that a device like 'poison pill' encouraged the management to manage the corporation without continuously being aware of the threat of possible takeover. There is yet another view that the takeover period was able to restore market accountability. It exposed the underperforming corporations to the threat of takeover.

Market for Corporate Control

When shareholders, by and large, are not interested in the well-being of the firm, as there are easy exit options available, boards do not necessarily take steps to enforce good governance and it has also been proved that there are serious limitations to what regulators can do. 'Who then can enforce these companies to behave in a necessary disciplinary behaviour? The only alternative seems to be a well-developed market for corporate control. Poor governance usually leads to poor performance, leading to rejection by product and capital markets, driving down the value of the company in the markets. When such a downward push of share prices happens, the firm may become vulnerable and attractive to many investors. But are there enough investors and the market mechanisms to support them in enabling them to threaten the poorly governed companies with takeover attempts? In developed markets, corporate control threats are very commonly seen but there is very little evidence of the existence of a market for corporate control in emerging markets such as India. When boards, shareholders, and regulators fail in disciplining companies, the market for corporate control can effectively instill a governance process which will force the boards and shareholders to see that their firm is not under threat, and improve the governance processes in their companies. Many developing countries such as India do not have, legal systems conducive to such establishment of a market for corporate control. In India, the market for competitive corporate control is by and large absent. All developing countries should

encourage such a market for corporate control, which will act as a disciplining mechanism on corporates.

7.6 SUMMARY

Although is the matter of good leadership to have good governance in place, but there are external agents like-Government, Regulators and Capital Market Institutions. Capital Market Institution comprises of Investment Bankers, Rating agencies etc. which are watchdog for the capital market and help the investor in taking informed decision. Moreover, manager can be enforced towards their duties by the active shareholders. There are different mechanisms with the shareholders like voting, proxy voting, takeover bid, tender offer etc. which can be used for the purpose of disciplining the managers and directors towards their duties. If every agent is performing it duty very well, there cannot be any chances of malpractices, scams and fraud to name a few. Senior management with CEO runs the corporation's day-to-day business operations. Hence, it is the responsibility of senior managers under the CEO's direction, to operate the corporation in an effective and ethical manner. As explained in this lesson, the articulation of a ‘fiduciary’ duty is necessary for investors to be secure that their rights will be protected. It must be taken care by law or any other mechanism. The ‘fiduciary’ duty concept is a critical tool for courts, or whoever adjudicates matters relating to investor protection. Any country seeking to assure investors that their rights will be protected must have some form of ‘fiduciary duty’ embodied in its enforcement system. The fiduciary duty is the foundation stone by which to adjudicate manager and director actions that impact investors- actions that often fall within the gaps and ambiguities of incomplete law. If a country’s legal and regulatory system doesn’t yet articulate that duty, either explicitly or implicitly, it should do so, or its system is truly incomplete. Many publicly traded companies have a large controlling shareholder. While the presence of a controlling shareholder can reduce the agency problem by closer monitoring of management, weaknesses in the legal and regulatory framework may lead to the abuse of other shareholders in the company. The potential for abuse is marked where the legal system allows, and the market accepts, controlling shareholders to exercise a level of control which does not correspond to the level of risk that they assume as owners through exploiting legal devices to separate ownership from control, such as pyramid structures or multiple voting rights. Such abuse may be carried out in various ways, including the extraction of direct private benefits via high pay and bonuses for employed family members and associates, inappropriate related party

transactions, systematic bias in business decisions and changes in the capital structure through special issuance of shares favouring the controlling shareholder. In the present lesson, various mechanisms to use the accountability of the shareholders are discussed. Although there are various mechanisms available, but the actual zeal to promote the corporate governance rests with the leadership at place. How ethical directors are there in the company and how mangers are following the ethical practices will determine the fate of corporate governance.

7.7 SELF –ASSESSMENT EXERCISE

Fill in the blanks for the following statements:

a). A key factor in a party's decision to participate in or engage with a corporation is their …….that the corporation will deliver the expected outcomes of different stakeholders.

b). With a thorough understanding of how the corporation operates and earns its income, …….. carry out the corporation's strategic objectives within the annual operating plans and budgets reviewed by the board.

c). Other common provisions to protect …….shareholders, which have proven effective, include pre-emptive rights in relation to share issues, qualified majorities for certain shareholder decisions and the possibility to use cumulative voting in electing members of the board.

d). When …….enjoy intimate relationship with their corporation, a lot of pressure is brought to bear upon them for their support, since new proxies can be made on any occasion till the votes are being counted.

e). According to Jensen & Ruback (1983), '……..as a means of discipline company management through the takeover mechanism. If the shareholders are dissatisfied with company's management structure, they can vote in favour of takeover.

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7.9 SUGGESTED READINGS

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7.10 ANSWERS TO SELF –ASSESSMENT EXERCISE

These are the answers for the self-assessment exercise:

a). Confidence

b). Mangers with the direction of CEO

c). Minority

d). Shareholders

e). Stock market

7.11 MODEL QUESTIONS

Q1). What is the role of mangers in promoting corporate governance? Discuss in detail.

Q2). How mangers can be enforced towards their duties? Discuss.

Q3). Elaborate the accountability of stockholders in promoting corporate governance? Discuss in detail.

Q4). Describe the various mechanisms available with the stockholders to make mangers work towards the interest of shareholders.

Q5). What are the takeover denences? Discuss in detail.

Q6). What do you mean by market for corporate control? How these measures can help in improving the governance practices in the companies? Explain.

Q7). What is a takeover bid? How it is different from tender offer? Explain.

Q8). What are the class suits? Are the applicable in India? Are these effective mechanisms to enforce managers towards their primary duty? Describe in detail

Q9). What are derivative actions? How these are different from class suits? What are the requirements to file a derivative suits? Describe.

Q10). Explain to what extent the various mechanisms available to stockholders for disciplining the mangers towards their duties are effective. Describe in detail citing one relevant example.

LESSON-8

FACILITAORS, ROLE PLAYERS AND REGULATORS

STRUCTURE OUTLINE

8.1 Objectives
8.2 Introduction
8.3 Role of Government in Ensuring Corporate Governance
8.4 Role of Regulators in Promoting Corporate Governance
8.5 Role of Auditors in Enforcing Corporate Governance
8.6 Role of Investment Bankers in Corporate Governance
8.7 Role of Rating Agencies in Promoting Corporate Governance
8.8 Summary
8.9 Self –Assessment Exercise
8.10 Bibliography
8.11 Suggested Readings
8.12 Answers to Self –Assessment Exercise
8.13 Model Questions

8.1 OBJECTIVES

After reading the lesson/unit, the learner will be able to:

- To know about the Role of Government and regulators in promoting Corporate Governance
- Discuss the Capital Market Institutions like-rating agencies, investment bankers in enforcing corporate Governance practices.

8.2 INTRODUCTION

It has been explained in detail that corporate governance deals with the set of rules by which the company is governed. Although, it the matter of conscience for the company's Board of directors, Managers and Employees to promote the corporate governance at place, but regulators, Government, Rating Agencies, Media and Press also force the company to act in a very disciplined manner. In this lesson, the role of different regulators, Government, Auditors etc. is explained in detail. These external agents are helpful in acquiring and disseminating information on a timely basis, enabling fair and efficient execution of financial transactions. These external players are playing important role in modern corporate governance. In addition to these agents, Government play an important role by laying down framework of laws for establishment of corporate entity and constitution of board of directors and norms for compensating the directors, submission of returns to the Governments on financial structure and performance of the entity,

the size of board, raising capital, closure and winding up to name a few. Thus, there is an important role of government and its bodies in establishing a framework for corporate governance. The institutions in the market through their interventions enable companies to establish and nurture a process of governance. To add it, the capital market institutions, gate keeper to the access of capital like auditors, investment bankers, rating agencies can help in effective corporate governance.

8.3 ROLE OF GOVERNMENT IN ENSURING CORPORATE GOVERNANCE

Government is absolutely essential in setting up of a market economy. Without rules and structures of a binding nature, anarchy will be the outcome.

Different Roles of Government in the Economy

There are four important roles played by the government in an namely:

I. The regulatory role
II. The promotional role
III. The entrepreneurial role
IV. The planning role

A large part of the economy of even most of non-centrally planned countries is regulated by the government like Government may determine the conditions under which persons or corporations may enter certain lines of business as in the granting of a charter, a franchise, a licence etc. The promotional role played by government is very important in developed as well as developing countries. Thus, considering the whole of its activities, a government does more to assist and to help develop industrial, labour, agricultural and consumer interests than it does to regulate them. In developing countries, where the infrastructure facilities for development are inadequate and entrepreneurial activities scarce, the promotional role of the government assumes special significance. The state will have to assume direct responsibility to build up and strengthen the necessary development of infrastructure such as power, transport, finance, marketing, institutions-for training and guidance and other promotional activities. The growing importance of the entrepreneurial or participative role of the state has been evident from the fast expansion of the public sector in most developing countries. However in post-1990s there has been a significant reversal in this policy as governments having experienced inefficient functioning of public sector industries and the huge losses incurred by them which are made good by budgetary allocations affecting tax-payers, have given up their policy of promoting them.

Public Governance and Corporate Governance

Governance is the exercise of authority, which involves not solely the right to direct but also to lead and to control within an organization. Two problems exist regardless of whether the organization operates within political society or within civil society:

1. How to accumulate the power and authority required achieving the purposes of the association?

2. How to limit the power and authority to specified areas rather than to allow it to overflow into areas that are not its concern?

Although the same problems need to be addressed, governance within enterprise associations such as corporations is not at all like governance within a governmental body. Commercial activity conducted by corporations and by other forms of business is fundamentally different from the types of activity conducted by coercive government.

Good governance is supposed to exist if the following three objectives are achieved:

- The first is there should be equality of law and effective implementation of laws.
- Second there should be opportunity for every individual to realize his full human potential.
- Third, there should be effective productivity and no waste in any sector.

Political Governance Requires Restraints of Power

Constitutional governments are characterized by specific restraints established by law and imposed on power-holders to ensure that citizens' rights are not being transgressed. Constitutionalism embodies the principles that the government is organized by, and operated on behalf of the people, but subject to a series of restraints, a system of checks and balances and to keep power from being abused. By dividing power, constitutionalism provides a system of restraints upon coercive state action. The basic idea underpinning restraints rests on the notion of a law higher than positive man-made law, and thus limiting the operation of the state. Natural law provides a criterion by which positive laws are judged. Another basic principle underlying the idea of limited government is that legitimate governments always rest on the consent of the governed. The working democracies that have developed from these ideas are given below.

I. A political system with a central-local distribution of power
II. Subordinate distributions of power among agencies with functionally-defined realms of authority

III. A chronological distribution of power through periodic and regular elections

IV. A written constitution enforceable by the courts limiting the exercise of political power

The object of government regulation, as has been pointed out earlier, is to steer the wheel of the economy in the direction of maximum social good without replacing it. This can be achieved through regulatory action at all-important points in the economic system. However, the regulatory system and the context of regulation may vary from country to country, the degree of maturity of political governance and the degree of economic growth. The more important forms of regulation of private enterprises by the government especially in developing countries like India are as follows:

- General direction and regulation of investment activity in private enterprise. This is achieved through economic planning and industrial licensing policy.
- Regulation of investment activity in private enterer Regulation of investment, location, size and expansion of individual enterprises and specific industries through a well-defined policy of industrialization.
- Regulation of prices of commodities and industrial products through legislative authority and systematic investigations into cost structures and mark-ups.
- Regulation of monopolies and unfair trade practices or restrictive practices through legislation.
- Regulation of wages and bonus for employees in private sector to minimize exploitation, ensure reasonable standards of living and maintain peace and harmony in industry.
- Regulation of corporate management.
- Regulation of specific norms of business activity such as speculation in shares and commodities or imports/exports, etc.

Role of Governments in Limiting Corporate Power

Modern corporations have grown so huge in size and so powerful in influence that these mega corporations, if unrestrained by political authority, might over-reach all the segments of the society with their mercenary and baneful influence. Unrestricted and unregulated corporations could overwhelm governments if proper checks and balances are not worked out and put in place, as Enron and WorldCom tried to do.

The economic government (giant corporations) is largely unaccountable to its constituencies-shareholders, workers, consumers, local communities, tax payers, small businesses, future generations, etc.

8.4 ROLE OF REGULATORS IN PROMOTING CORPORATE GOVERNANCE

Corporate governance, as of now, encompasses only companies or corporate entities which have chosen to raise capital from the public. Even though the stakeholder theory or approach has been considered as good for the running of an enterprise, the underlying premise of corporate governance continues to be the shareholder theory or approach, as the assumption that continues to pervade even today is that corporate governance is required because (or only because) there is possibility for agency conflict to exist between owners and managers. Most of the regulations of corporate governance in most parts of the world have been drawn up on this in the area fundamental premise.

There are definite expectations about corporates from the economy and society. Companies use a lot of resources in the economy and hence are accountable to them. They also depend on a number of stakeholders for their success-other service providers, customers, government, and of course, the shareholders. They have a responsibility to ensure that the interests of all these stakeholders are taken care of. While it is expected that the corporate entity takes care of the interests of the different stakeholders voluntarily, there may arise situations which may affect the stakeholders, since the corporate entity may act in ways that will try to achieve one of its objectives—making more money for the business and increasing the wealth of the providers of capital (the shareholders). This is where some kind of external regulation makes sense. According to Shultz, 2001, “To the extent corporations don't meet implicit and explicit expectations, regulation looms”.

According to convention, developed markets and countries have lesser external regulations, and the institutions created by the market regime are expected to make the necessary checks and balances, while lesser developed markets and countries have in many ways prohibitive external regulations.

Relaxations of regulations have led to exploitation by market players leading to conflicts of interest situations culminating in crises such as Enron, WorldCom, etc., with the US government giving a knee-jerk response in the form of the Sarbanes–Oxley Act to discipline the corporates. ‘Capital markets failed in developing or developed countries not because they were inherently

flawed and fundamentally dangerous in their design. They failed because their structural weaknesses (and every society, economy, or market) were systematically exploited and abused. Regulatory and governance mechanisms designed to prevent such outcomes failed to do what they were supposed to' (Som 2006). This was revealed again in 2007-08 in the US and India in the form of failures of Bear Stearns, Lehman Brothers, AIG, Merrill Lynch in the US, and Satyam in India, despite the very stringent governance norms in these countries. Boards failed to curtail the risks through self-regulation, and regulations failed by encouraging firms and boards to take unfettered risks and not enforcing the checks and balances which they have to perform. The unfortunate part is that the fortunes of even better-governed corporations have been badly affected.

Limits of Regulation

It has been experienced that governance failures occur despite stringent regulations. Is it that the regulations in position are not enough or adequate? Or, is it that the regulations are enough but have not been enforced in the required manner so as to prevent a crisis from recurring? Or, is it that there is a limit to which regulations can help, or that self-regulation by boards and companies is what is required and regulators have to be there just to offer guidelines? There are no definite answers to these questions. But, one thing is very clear. Despite stringent regulations, failure of corporations due to corporate governance shortcomings recur. Also, there were extremely well-governed companies in the US and India before the Sarbanes-Oxley Act and Clause 49 guidelines. Failures of the likes of Enron and WorldCom in the US, Satyam in India, or Parmalat in Italy happened because of a few people who were enjoying a great deal of power and nurturing unfettered financial ambitions. Can regulators make a few people sit around a table in the boardroom, behind closed doors, and behave in the right manner? Should they make the regulations even more stringent or should they encourage and take steps to develop more activism among institutions such as institutional investors, auditors, banks, etc., and within boards? Some of the regulations themselves have to be seriously looked into.

their adjustment to the ever-changing environment' said The Hindu report, quoting Garratt: Notwithstanding the limitations of regulation on corporate governance and firm behavwur) regulations are necessary even in the most free market oriented economies. This is because even they will be constrained by the economic and constrained by the economic and social policies which are directly determined by theY wiring cbaei, 6 processes. Such involvement of the

political processes on the economic policies ep result in, and at times even significant, deviations According to Shultz, 2001 ‘government regulation should aid, not harm or hinder. Its role should be to define and enforce the ground rules that make the playing field level and keep the system open. When change is the barometer, government regulation, which looks backwards instead of forward, can be stifling if not crippling. It smothers the very creativity and innovation that has allowed business to flourish'.

Smith and Walter (2006) opine that ‘regulators constantly face the possibility that inadequate regulation will result in costly failures, as against the possibility that over-regulation will result in opportunity costs in the form of economic efficiencies which are not achieved, or in the relocation of firms to other, more friendly regulatory regimes .... Consequently, there are no definitive answers with respect to optimum regulatory structures with respect to corporate governance.'

J.R. Varma, professor at IIM, Ahmedabad and former member, SEBI, feels that there is a view that corporate governance ‘too, is an area where market discipline is more valuable than regulation. The threat of hostile takeovers disciplines incumbent managements to a far greater degree than all the corporate governance codes put together' and, ‘in the market discipline approach, disclosure is the only thing that needs to be ensured, because once the disclosures are there, market forces respond to the information and impose pressure on the company to shape up’ (Basu 2005).

While governance experts and critics put the blame for all the failures at the doors of the entire board, citing conflicts of interest, passive attitudes of the independent directors, lack of expertise of or diligence or rigour by the audit committee, and other innumerable reasons, analysis of failures mostly leads to a general conclusion: most of the failures have occurred due to the selfish interests nurtured by a few powerful individuals be it Enron, WorldCom, or Satyam. The search for the reasons for the ills end at one thing: glaring deficiencies in the quality of leadership-a lack of values, integrity, humility, the knowledge that you are there to serve others, a sense that you are being looked up to for inspiration by associates within and outside your organization, concern for those whose lives depend on the organization you lead, the responsibility of leaving a rich legacy, and the moral character and courage to desist temptation. Can laws such as the Sarbanes–Oxley, or guideline s like Clause 49, or regulators such as SEC or SEBI influence leaders of corporates to bang about perceptible changes in the above aspects? It is very doubtful.

Governance is not a ‘hardware’ in the sense that changes in the structure of the board by including a majority of Independent directors or by having a non-executive independent chairman or by having audit, compensation, and nomination committees constituted only of independent directors it must become a ‘software’ that runs through the entire organizational system like processes, culture, and value system.

8.5 ROLE OF AUDITORS IN ENFORCING CORPORATE GOVERNANCE

Auditors who are supposed to be the watchdogs of organization are often bought in by managements through some profitable assignments. This has led to the rise of the concept of corporate governance which is about promoting corporate fairness, transparency and accountability relating to various participants of various organizations. Recent unearthing of corporate frauds in numerous countries has revealed the fact that auditors had failed to do what they were assigned to do. They involved themselves in unethical practices and failed to whistle-blow when things went wrong in the organization. To have a check on the auditors' role and to prevent them from unethical practices, the Indian government and regulatory bodies as elsewhere have come out with many regulations, re-establishing corporate accountability and reinforcing investor confidence.

Role of Auditors

The allegation that annual reports presented by companies today lack truthfulness and transparency need not be dealt with in great details here. Window-dressing, manipulation of profit and loss accounts, hedging and fudging of unexplainable expenditures and resorting to continuous upward revaluation of assets to conceal poor performance are malpractices companies resort to with the help of obliging auditing firms.

The role of auditors who are expected to certify the veracity of accounts maintained by companies for the benefit of all stakeholders of the company including fair and transparent governance leaves a big question mark today. There are numerous instances where obliging auditors have helped companies falsify accounts and in window-dressing for small monetary gains.

Defining Audit

According to the ‘The Institute of Chartered Accountants of India (ICAI)’, audit means “The independent examination of any entity, whether profit oriented or not and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion

thereon". In other words, auditing is the process by which a competent independent person objectively obtains and evaluates evidence regarding assertions about an economic activity or event for the purpose of forming an opinion about and reporting on the degree to which the assertion conforms to an identical set of standards.

Objectives of an Audit

As per the Institute of the Chartered Accountants of India, "The objective of an audit of financial statements is to enable an auditor to express an opinion on financial statements which are prepared within a framework of recognized accounting policies and practices and relevant statutory requirements."

Types of Audit

There are three types of audits, namely, financial statement audit, Compliance audit and Operational audit.

Financial statement audit: An audit of financial statements is conducted to determine whether the overall financial statements are stated in accordance with specified criteria. The financial statements commonly audited are balance sheet, the income statement, the cash flow statement and the statement of stockholders' responsibility.

Compliance audit: The purpose of compliance audit is to determine whether the auditee is following specific procedures, rules or regulations set down by some higher competent authority.

Operational audit: An operational audit is a review of any part of an organization's operating procedures and methods for the purpose of evaluating effectiveness and efficiency.

Defining Auditor

An auditor is defined as a person appointed by a company to perform an audit. He is required to certify that the accounts produced by his client companies have been prepared in accordance with normal accounting standards and represent a true and fair view of the company. Usually, chartered accountants are appointed as auditors.

An auditor is a representative of the shareholders, forming a link between government agencies, stockholders, investors and creditors.

Types of Auditors

There are three types of auditors, namely,

(1) Internal auditors,

(2) Independent auditors

(3) Government auditors.

Internal auditors: Internal auditors are employed by the organization for which they perform audits. Their responsibilities vary and may include financial statement audits, compliance audits and operational audits. They may assist the external auditors in completing the financial statement audit or perform audits for use by management within the entity. Internal auditors must have no operating involvement in activities they audit. An organization may have a small or very large internal audit staff. They cannot he independent as long as the employer-employee relationship exists. Independence is often accomplished by giving the highest ranking person in internal auditing the status of vice president and having that person report directly to a committee of the board of directors.

Independent auditors: Independent auditors are usually referred to as CPA (Certified Public Accountants) firms. The opinion of an independent auditor about financial statements makes the statements more credible to such users as investors, bankers, labor unions, government agencies and the general public.

Government auditors: Government auditors work in various local, state and federal or central government agencies performing financial, compliance and operational audits. Local and state governments, for example, employ auditors to verify that businesses collect and remit sales taxes and excise duties as required by law.

Duties of an Auditor

The duties of an auditor are defined under Section 227 (1A) of the Companies Act 1956. It says that an auditor can enquire

- Whether loans and advances made by the company on the basis of security have been properly secured.
- Whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company.
- Where the company is not an investment company within the meaning of Section 372 or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company.
- Whether loans and advances made by the company have been shown as deposits.

- Whether personal expenses have been charged to revenue account In other words, the auditor is responsible for.
- Verifying that the statements of accounts are drawn up on the basis of the books of business.
- Verifying that the statements of accounts drawn up on the basis of the books exhibit a true and fair state of affairs of the business.
- Confirming that the management has not exceeded the financial/ administrative powers vested in it by the Articles of Association of the Company and/or resolutions of shareholders.

Responsibilities of Auditors

The Institute of Chartered Accountants of India (ICAI) has issued the Standard Auditing Practices and Auditing and Accounting Standards with emphasis on effective auditing practices. It talks about the integrity, objectivity, independence, confidentiality and responsibility of an Auditor.

As per the Standard Auditing Practices (2), an auditor has the following responsibilities:

- He is responsible for forming and expressing his opinion on the financial statements. He assesses the reliability and sufficiency of the information contained in the underlying accounting records and other source data by making a study and evaluation of accounting systems and internal controls.
- He determines whether the relevant information is properly disclosed in the financial statements by comparing the financial statements with the underlying accounting records and other source data to see whether they properly summarize the transactions and events recorded.
- He has to ensure that his work involves exercise of judgment, e.g., in deciding the extent of audit procedures and in assessing the reasonableness of the judgments and estimates made by management in preparing the financial statements.
- He is not expected to perform duties which fall outside the scope of his competence, e.g. the professional skill required of an auditor does not include that of a technical expert for determining physical condition of certain assets.

Responsibilities Regarding the Mis-statement of Financial Statements

If appropriate disclosures regarding the material mis-statements affecting the prior period financial statements is not made, then the auditor should issue a modified report on the current period financials modified with respect to the corresponding figures included. Moreover, when the prior period financial statements are not audited, the incoming auditor should state in the auditor's report that the corresponding figures are unaudited. The auditor should obtain sufficient appropriate audit evidence that the closing balances of the preceding period have been correctly brought forward to the current period and the opening balances do not contain mis-statements that materially affect the financial statements for the current period.

When the auditor has determined that a mis-statement is, or may be, the result of fraud, the auditor evaluates the implications, especially those dealing with the organizational position of the person or persons involved.

For example, fraud involving misappropriations of cash from a small petty cash fund is ordinarily of little significance to the auditor in assessing the risk of material mis-statement due to fraud. This is because both the manner of operating the fund and its size tend to establish a limit on the amount of potential loss, and the custodianship of such funds is ordinarily entrusted to an employee with a low level of authority. Conversely, when the matter involves management with a higher level of authority, even though the amount itself is not material to the financial statement, it may be indicative of a more pervasive problem In such circumstances, the auditor reconsiders the reliability of evidence previously obtained since there may be doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation. The auditor also considers the possibility of collusion involving employees, management or third parties when reconsidering the reliability of evidence.

The auditor is also responsible to communicate that information (mis-statement resulting from fraud) to management, those charged with governance and, in some circumstances, when so required by the laws and regulations, to regulatory and enforcement authorities also. The auditor should communicate these matters to the appropriate level of management on a timely basis, and consider the need to report such matters to those charged with governance.

Preventing Fraudulent Auditing Practices

With an aim to protect the investors from the fraudulent accounting practices of corporations, the Indian government as well as the regulatory bodies has appointed many committees. Till date, four committees played a vital role in framing the responsibilities of the auditors and the audit

committees: The R. D. Joshi Committee, the Kumar Mangalam Birla Committee, the Naryana Murthy Committee and the Naresh Chandra Committee. All these committees' recommendations focused mainly on the following aspects of auditing: formation of the audit committee, their responsibilities, rotation of auditors, prohibition of non-audit services and the transparency of financial statement.

A more recent and ominous case is that of Ramalinga Raju, who promoted Satyam Computers, which was credited as the then fourth largest software company in India. The spectacular breakdown of the audit function that enabled Raju to commit fraud amounted of Rs. 40,000 million through manipulation, insider trading, formation of innumerable sister concerns has made a mockery of the audit function as is being practiced now. Naturally, this elicited calls for reform and review of the audit system for public companies in the country. Joint audits, audit rotation and peer review are some of the suggestions that have been floated in recent times. It was suggested to have a system of 'dual audit' so that there are two firms keeping a check on each other.

Audit Committee

An audit committee is the committee comprising independent directors. It is responsible for appointment, fixing of fees and oversight of the work of independent auditors. The committee is also responsible for establishing, reviewing the procedures for the receipt, treatment of accounts, internal control and audit complaints. All the committees emphasized more on the formation of audit committee, but the proposed size of the committee differed from one to the other.

8.6 ROLE OF INVESTMENT BANKERS IN CORPORATE GOVERNANCE

The investment bankers play a great role in the successful issuance of Initial Public Offers (IPOs) of companies. In order 'to gain mandate for IPOs, the banks had to promise the new companies that they would -wholeheartedly sponsor the IPO, by making an extra effort to distribute the shares to investors all over the world, by following the company in research after the issue, and by making a secondary market (for block trades) in the stock for institutional investors' (Smith and Walter 2006).

During the mid-1990s, when internet companies were mushrooming, the demand for IPOs was very high. There was a huge potential for a good gain on selling it immediately on listing. Smith and Walter (2006) say that 'realizing the premium available to investors favoured by generous IPO allocations became a way to lock-in solid investment profits, and as a result, most large

institutional investors began to demand IPO allocations from the investment bankers handling the sales.' Such was the nexus between investment bankers and institutional investors. Investment bankers and institutional investors offering a variety of financial and other services often acted in connivance with the companies, not acting in the best interests of their clients and/or investors. Most of the investment banks who employed analysts to ascertain the future prospects of a potential client, advised on possible mergers and acquisitions, and also in identifying potential IPO candidates. According to Smith and Walter, 'Such analysts, however, to get the jump on other analysts and on the company's own announcements, had to be plugged in to the company's chief executive officer (CEO) and chief financial officer (CFO) closely, so as to receive information that not everyone was getting. Many CEOs believed that such close information sharing with star analysts would be to their advantage.'

This nexus between the investment bankers was evident in the case of Enron. 'Chung Wu e-mailed his clients to sell Enron shares. Later on, he was sacked and escorted out of his office. There must be a resilient system at place to check and penalized the wrongdoers so as to prevent such malpractices which can hinder the good governance practices.

8.7 ROLE OF RATING AGENCIES IN PROMOTING CORPORATE GOVERNANCE

It has been identified that institutional investors use the corporate governance rating system as a tool to ascertain the quality of governance systems in a company where they propose to invest or where they have invested. According to Mallin, 2007 “A corporate governance rating can be a powerful indicator of the extent to which a company is currently adding, or has the potential to add in the future, the shareholder value. This is because a company with good corporate governance is generally perceived as more attractive to investors than one without”. Post various scams like Enron, WorldCom and Satyam etc., investors have begun to be seriously concerned about governance practices of companies where they plan to invest their hard-earned savings. According to Adilabadkar, 2005 “With this increasing level of awareness of corporate governance, there is a role for global benchmarks to help a company's stakeholders to assess and compare corporate governance practices from one firm to another. The concept of corporate governance ratings is a way to address this gap”.

A number of rating agencies from all over the world have developed their models for evaluating corporates from a governance point of view, and assigning them corporate governance scores. Credit Rating agencies like Standard and Poor's (S&P), Governance Metrics International (GMI),

Institutional Shareholder Services (ISS), the Corporate Library, and Audit Integrity in the US; Credit Rating Information Services of India Ltd (CRISIL), an affiliate of S&P, Investment Information and Credit Rating Agency Ltd (ICRA), and Credit Analysis and Research Ltd (CARE) in India; and Deminor in Brussels, Belgium, etc., have been in the practice of rating governance of publicly-listed corporates for many years now. S&P has been using its governance rating system in widely different markets. GMI ratings extend beyond the US to countries in the Asia-Pacific region and Europe. Deminor has been concentrating on European companies while ISS, Corporate Library, etc. have concentrated mainly on the US. With the acquisition of the corporate governance practice of Deminor, ISS has been extending its presence in Europe. But, in India, these rating agencies are prohibited to do their operations outside India.

According to Mallin, 2007 "Since corporate governance depends greatly on the levels of transparency and the reporting practices in a county in general, an appropriate approach for a corporate governance rating system is first to have a rating of the corporate governance in a given country". This necessitates finding out whether the country is enlightened on the need for better corporate governance, are there established guidelines, laws, or codes of best practices, and are the corporates following these. After establishing the scenario present in a country, the rating companies can set about assigning governance ratings for individual companies. The rating agencies collect a variety of information from companies but do not depend only on them. They also try to cross-check and verify such information through other channels. Different rating agencies follow different rating models, but the underlying fundamental principles are rather similar—fairness, transparency, accountability, and responsibility.

According to Adilabadkar (2005), a corporate governance score is based upon the assessment of four key areas of corporate performance:

I. Ownership structure, which asks who owns and controls the company and what conflicts are likely to arise from the ownership structure;
II. Financial stakeholder rights and relations, which look into ownership rights; minority shareholder protection, voting procedures and takeover defences;
III. Transparency and disclosure, which look at the quality and accessibility of financial and operational disclosure, including transparency of accounting methods, the integrity of the audit process, and how the audit committee oversee and maintains auditor independence.

IV. Board structure and process, which looks at board independence, effectiveness, succession policies, and the process of setting executive pay and aligning shareholders.

S&P which started its corporate governance score (CGS) services in 2002, is based on four company characteristics (Adilabadkar 2005):

- Ownership structure and concentration
- Financial stakeholders' rights and relations
- Transparency and disclosure, and
- Board structure and process.

For S&P to determine a CGS for a company, the company has to request S&P for it. S&P reviews the client company's documents both publicly available and confidential, and has discussion with executive management, directors, shareholders, analysts, bankers, etc. After the process is completed, S&P awards a score on a scale of 1 to 10 within each of the four areas above. The client company can decide whether to make the rating public.

GMI on the other hand, examines a company's website, statutory filings, press coverage, etc., and gathers data on each of the 600 metrics, and checks with the company for verification of facts. After getting feedback from the company, it puts the details into the database which comes out with the governance score on a scale of 1 to 10. In addition to an overall score, it provides scores in seven discrete categories.

CRISIL uses the following rating criteria:

- Equitable treatment of shareholders
- Ownership rights of shareholders
- Transparency and disclosure
- Composition of board
- Management assessment
- Value creation for various stakeholders.

CARE, on the other hand, uses the following seven criteria:

- Board composition and functioning
- Ownership structure Organization structure and management information system
- Shareholder relationship
- Disclosure and transparency
- Financial prudence, and

- Statutory and regulatory Compliance.

Merits of Corporate Governance Ratings

Investors have become highly demanding and discerning after the high profile corporate collapses at the beginning of the century This has put pressure on corporates to be better governed. Evidence from various studies on corporates, with emphasis on the governance processes and practices, point to the fact that those with less meaningful governance practices have been required to pay a significant risk premium in their competition for garnering funds from capital markets. While legislation and regulations can mostly enforce a firm thorough insistence on the structure of the board, formation of committees, separating chairman and CEO positions, etc. The governance will eventually determine the credibility of the firm among all the stakeholders. Hence, the onus falls on the firm to be better governed and also to project it as being better governed to all the stakeholders. The governance rating process enables a company to achieve this and, in turn, enables investors to make informed decisions from among a large range of options available. This can be of great help to investors in countries such as India where more than 4000 companies are listed on the stock exchanges. The major advantages of governance ratings can he listed as follows:

For firms

- Enables firms to obtain an independent and reliable assessment about their quality of governance
- Firms can understand their relative positioning in the national and international scenario
- Firms with better ratings can expect to lower the risk premium placed on them by capital markets, and thereby reduce cost of capital
- Firms can use the ratings (their own and those of competitors) as references and set benchmarks for further improvements
- Firms get to understand whether they add value to the stakeholders of the company
- It enables firms to improve their image/visibility/credibility in society
- Enables the company to attract talent to the board and management.

For the stakeholders including investors

- Enables investors to make informed decisions
- Information availability brings in institutional interest in the company resulting in better price efficiency

- Banks and other financial institutions can make informed decisions to lend and fund the company
- Employees, customers, suppliers, and other stakeholders will be keen to associate with a well-governed firm
- Increases the confidence of the capital markets in firms.

Limitations and Demerits of Corporate Governance Ratings

While apparently governance ratings have a number of merits as described above, there are also de-merits and limitations:

- The rating agencies have to rely heavily on information provided by the firms.
- Different institutions offering governance ratings stress on different parameters to ascertain governance performance. Thus, the ratings of a firm may vary from one rater to another. This can send confusing signals to the ordinary investors who don't have the knack about the differences in parameters.
- It is voluntary in nature; hence, if a company does not volunteer it need not necessarily mean that they are low on governance performance compared to other firms with a high rating.
- The methodology relies heavily on structural aspects rather than on the process of governance. This, once again, brings back the criticism on general governance reforms which have been more structural with consequent in-built deficiencies.
- Governance scores may not be able to prevent many maladies such as insider trading, false reporting, intentional fraudulent practices of the CEO and other members of the board, or misuse of resources by the management, etc. This was evident in the case of Satyam Computers which had a high governance rating.
- The decision on making the rating public, by and large, rests with the company.
- Since rating is not compulsory and involves a lot of costs for the firm (S&P is said to be charging a fee in the range of $18,000 to $150,000, according to Adilabadkar (2005)), only a very small percentage have volunteered, making it difficult for an investor to use them as a yardstick.
- Ratings have been assigned based on data and information about current working of the firm. They do not necessarily look at the historical behaviour of a firm with regard to governance matters and cannot assure that the good/bad practices of the current will be

carried over to the future. This once again puts the responsibility on to the investors to make their own judgments.

Notwithstanding the deficiencies, the number of institutions that are entering the governance rating business and the number of firms volunteering to be rated have been on the rise.

8.8 SUMMARY

Although is the matter of good leadership to have good governance in place, but there are external agents like-Government, Regulators and Capital Market Institutions. Capital Market Institution comprises of Investment Bankers, Rating agencies etc. which are watchdog for the capital market and help the investor in taking informed decision. If every agent is performing it duty very well, there cannot be any chances of malpractices, scams and fraud to name a few.

8.9 SELF –ASSESSMENT EXERCISE

Fill in the blanks for the following statements:

a). Companies use a lot of resources in the economy and hence are ……..to them.

b). The ……..committee is also responsible for establishing, reviewing the procedures for the receipt, treatment of accounts, internal control and audit complaints.

c). Regulators constantly face the possibility that inadequate regulation will result in costly failures, as against the possibility that ……..will result in opportunity costs in the form of economic efficiencies which are not achieved, or in the relocation of firms to other, more friendly regulatory regimes

d). The objective of an audit of financial statements is to enable an auditor to express an opinion on financial statements which are prepared within a framework of recognized …….and practices and relevant statutory requirements.

e). Government play an important role by laying down …….for establishment of corporate entity and constitution of board of directors and norms for compensating the directors, submission of returns to the Governments on financial structure and performance of the entity, the size of board, raising capital, closure and winding up to name a few.

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8.11 SUGGESTED READINGS

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8.12 ANSWERS TO SELF –ASSESSMENT EXERCISE

These are the answers for the self-assessment exercise:

a). Accountable

b). Audit

c). Over-regulation

d). Accounting policies

e). Framework of laws

8.13 MODEL QUESTIONS

Q1). What is the role of Government in promoting corporate governance? Discuss in detail.

Q2). How auditors can help in ensuring corporate governance? Discuss.

Q3). Elaborate the role of media & press in promoting corporate governance? Discuss in detail.

Q4). Describe the role of regulators in ensuring corporate governance.

Q5). How rating agencies can enforce discipline in the market? Describe.

Q6). What are capital market institutions? How theses can enforce effective corporate governance. Describe.

LESSON-9

CORPORTAE GOVERNANCE MECHANISM & CONTROL

STRUCTURE OUTLINE

9.1 Objectives

9.2 Introduction

9.3 OECD Principles of Corporate Governance

9.4 Sarbanes Oxley Act: USA

9.5 CII Code-Desirable Corporate Governance

9.6 Kumar Mangalam Birla Committee on Corporate Governance (2001)

9.7 Companies (Appointment of Small Shareholder's Director) Rules, 2001
9.8 Clause 49 of Listing Agreement
9.9 Provisions of Corporate Governance in Companies Act, 2013
9.10 Summary
9.11 Self –Assessment Exercise
9.12 Bibliography
9.13 Suggested Readings
9.14 Answers to Self –Assessment Exercise
9.15 Model Questions

9.1 OBJECTIVES

After reading the lesson/unit, the learner will be able to:

- To know about the meaning of Role of OECD in promoting Corporate Governance
- Discuss the carious acts, codes and committees in Corporate Governance

9.2 INTRODUCTION

The past few years have seen an explosion of interest in Corporate Governance all across the world. In 1997, the Business Roundtable, which takes a pro-business perspective, produced a statement on Corporate Governance. In 2001, a Blue Ribbon Commission set up by the National Association of Corporate Directors published the report 'Director Professionalism'.

Britain produced the first Corporate Governance report and subsequently has produced more than any other country.

The Cadbury Report (1992) was produced by a committee chaired by Sir Adrian Cadbury in response to a series of corporate failures in the United Kingdom. It was entitled 'The Financial Aspects of Corporate Governance', and was not intended to be a comprehensive review of the subject as Sir Arian subsequently emphasized. However, the few important highlights of Cadbury Report are as follows:

- The wider use of independent non-executive directors
- The introduction of an audit committee of the board with a minimum of three non-executive directors with a majority of them independent

- The division of responsibilities between the chairman of the board and the chief executive. But, if the roles were combined in a single person, the board should have strong independent element.
- The use of a remuneration committee of the board to oversee executive rewards.
- The introduction of a nomination committee with independent directors to propose new board members.
- Adherence to a detailed code of best practice It is interesting to note, that despite being written more than fifteen years ago, this report contained many proposals that remain at the heart of today's corporate governance thinking.

The Greenbury Report (1995) addressed issues of directors' remuneration. Some of the important highlights of Greenbury Report are as follows:

- The remuneration committees of companies should consist solely of independent non-executive directors.
- The chairman of the remuneration committee should respond to shareholders' questions at the AGM.
- Annual reports should include details of all director rewards-naming each director.
- Directors' contracts should run for no more than a year to avoid excessive golden hand-shakes .
- Share option schemes for directors should be linked to long term corporate performance

The Hampel Report (1998) was a response to a suggestion in the Cadbury Report that a review should be undertaken after a few years experience. The Hampel Report proposed that:

- Good corporate governance needs broad principles not prescriptive rules.
- Compliance with sound governance practices, such as the separation of board chairmanship from chief executive, should be flexible and relevant to each company's individual circumstances
- Governance should not be reduced to what the report called a 'box-ticking' exercise.
- The unitary board is totally accepted in the UK. There is no interest in alternative governance structures or processes such as two-tier boards.

- The board is accountable to the company's shareholders. There is no case for redefining directors' responsibilities to other stakeholder groups.
- Self-regulation is the preferred approach to corporate governance. There is no need for more company legislation.

The Hampel Committee consisted mainly of directors of major public companies and their professional advisers. Predictably, therefore, it did not criticize contemporary corporate governance practices, neither did it advocate any measures which would further limit directors' power to make unfettered decisions, nor widen the scope of their accountability. In fact it reduced the force of the original Cadbury proposals by suggesting greater flexibility. The Cadbury, Greenbury, and Hampel committees were set up by the UK's financial sector. The codes were essentially voluntary and applied principally to listed companies, although it was suggested that of the recommendations could be applied to private companies.

In 1998, the Cadbury, Greenbury, and Hampel proposals were consolidated into the UK Combined Code, which was incorporated into the London Stock Exchange's. This Combined Code set out standards of good practice on matters such as board composition, director remuneration, accountability, and audit in relation to shareholders. All companies incorporated in the UK and listed on the main market of the London Stock Exchange were now required to report on how they had applied the principle Stock Combined Code in their annual report to shareholders. In this report, companies had to confirm that they had complied with the Code's provisions or, if they had not, to provide explanations.

The UK Turnbull Report (1999) elaborated a call in the Hampel Report for companies to have appropriate internal controls. It set out how directors of UK listed companies should comply with the combined code requirements about internal controls, including financial, operational, compliance, and risk management. The report recognized that risk assessment was vital and recommended that reporting on internal controls became an integral part of the corporate governance process. Thus two new dimensions, enterprise risk analysis and risk management, and internal management controls were added to the field of corporate governance.

The UK Higgs Report (2003) re-examined corporate governance in British companies ten years after the Cadbury Report. The proposals sharpened the requirements in the previous codes, in particular recommending that in listed companies:

- At least half the board should comprise independent non-executive directors.
- All members of the audit and remuneration committees and a majority of the members of the nomination committee should ne independent non-executive directors.
- The role of chief executive should always be completely separate from that of chairman
- Director recruitment should be rigorous, formal, and transparent
- Executive directors should not hold more than one non-executive directorship of a FTSE (Financial Times Stock Exchange) 100 company.
- Boards should evaluate the performance of directors and board committees annually, and have a comprehensive induction programme.
- Boards should have a senior independent director to liaise with shareholders.

It can seen that Higgs had strengthened requirements of the combined code; in particular, demand for independent non-executive directors on the board and in board committees, insisting that the roles of board chairman and CEO should never be combined, that director appointments had to be more transparent, and that directors' and board committees' performance should be evaluated annually-a particularly contentious proposal at the time for many directors. This was the major highlights how corporate governance codes were incepted in UK. Although, in various countries, different codes were developed to promote corporate governance, but, it was the country UK that provided the code which became the basis for other countries ‘codes too.

9.3 OECD PRINCIPLES OF CORPORATE GOVERNANCE

OECD (Organization for Economic Development and Cooperation) has produced sets of Principles that are intended to assist governments in their efforts to evaluate and improve the legal, international, and regulatory framework for corporate governance in their countries and to provide guidance and suggestions to stock exchanges, investors, corporations, and others that have a role in the process of developing good corporate governance. The Principles are intended

to provide the basis for the development of good corporate governance in a country. Against the backdrop of major corporate scandals like Enron, the OECD Council of Ministers has recognized the need to survey developments and regularly update the Principles. The OECD Principles of Corporate Governance are explained as below:

I. **Ensuring the basis for an effective corporate governance framework:** The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory, and enforcement authorities.

II. **The rights of shareholders and key ownership functions:** The corporate governance framework should protect and facilitate the exercise of shareholders' rights.

III. **The equitable treatment of shareholders:** The corporate governance framework should ensure the equitable treatment of shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain redress for violation of their rights.

IV. **The role of stakeholders in corporate governance:** The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active cooperation between the corporations and stakeholders in creating wealth, jobs, and sustainability of financially sound enterprises.

V. **Disclosure and transparency:** The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

9.4 SARBANES OXLEY ACT: USA

In the United States the main driver of change has not been voluntary codes or stock exchange listing requirements but legislation. It is important to mention that companies in the United States are incorporated in a specific state and the state company laws and regulations apply to them. Each state tends to guard its own rights jealously. Consequently, companies cannot be incorporated at the federal level, as in other countries. But since 1933, there has been strong federal oversight of the securities market, through the Securities and Exchange Commission (SEC). Over the years the SEC developed an extensive corporate governance regime for

America's listed companies. A number of reports contributed to these developments, including the 1978 Cohen Commission Report from the American Institute of Certified Public Accountants (AICPA) on auditors' responsibilities; the 1987 Treadway Report, from the National Commission of Fraudulent Reporting, again from AICPA; and the 1992 COSO Report offering an integrated framework for internal control.

In 1997, the Business Roundtable, representing the leaders of major US companies, produced a statement on corporate governance. In 1999, a report 'Blue-Ribbon Report' was published with a view to improve the effectiveness of corporate audit committees.

Between the establishment of SEC and the collapse of Enron, regulators and business leaders in USA were confident of US corporate governance framework. The system seemed to work, met state and federal concerns, and equated the rule of law with regulation through stock exchanges' listing rules to protect investors, and balanced transparency and disclosure with unnecessary and costly bureaucracy.

The expectation was that the rest of the world would gradually converge with this approach to corporate governance. Indeed, some American institutional investors proposed changes to corporate governance practices in Germany, Japan, and other countries to ensure this convergence.

Then the corporate collapses of the 1990s and the early 2000s came. The boxed cases of Tyco, Waste Management, WorldCom, and Enron demonstrate the problems that then emerged. As a consequence, the Sarbanes-Oxley Act, named after US Senator Paul Sarbanes and US Representative Michael Oxley who promoted the bill, was passed in 2002. This was the most significant change in federal securities law since the 1930s.

In 2002, post the Enron and Arthur Andersen debacle, the Sarbanes-Oxley Act was incorporated into the New York Stock Exchange's new corporate governance rules of 2003 and 2004. Simultaneously, in 2002 the Council of Institutional Investors published Core Policies and Principles of Corporate Governance, followed by the American Law Institute's 'General Principles, Positions and Explanatory Notes, and the Business Roundtable's 'Principles of Corporate Governance'.

The SOX Act applied criminal and civil penalties for non-compliance, required certification of internal auditing, and increased financial disclosure. It applied to all public US companies and non-US companies listed in the United States. All public-traded companies were now required to submit an annual report about their internal accounting controls to the US Securities and Exchange Commission.

Section 302 of the Act mandates a set of internal procedures designed to ensure accurate financial disclosure. The signing officers must certify that they are ‘responsible for establishing and maintaining internal controls’ and have designed such internal controls to ensure that material information relating to the company and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared.

The officers must have evaluated the effectiveness of the company's internal controls of a date within 90 days prior to the report and have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date.

Section 404 has attracted much criticism, particularly on the unexpectedly high cost of compliance. The section requires management to produce a report on the company's internal controls as part of the annual report, affirming the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting. The report must also contain an assessment of the effectiveness of the internal control structure and procedures for financial reporting. Independent external auditors must also attest to management's internal control assessment, pursuant to the new SEC rules. This has proved to be an expensive requirement. The act further established:

- New standards for boards and their audit committees
- New accountability standards and criminal penalties for management
- New independence standards for external auditors
- A new Public Company Accounting oversight Board (PCA0B), to oversee public accounting firms and issue accounting standards overseen by the SEC

The SOX legislation has been incorporated into the listing rules of the New York Stock Exchange. The SOX Act has undoubtedly forced a massive concentration on corporate

governance in the United States. Compliance added large costs to companies listed in the US and companies associated with them, brought significant fees to legal and accounting firms, and spawned a new corporate governance advisory and training industry. Some companies based overseas have delisted, others have dropped plans to list. More positively, many US companies report benefits from SOX compliance, including better accountability of individuals, reduced risk of financial fraud, and improved accuracy in financial reports.

9.5 CII CODE-DESIRABLE CORPORATE GOVERNANCE

To follow the trend of setting up various codes related to corporate governance, to protect the interest of investors, the Confederation of Indian Industry (CII) took the initiative in 1996 to develop and promote a code for corporate governance. In a globalizing scenario, in which global investors would demand greater disclosures and transparency of decision-making it was felt necessary to have a set of governance guidelines for the Indian business and industry. With this mandate, CII set up a National Task Force, under the chairmanship of Mr Rahul Bajaj, a former president of CU and Chairman and Director of Bajaj Auto Ltd, that included members from the industry, legal profession, media and academia. The task force prepared the draft reports of guidelines in April 1997 which was then publicly debated and after incorporating the suggestions from various quarters, was published in April 1998. The major recommendations were:

1. A single board structure as it will suffice to take care of good governance.
2. Inclusion of independent, non-executive directors. 30 per cent if the chair is non-executive and 50 per cent if the chair also holds the position of managing director.
3. Number of directorships of a person shall be restricted to 10 listed companies.
4. Non-executive directors (NEDs) to become actively involved on the board, take more responsibilities such as audit committees, and be knowledgeable on the financial aspects of the company.
5. Pay commission and offer stock options to NEDs in addition to sitting fees to attract talent, subject to certain limits.
6. Reappointment must be based on their attendance record during the previous tenure and in case of failure to attend 50 per cent or more meetings, this must he stated in the resolution that is put to vote.
7. Key information that must be placed before the board was given in detail.

8. Audit committees be constituted with at least three members, all of whom must be non-executive and the terms of reference must be clearly defined. The desirable disclosures were also detailed.
9. The annual reports shall include details in the form of additional shareholder information.
10. The consolidation of group accounts shall be optional and voluntary.
11. Major Indian stock exchanges must gradually insist on a compliance certificate signed by the CEO and the CFO stating the responsibility of the management in the integrity and fair presentation of financial statement in the annual reports.
12. About capital market related aspects such as more funding for corporate sector, not insisting on nominee directors by FIs as part of loan covenants, regarding disclosure in the offer documents of credit ratings by more than one rating agency, regarding banning companies from accepting fresh deposits or declaring dividends in the case of defaults on fixed deposit programmes.

9.6 KUMAR MANGALAM BIRLA COMMITTEE ON CORPORATE GOVERNANCE (2001)

SEBI had constituted a Committee on May 7, 1999, under the chairmanship of Shri Kumar Mangalam Birla, then Member of the SEBI Board "to promote and raise the standards of corporate governance". Based on the recommendations of this Committee, new clause 49 was incorporated in the Stock Exchange (Listing Agreements).

The major recommendations of the committee were as follows:

I. The Board of directors of a company should have an optimum combination of executive and non-executive directors with not less than 50% of the Board consisting of non-executive directors. In case the company has a non-executive chairman, at least one third of the board should consist of independent directors.
II. Board meeting should be held at least four times in a year with a maximum time gap of four months between any two meetings.
III. The board should set up a remuneration committee to determine the company’s policy on specific remuneration packages for executive directors.

IV. The board should have a qualified and independent audit committee.

V. The Companies should be required to give consolidated accounts in respect of all their subsidiaries. A company having multiple lines of business should be segmental reporting.

VI. A management discussion and analysis report should form part of the annual report to the shareholders covering industry structure, opportunities and threats, segment wise or product wise performance, outlook and risks.

VII. Companies should arrange to obtain certificates from their auditors regarding compliance of corporate governance provisions and the certificates should be sent to stock exchanges and all the shareholders.

As mentioned, these recommendations were incorporated in the listing agreement (Clause 49) and were sought to be implemented within a time frame of three years. Later, these recommendations got statutory recognition when they introduced provisions in the Companies (Amendment) Act, 2000. The Birla Committee also laid down recommendations for the induction of independent executive directors. Independent directors are those directors who do not have any material, pecuniary relationship of transactions with the company, its promoters, its management or its subsidiaries, which in the judgment of the board may affect their Independence of judgment.

The following board committees are recommended:

1. Audit

2. Remuneration

3. Shareholders

4. General Body

5. Disclosures

6. Means of Communication

The Birla Committee also took note of various steps taken by SEBI for strengthening the corporate governance, some of which are:

1. Stringent disclosure norms for Initial Public Offerings (IPOs).

2. Providing information in directors' reports for utilization of funds and variation between projected and actual use of funds as per the requirement of the Companies Act.

3. Declaration of quarterly results.

4. Mandatory appointment of compliance officer for monitoring share transfer process

5. Timely disclosure of material and price-sensitive information having a bearing on the performance of a company.

6. Dispatching one copy of complete balance sheet to every household and abridged balance sheet to all shareholders.

7. Issue of guidelines for preferential allotment.

8. Issue of regulations providing for a fair and transparent framework for takeovers and substantial acquisitions.

9.7 COMPANIES (APPOINTMENT OF SMALL SHAREHOLDERS' DIRECTOR), RULES 2001

The role of independent directors in public sector is a critical issue. In India, there is a need of corporate governance code, which is rooted in Indian corporate reality. In today's era of consumerism, in the long run only those companies are going have a healthy balance sheet that willingly follow high standards of ethics and corporate standards governance.

To ensure corporate governance, the Securities and Exchange Board of India (SEBI) has stipulated that effective from January 2006, at least one-third of the directors on the board of a company should comprise ‘independent directors’. Known as 'Revised Clause 49', SEBI fixed December 31, 2005 as the date by which all the listed entities would have to comply with Clause 49. The revised clause 49 stipulates that in companies that have executive chairmen, 50% of the board should constitute independent directors. For companies with non-executive chairmen, one-third of the board must comprise of independent directors.

The companies, which will not be able to ensure this may have to face penalties such as suspension of trading or delisting from the stock exchange. While SEBI can delist a company for non-compliance, even individual stock exchanges have been empowered to suspend the trading of shares of defaulting companies. According to the clause, the functions of the board of the directors now include:

- Corporate as well as the operational strategy.
- Policies determining the terms of employment of the top management; its performance evaluation, compensation and succession, etc.
- Determining and propagating the right values and culture in the organization. • Ensuring healthy governance practices within the organization.
- Ensuring co-ordination between the CEO and the top management and balancing the relationship with various stakeholders.
- Statutory responsibilities.
- Ensuring legal compliance with 'clause 49' of SEBI's 'listing agreement'.

Now companies are to form various committees like a 'nomination committee', 'compensation committee', 'governance committee' and others to adhere to corporate governance. The function of the 'compensation committee' for instance, is to ensure a credible and transparent policy in determining and accounting for specific remuneration packages for executive directors, including pension rights and any compensation payment. According to the new law, the nomination committee of the board is to be composed entirely of independent directors, who will be responsible for the evaluation and nomination of board members.

The Companies Act defines the independent director in following manner:

Independent Directors:

- Are not relatives of the chairman, managing director, whole time director, or the company secretary
- Should not have been auditors, internal auditors, legal advisors or consultant to the company during any of the preceding three financial years
- Should not have been suppliers, vendors or customers of the company.

- Should hold below 2% of the shares of the company, presently or in the past.
- Should not have held any position in the company for a continuous period of nine years.
- Nominee directors of banks or financial institutions cannot be considered independent

According to SEBI's clause 49 of the Listing Agreement:

Independent Director

- Should not be related to promoters or the management at the board level or at one level below the board
- Should not have been a partner or an executive of the statutory Audit firm or an internal audit firm or legal and consultancy firm, during the previous three years
- Should not have been suppliers, service providers or customers of the company
- Should hold below 2% of the shares of the company
- Should not have been an executive of the company in the immediately preceding three financial years
- Appointment of non-executive directors beyond a continuous period of nine years not permissible
- Nominee directors of banks or FIs will be considered as independent directors.

9.8 CLAUSE 49 OF LISTING AGREEMENT

SEBI in January 2000 considered the recommendations of the Kumar Mangalam Birla Committee to promote and raise the standard of corporate governance of listed companies. It decided to incorporate a new clause in the listing agreement between companies and stock exchanges to include the recommendation of the committee. The following guidelines were incorporated:

I The board of directors

(a) The board shall have optimum combination of executive and non-executive directors. In case the company has an executive chairman, at least half of the board shall be independent and in the case of a non-executive chairman, at least one-third of the board shall be an independent.

(b) All pecuniary relationships or transactions of the non-executive directors and the company should be disclosed in the annual report.

II Audit Committee

(a) A qualified and independent committee shall be set up. The committee shall have minimum three members, all non-executive directors, with the majority being independent, and the chairman must attend the AGM to answer shareholder queries. The committee can invite executives to be present at the meetings. The CFO/finance director, the head of internal audit, and a representative of the external auditor shall be present, if required. The company secretary will act as the secretary of the committee.

(b) The committee shall meet at least thrice a year, once before the finalization of annual accounts and others in a gap of 6 months. The quorum shall be either two members or one think the members whichever is higher with a minimum of two independent directors.

(c) The powers of the audit committee shall include

• To investigate any activity within its terms of reference

• To seek information from any employee

• To obtain outside advice

• To secure attendance of outside experts if necessary

(d) The committee's role will include

• Oversight of the company's financial reporting with adequate disclosure

• Recommending the appointment or removal of external auditor, fixation of audit fee and approval of fees for any other services

• Discuss with management the annual financial statements before submission to the board with focus on

- Any changes in accounting policies and practice
- Qualifications in draft audit report
- A significant adjustments
- Compliance with accounting standards
- Compliance with requirements by stock exchanges and other legal aspects
- Any related party transactions that may have potential conflict with the interests of the company at large.

- Review of internal control systems with management, internal, and external auditors.
- Review of internal audit functions including structure, staff, leadership, reporting structure, frequency of internal audit, etc.
- Discussion with internal auditors on any significant findings and follow up there on

- Review of any internal investigations by internal auditors
- Discussion and finalization of nature and scope of audit with external auditors
- Review the company's financial risk management policies
- To look into the reasons of substantial defaults in the payments to depositors, debenture holders, shareholders (non-payment of declared dividends), and creditors

III Remuneration of Directors

• The remuneration of non-executive directors shall be decided by the board.

• All details regarding remuneration shall be disclosed in the report on corporate governance in the annual report. Details like salary, benefits, bonuses, stock options, perquisites, etc., as well as details of fixed components and performance linked incentives along with performance criteria and service contracts, notice periods, severance pays and stock option details.

IV Board Procedure

• Board should meet at least four times a year with a maximum gap of 4 months between two meetings. .No director can be a member of more than 10 committees or act as chairman of more than five committees across all companies in which one is a director. It is mandatory for every director to declare the committee positions he occupies to the company and notify the changes as and when they take place.

V Management

In addition to the director's report, MDA is added. Report is added as part of the annual report. MDA should discuss

- The industry and developments.
- Opportunities and threats
- Segment-wise or product-wise performance
- Outlook
- Risks and concerns
- Internal control systems and adequacy
- Financial performance with respect to operational performance
- Material developments in HR/industrial relations including employed number of people
- All financial and commercial transactions made by managements, where they have a personal interest that may have a potential conflict with the interests of the company at large.

VI Shareholders

• When a new director is to be appointed, the shareholders must be provided resume of the director, nature of his expertise in specific functional areas, and companies where the person holds directorship and memberships of committees of the board.

• Information like quarterly results and presentation to analysts on its website be forwarded to the stock exchanges who may display them on their website.

• There must be a committee (shareholders'/investors' grievance committee) to look into the grievances of the shareholders regarding transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends, etc.

• The company must expedite the process of share transfers and for this it should delegate the power to either an officer, a committee, or to the registrar and transfer agents with delegated authority attending to the transfer formalities at least once a fortnight.

VII Report on Corporate Governance

There shall be a separate section on corporate governance in the annual reports with a detailed compliance report-compliance with any mandatory requirement and the extent to which non-mandatory requirements have been adopted shall be highlighted.

VIII Compliance

• The company shall obtain a certificate of compliance with regard to corporate governance requirements from the external auditors which shall be annexed to the corporate governance report and sent to the stock exchanges along with the annual returns.

IX Schedule of implementation

• By all entities seeking listing for the first time, at the time of listing.

• By 31 March 2001 by all entities either in group of BSE A or in S&P Nifty Index as on January 2000.

• By 31 March 2002 by all entities which are listed with paid-up capital Rs 10 crones above or net worth of Rs 25 crones or more any time in the history of the company

• By 31 March 2003 by all entities which are listed with paid up capital of Rs 3 crores and above.

• The non-mandatory requirements shall be implemented at the discretion of the company.

Disclosures regarding adoption/non-adoption of the non -mandatory requirements made in the corporate governance report.

9.9 PROVISIONS OF CORPORATE GOVERNANCE IN COMPANIES ACT, 2013

The 2013 Companies Act also intends to improve corporate governance by requiring disclosure of nature of concern or interest of every director, manager, any other key managerial personnel and relatives of such a director, manager or any other key managerial personnel and reduction in threshold of disclosure from 20% to 2%. The term 'key managerial personnel' has now been defined in the 2013 Act and means the chief executive officer, managing director, manager, company secretary, whole-time director, chief financial officer and any such other officer as may be prescribed. Companies Act, 2013 put greater Emphasis on Governance through The Board and Board Processes as a few highlights are as follows:

- It introduces significant changes to the composition of the boards of directors.
- Every company is required to appoint 1 (one) resident director on its board.
- Nominee directors shall no longer be treated as independent directors.
- Listed companies and specified classes of public companies are required to appoint independent directors and women directors on their boards.
- Companies Act, 2013 for the first time codifies the duties of directors.

The observations and its impact are briefly explained as below:

Board Composition

a). **Number of Directors:** According to Companies Act, 2013 a company may have a maximum of 15 (fifteen) directors. Allowing companies to increase the maximum number of directors on their boards by way of a special resolution would ensure greater flexibility to companies as required by the Companies Act, 2013.

b). **Resident Director:** The requirement to have a resident director on the board of companies has been viewed as a move to ensure that boards of Indian companies do not comprise entirely of non-resident directors. This provision has caused significant difficulties to companies, since it has been brought into force with immediate effect, requiring companies to restructure their boards immediately to ensure compliance with Companies Act, 2013.

c). **Independent Directors:** It is evident from provisions of Companies Act, 2013 that much emphasis has been placed on ensuring greater independence of independent directors. The overall intent behind these provisions is to ensure that an independent director has no pecuniary relationship with, nor is he provided any incentives (other than the sitting fee for board meetings) by it in any manner, which may compromise his / her independence. In view of the additional criteria prescribed in Companies Act, 2013, many listed companies may need to revisit the criteria used in appointing their independent directors.

Duties of Independent Directors: The act imposes significantly onerous duties on independent directors, with a view to ensuring enhanced management and administration. While a list of specific duties has been introduced under Companies Act, 2013, it should by no means be considered to be exhaustive. Independent directors are unlikely to be exempt from liability merely because they have fulfilled the duties specified in Companies Act, 2013, and should be prudent and carry out all duties required for effective functioning of the company.

Liabilities of Independent Directors: Companies Act, 2013 proposes to empower independent directors with a view to increase accountability and transparency. Further, it seeks to hold independent directors liable for acts or omissions or commission by a company that occurred with their knowledge and attributable through board processes. While Companies Act, 2013 introduces these provisions with a view of increase accountability in the board this may discourage a lot of persons who could potentially have been appointed as independent directors from accepting such a position as they would be exposed to greater liabilities while having very limited control over the board.

Position of Nominee Directors: The concept of independent director was introduced as part of the Companies Act, 2013 with a view to bring in independent judgment on the board. A director, once appointed, has to serve the interest of the shareholders as a whole. Directors appointed by private equity investors shall also be covered under the definition of nominee directors, and would no longer be eligible for appointment as independent directors.

Woman Director: While the mandatory requirement for appointment of women directors is expected to bring diversity on to the boards, companies may find it difficult to be in compliance

with Companies Act, 2013 unless they have already identified or internally groomed women candidates that are qualified to be appointed to the board.

Duties of Directors: Companies Act, 2013 seeks to bring about greater standards of corporate governance, by imposing higher duties and liabilities for directors. While the act sets out specific duties, it does not clarify whether the duties of directors listed therein are exhaustive. Therefore, it would be prudent for directors to comply with all duties required for the effective functioning of the company and not be merely be directed by the specified duties which are at best very broadly phrased principles that should guide their behavior.

Further, every director should take care to ensure that it acts in the best interested of all the shareholders as a whole. These provisions become particularly significant in case of nominee directors appointed by private equity investors, who have been known to represent the interests of the investors appointing them in direct contravention of their duties to the shareholders as a whole.

Committees of the Board

Companies Act, 2013 sets out an advanced framework for board functioning by division of core board functions and their delegation to committees of the board. While the audit committee and the nomination and remuneration committee provide the back end infrastructure for boards, the stakeholder's relationship committee and CSR Committee have been entrusted with the task of interaction with key stakeholders. Irrespective of their function, each of the committees would act as a "check and balance" on the powers of the board, by ensuring greater transparency and accountability in its functioning.

Board Meetings and Processes

In the backdrop of global corporate transactions, the changes relating to participation of directors by audio visual and electronic means are a welcome step, aimed at keeping pace with technological advancements.

Companies Act, 2013 has introduced significant changes regarding the board composition and has a renewed focus on board processes. Whilst certain of these changes may seem overly prescriptive, a closer analysis leads to a compelling conclusion that the emphasis is on board

processes, which over a period of time would institutionalize good corporate governance and not make governance over-dependent on the presence of certain individuals on the board.

9.10 SUMMARY

In the lessons, various codes, committees, and acts have been discussed in great detail. It can be observed that although, the code that were initiated in UK still have relevance and the provisions are adopted in various codes developed in recent times too.

9.11 SELF –ASSESSMENT EXERCISE

Fill in the blanks for the following statements:

a). The Cadbury Report (1992) was produced by a committee chaired by Sir ……..

b). OECD has produced sets of Principles that are intended to assist governments in their efforts to evaluate and improve the legal, international, and ……..framework for corporate governance.

c). Major Indian stock exchanges must gradually insist on a compliance certificate signed by the CEO and the CFO stating the responsibility of the management in the integrity and fair presentation of ……..in the annual reports.

d). Companies Act, 2013 proposes to empower ……..directors with a view to increase accountability and transparency.

e). While the mandatory requirement for appointment of women directors is expected to bring …….on to the boards, companies may find it difficult to be in compliance with Companies Act, 2013

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9.13 SUGGESTED READINGS

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9.14 ANSWERS TO SELF –ASSESSMENT EXERCISE

These are the answers for the self-assessment exercise:

a). Adrian Cadbury

b). Regulatory

c). Financial statement

d). Independent

e). diversity

9.15 MODEL QUESTIONS

Q1). How codes regarding corporate governance evolved? Discuss its genesis.

Q2). How SOX Act is linked to corporate governance? Discuss.

Q3). What is clause 49 of listing agreement? What are its provisions?

Q4). What are the changes that have been observed in Companies Act, 2013 regarding corporate governance? How do you see the impact of these on corporate governance?

LESSON-10

SEBI's ROLE IN PROMOTING CORPORTAE GOVERNANCE

STRUCTURE OUTLINE

10.1 Objectives

10.2 Introduction

10.3 SEBI's Role

10.4 SEBI's Major Achievements

10.5 SEBI's Role in Promoting Corporate Governance

10.6 SEBI's Record of Performance

10.7 SEBI's Role in the New Era

10.8 Primary Market Reforms

10.9 Secondary Market Reforms

10.10 SEBI's Shortcomings

10.11 Suggestions

10.12 Summary

10.13 Self –Assessment Exercise
10.14 Bibliography
10.15 Suggested Readings
10.16 Answers to Self –Assessment Exercise
10.17 Model Questions

10.1 OBJECTIVES

After reading the lesson/unit, the learner will be able to:

- To know about the meaning of Role of SEBI in promoting Corporate Governance
- Discuss the SEBI's Record of Performance
- Describe the reforms brought about by SEBI
- To know the existing rote of SEBI and what it ought to be.
- To discuss about the performance, lacunae in its performance and suggestions to improve its performance.

10.2 INTRODUCTION

SEBI (Security and Exchange Board of India) is a statutory body, and was enacted by the government by the SEBI Act, January, 1992. Initially, at the time of its inception, it was not given autonomy with full authority to achieve the purposes for which it was created. The SEBI was enacted primarily to provide protection to investors' interests. Another important purpose of SEBI was to develop the capital market. There was a lacuna in creation of SEBI when it was incepted that although it had been given the responsibility for protecting the investors interests whereas the key areas were retained by the Department of Company Affairs (DCA). Nowadays, DCA has been changed to Ministry of Company Affairs (MCA). SEBI, however, has in due course, been granted more powers/authorities in its areas of operation. The powers granted by the Government are for prudential regulation and not for control. This implies that SEBI is authorized to regulate the stock exchange working, monitoring of the members of stock exchanges and the diverse players in the capital market. SEBI's operations extend over a wide spectrum of players including FFIs (Foreign Financial Institutions), mutual funds and AMCs (Assets Management Companies), venture capital funds, credit rating agencies, underwriters, portfolio managers, and bankers as well as the registrars to the issue, etc.

SEBI has been vested with the important role in our economy. As far as the working of SEBI is concerned, on a few fronts, it has been not very active. Had its role been very active, the scams like Shardha Chit fund and fraud in Satyam would have never happened in our country.

10.3 SEBI'S ROLE

Before we come to know about the role of SEBI in Corporate Governance, let us discuss about the role of SEBI in general. The role of SEBI is that of the regulator of the market. It has been developing guidelines and regulations for regulating the market, with clear objective for promoting effective as well as responsible corporate governance. The regulations framed by SEBI aim

- To help the investors by providing full information so that they are can take informed decisions related to their investments in the capital market.
- To achieve maximum transparency in market for exercising more corporate control so as to force the market to behave in a disciplined manner.
- To prevent such activities as price rigging or artificially decreasing/increasing price of shares which is a normal cause for worry in manipulation of stock exchanges and cause harm to the interest of the shareholders.
- To provide effective measures for investors in cases of abuses for the standard practices by corporates.
- To provide equal opportunities/ treatment to minority shareholders and to protect their interest.
- To ensure complete disclosure by the acquirer of material facts and figures.
- To curb insider trading as well as manipulation, as also bringing transparency, fair play, confidence and integrity for benefit of investors.
- To curb the dangerous practice of front running that is taking place in large fund house like L&T AMC and the latest one being HDFC AMC. Front running is selling and purchasing of shares by a fund manager or a broker which is an illegal act and is at the cost of the unit holder. The case is under SEBI's probe. SEBI should bring self-regulatory guidelines.

10.4 SEBI'S MAJOR ACHIEVEMENTS

SEBI's major achievement refers to its initiative taken in the field of the Listing Agreement-introduction of clause 49 in the stock exchange. It, first of all, brought the change through its original circular dated 21st Februay, 2000, wherein it had specified the principles of corporate governance, but the circular was superseded by other circulars and finally, the new SEBI circular came on 29th October, 2004. The revised circular contained the under-mentioned provisions related to the clause-49of listing agreement:

- ✓ By those institutions which, for the first time, seek listing approval
- ✓ By those institutions which are listed and are obliged to comply with clause 49.These are the bodies which have paid-up share capital 30 million rupees, plus those having net worth of Rs. 250 million or in excess at any time. The timeframe was 1st April, 2005.

The above provision of clause 49 was to be observed by the companies up to 31st March, 2005 or till such time the next revision is brought out. In respect of the other institutions which are not companies like the public sector banks, insurance companies or financial institutions, the revised clause 49 was applicable. Such institutions were to comply with their respective statutes, guidelines/directives issued by the respective regulatory bodies. However, the clause 49 (revised) did not apply to the mutual funds. Clause-49 of the Listing Agreement contains mandatory and non-mandatory provisions. These provisions are already been discussed in the previous lesson-9.

10.5 SEBI'S ROLE IN PROMOTING CORPORATE GOVERNANCE

G. N. Bajpai, former Chairman, SEBI, claimed in an international conference in 2003: "With the objective of improving efficiency, enhancing transparency, preventing unfair trade practices and bringing the Indian market up to international standards, a bundle of reforms consisting of measures to liberalize, regulate and develop the securities market was introduced in the 1990s. The practice of allocation of resources among different competing entities as well as its terms by a central authority was discontinued. The issuers complying with the eligibility criteria now have freedom to issue the securities at market-determined rates. The secondary market overcame the geographical barriers by moving to screen-based trading, which made trading system accessible to everybody anywhere in the Indian sub-continent. Trades enjoy counter-party guarantee. The trading cycle has been shortened to a day and trades are settled within two working days while all deferral products are banned. Physical security certificates have almost disappeared. A variety of derivatives are available. In fact, some reforms such as straight through processing in

securities, T+2 rolling settlement, clearing corporation being the central counter party to all the trades on the exchanges, real time monitoring of brokers positions and margins, automatic disabling of brokers' terminals are singular to the Indian securities market. Indian disclosure and accounting standards are as modern, updated, potent and versatile as those of any other market. Today, the Indian securities market stands in a good position as with most developed markets in North America, Western Europe and Far East."

According to SEBI's former chairman, The Securities and Exchange Board of India has been focusing on the following areas to improve corporate governance:

I. Ensuring timely disclosure of relevant information
II. Providing an efficient and effective market system
III. Demonstrating reliable and effective enforcement
IV. Enabling the highest standards of governance.

These are explained in detail as follows:

Disclosure standards

It has been observed that disclosure standard in the Indian regulatory jurisdiction are at par with the best in the world. Several global organizations-both regulatory and market participants-have appraised the disclosure standards followed by Indian companies. SEBI has ensured that a company is required to make specified disclosures at the time of issue and make continuous disclosures as long as its securities are listed on exchanges. The standards for these disclosures including the content, medium and time of disclosures have been specified in the Companies Act, Disclosure and Investor Protection Guidelines, Listing Agreement Regulations relating to insider trading and takeover etc. These disclosures are made through various documents such as prospectus, quarterly statements, annual reports etc. and are disseminated through media, web sites of the company and the exchanges, and through EDIFAR (Electronic Data Information Filing and Retrieval) system maintained by the regulator. These disclosures relate to financial performance, shareholding pattern, trading by insiders, substantial acquisitions, related party disclosures, audit qualifications, buyback details, corporate governance, actions taken against company, risk management, utilization of issue proceeds, remuneration of directors etc. All listed companies and organizations associated with securities markets including the intermediaries,

asset management companies, trustees of mutual funds, SROs (Self Regulatory Organizations), stock exchanges, clearing house/corporations, public financial institutions, professional firms such as auditors, accountancy firms, law firms, consultants, etc. assisting or advising listed companies are required to abide by the Code of Corporate Disclosure Practices specified in SEBI (Insider Trading) regulations.

Efficient and effective market system

The Indian securities market has a large infrastructure to cater to the demands of a sub-continental market. There is sufficient length and breadth in the Indian Financial markets. Yet, there is only one regulator. The systems and infrastructure used in the markets are sophisticated and up to date. All stock exchanges in India offer on line, fully automated, nation-wide anonymous, order-driven screen based trading system. It has a comprehensive risk management system. The depositories' legislation ensures free transferability of securities with speed, accuracy and security. The securities are transferred electronically in demat form. Further, Indian accounting standards follow international accounting standards and are by and large aligned. In addition to creating an efficient trading platform and settlement mechanism, SEBI's focus is substantially directed towards the following:

- Provision of timely availability of high quality price sensitive information to the market participants so as to enable them take informed decision and ensure efficient price discovery
- Maintenance of high quality of services and fair conduct for market participants. The regulations specify high standards to become market intermediaries and require them to abide by a code of conduct
- Ensuring that the market is fair, transparent and safe so that investors are at ease to carry out transactions.

Reliable and Effective Enforcement

SEBI aims at ensuring that no misconduct goes unnoticed or unpunished. That is why it keeps an eye on the happenings in the market and identifies anything unusual or undesirable which may adversely affect the efficacy of the market. Every market participant, irrespective of his size and influence in the market or in the policy, is held accountable for his misdeeds.

Highest Standards of Governance

SEBI has avowed that its regulation and guidance of the country's securities market would spell success in the area of corporate governance. The Kumar Mangalam Birla Committee of the Indian jurisdiction outlined a code of good corporate governance, which compared very well with the recommendations of the Cadbury Committee and the OECD codes. The code was operationalised by inserting a new clause (Clause 49) to the Listing Agreement and have been made applicable to all the listed companies in India in a phased manner. Following the implementation of the Birla committee recommendations, substantial developments took place in the corporate world and securities market, which required revisit of the issue. The Narayana Murthy Committee has refined the corporate governance norms, which are proposed to be implemented through modification in the listing agreement. The government also appointed few committees to suggest ways and means of realizing good corporate governance. Based on their recommendations, government is trying to provide statutory back-up to corporate governance standards.

The initiatives for improvement in corporate governance have come because of the efforts form mainly from three sources, namely, the market, regulator and the legislature. While the legislative initiative is directed towards bringing about amendments to the basic law-India's Companies Act to include certain fundamental provisions related to corporate governance, dynamic aspects of corporate governance such as disclosures, accounting standards etc. are being pursued through the regulatory initiatives by bringing about amendments to the Listing Agreement. Such an approach is aimed at because a comparatively more complicated and protracted process is involved in the amendments to legislation in a democratic country like India. The most important initiative comes from market forces and mechanisms, which encourage and insist on the management's improving the quality of corporate governance. Indian market has formalized such forces in the form of a rating called "Corporate Governance and Value Creation Rating", which is sought after voluntarily by companies.

10.6 SEBI's RECORD OF PERFORMANCE

By continuously focusing on various issues-protection of small investors' interests, or technology upgradation or development of securities market-SEBI has indeed been working with commensurate speed and efficiency in the last couple of years. There has, however, been a common perception that SEBI has not developed a set of regulatory personnel to effectively

track violations. After the Harshad Mehta's securities scam in 90s which was blamed on a systemic failure, the system needed a thorough overhauling. However, nothing really happened. Later another scamster, Ketan Parikh made use of the loopholes in the system to his advantage. He was instrumental in rigging the prices of shares resulting in heavy losses to the investing public, which led to erosion of faith in the capital market. Over the years, quite a few companies raised money through IPOs and disappeared without a trace. It is not seen that the perpetrators of these frauds are promptly brought to book.

10.7 SEBI's Role in the New Era

In the changed environment of the Indian economy, when after more than four decades of heavy regulation and much needed growth, with the government slowly opening the economy to market forces, and promoting modification of financial institutions, SEBI has to play a proactive role as a capital market regulator. SEBI's performance has to be judged in the context of its efficiency in this dynamic environment. The SEBI has made progress in a number of areas:

- Abolition of capital issues control and retaining the sole authority for new capital issues
- Regulation and reform of the capital market by arming itself with necessary authority and powers
- Regulating stock exchanges under Securities Contracts Regulation Act
- Bringing all primary and secondary market intermediaries under the regulatory framework
- Enforcing the companies to disclose all material facts and specific risk factors associated with projects while going in for public issues.

The record of the SEBI, over the period, has indeed been encouraging. SEBI has sought to check and control unfair practices on the stock exchanges, acted against transgressing companies, brokers accused of rigging prices, and scrips showing large price movements. At the same time, SEBI has sought to reduce regulation, and instead to leave it largely to the players in the market.

The capital market is composed of two constituents: the primary market and the secondary market. While the primary market deals with the issue of new stocks and shares, the secondary market deals with the buying and selling of existing stocks and shares. SEBI, as a regulator of capital market, has to play a regulatory role in both these markets. With a view

to improving practices and ensuring greater transparency in capital markets so as to have a healthy capital market development and promote corporate governance among companies, SEBI has taken several steps as explained in the next session.

10.8 PRIMARY MARKET REFORMS

The primary capital market plays pertinent role in the overall functioning of securities market. Vibrancy of primary market, among other things, is a function of macroeconomic factors, industrial output and demand. Over the years, the Securities and Exchange Board of India, the market regulator, has taken several initiatives to improve the operational efficiency and transparency of the primary market, which provides investors with issues of high quality and for firms a market where they can raise resources in a cost-effective manner.

With regard to the primary market, these are the following major reforms have been effected by SEBI:

I. **Relating to new issues:** In case of new issues, the SEBI has introduced various guidelines and regulatory measures for capital issues with the objective of strengthening standards of disclosures, and certain procedural norms for the issuers and intermediaries with a view to removing the inadequacies and systemic deficiencies in the issue procedures. Companies issuing capital in the primary market are now required to disclose all material facts and specific risk factors regarding the projects; they should also give information regarding the basis of calculation of premium. SEBI has also introduced a code of advertisement for public issues with a view to ensure fair disclosures in the same regard. The SEBI has also put in place a system of appointing its representatives to supervise the allotment process and to minimize malpractices and anomalies in the allotment of oversubscribed issues. Prudential norms have also been laid down for right issues.

II. **Freedom to fix par value of shares:** The SEBI has dispensed with the requirement to issue shares with a fixed par value of Rs. 10 and Rs. 100 and has given the freedom to the companies to determine the par value of shares issued by them. Companies with dematerialized shares have been allowed to alter the par value of a share indicated in the Memorandum and Articles of Association. The existing companies, which have issued shares at Rs. 10 and Rs. 100, can avail of this facility by consolidating, splitting their existing shares.

III. **Guidelines for tightening the entry norms:** Guidelines for tightening the entry norms for companies accessing capital market were issued by the SEBI on 16 April 1996. Accordingly, a company should have a track record of dividend for a minimum 3 years out of the immediate preceding 5 years. If a manufacturing company does not have such a track record, it can access the public issue market subject to the condition that projects have been appraised by a public financial institution or a scheduled commercial bank and such appraising agency is also participating in the project fund.

IV. **Relating to IPOs:** To encourage Initial Public Offers (IP0), SEBI has let companies determine the par value of shares issued by them. SEBI has permitted issues of IPOs to go for 'book building', i.e. reserve and allot shares to individual investors. However, the issuer will have to disclose the price, the issue size and the number of securities to be offered to the public.

V. **Investor protection measures:** On 15June 1998, SEBI advised investors to exercise a greater deal of caution while investing in plantation companies. At the same time, plantation companies and other collective investment schemes were directed to obtain credit rating from accredited agencies prior to the issue of advertisement.

VI. **Cost reduction measures:** To reduce the cost of issue, SEBI has made underwriting of issue optional, subject to the condition that if an issue was not underwritten and was not able to collect 90% of the amount offered to the public, the entire amount collected should be refunded to the investors. The lead managers have to issue due diligence certificate, which has now been made part of the offer document.

VII. **Relating to private placement market:** Private placement market has become popular with issuers because of stringent entry and disclosure norms for public issues. Low cost of issuance, ease of structuring investments and saving of time lag in issuance has led to the popularity and rapid growth of private placement. Total resource mobilization through private placement market had risen by more than three times between 1995-96 and 1998-99.

VIII. **Banker to the issue under SEBI's purview:** The 'Banker to the Issue' is now brought under the purview of SEBI for investor protection. The Unit Trust of India (UTI) has been brought under the regulatory jurisdiction of SEBI.

IX. **Regulations on acquisitions and takeovers:** SEBI has raised the minimum application size and also the proportion of each issue allowed for firm allotment to institutions such as mutual funds. SEBI has also introduced regulations governing substantial acquisition of shares and takeovers and lays down the conditions under which disclosures and mandatory public offers have to be made to shareholders.

X. **Merchant banking under SEBI's jurisdiction:** Merchant banking has been statutorily brought under the regulatory framework of SEBI. Merchant bankers are now to be authorized by SEBI and have to adopt the stipulated capital adequacy norms, abide by a code of conduct which stipulates a high degree of responsibility towards inspectors in respect of the pricing and premium fixation of issues. Merchant bankers will also have to adhere to provisions relating to disclosures or offer letters for issues.

XI. **Permission to set up private mutual funds:** The government has now permitted the setting up of private mutual funds. All mutual funds are allowed to apply for firm allotments in public issues. To improve the scope of investments by mutual funds, the latter are permitted to underwrite public issues. SEBI has relaxed the guidelines for investment in money market instruments. The market regulator has issued fresh guidelines for advertising by mutual funds.

XII. **Making companies provide authentic information:** SEBI has advised stock exchanges to amend the listing agreements to ensure that a listed company furnishes annual statement to the stock exchange showing the variations between financial projections and the projected utilization of funds in the offer documents and the actual utilization. This would enable shareholders to make comparisons between promises and performance of companies they invested in.

XIII. **Making companies comply with issue norms:** In order to make companies exercise greater care and diligence for timely action in matters relating to the public issues of capital. SEBI has advised stock exchanges to collect from companies making public issues, a deposit of 1% of the issue amount which could be forfeited in case of non-compliance of the provisions of the listing agreement and non-dispatch of refund orders and share certificates by registered post within the prescribed time.

XIV. **Scrutiny of offer documents:** SEBI scrutinizes offer documents to ensure that the company in the offer document has made all disclosures. All the guidelines and

regulatory measures of capital issues are meant to promote healthy and efficient functioning of the issue market.

XV. **Access to international capital market:** Since 1992, the government of India has permitted Indian companies to access international capital markets through Euro equity shares. Initially, the Euro issue proceeds were to be utilized for approved end uses within a period of 1 year from the date of issue. Since there was continued accumulation of foreign exchange reserves with the RBI and there were long gestation periods of new investments, the government allowed the issuing companies to retain the Euro issue proceed abroad and repatriate them to the country only as and when expenditure for the approved end uses were incurred.

The GOI has also liberalized investment norms for Non-Resident Indians (NRIs) so that they and overseas corporate bodies can buy shares and debentures without prior permission of the RBI of India which has been the practice followed hitherto.

10.9 SECONDARY MARKET REFORMS

In the matter of reform of the secondary market, a market that is engaged in the buying and selling of old stocks and shares, SEBI have initiated the following measures:

I. **Registration of Intermediaries:** SEBI has started the process of registration of intermediaries, such as the stockbrokers and sub-brokers under the provisions of the Securities and Exchange Board of India Act, 1992. The registration is made on the basis of certain eligibility norms such as capital adequacy, infrastructure and other necessary requirements. There has been much opposition and resistance to this step of SEBI. The capital market regulator has also made rules for making client-broker relationships more transparent, particularly with reference to the segregation of client and broker accounts.

II. **Reconstitution of stock exchange governing bodies:** To make the governing body (GB) of a stock exchange more broad-based, SEBI has issued guidelines for its composition. According to these guidelines, the governing body of a stock exchange should have five elected members, of which not more than four nominated by the government or SERI and three or fewer persons nominated as public representatives. During 1994-95, SEBI has reconstituted the governing bodies of stock exchanges.

III. **Measures to speed up settlements:** SEBI has prohibited ‘renewal’ of transactions in 'B' group securities, so that transaction could be settled within 7 days.

IV. **Simplification of procedures:** Since 1992, SEBI has constantly reviewed the traditional trading system in Indian stock exchanges. SEBI is simplifying procedures and achieving transparency in costs and prices at which customer orders are executed, speeding up clearing and settlement and finally transfer of shares in the names of buyers. SEBI is setting up depositories, which would immobilize securities and help eliminate paper work-this would give impetus to the growth of stock markets.

V. **Regulations on insider trading:** SEBI has notified regulations on insider trading under the provisions of SEBI Act. Such regulations are meant to protect and preserve the integrity of stock markets and, in the long run, to help inspire investor confidence in them. Despite these regulations, insider trading is rampant in our stock exchanges, and rigging the market and manipulating stock market price quotations are quite common.

VI. **Regulation of collective investment schemes:** SEBI's regulations for collective investment schemes (CIS) were notified on 15 October 1999. CIS includes any scheme, or arrangement with respect to property of any description, which enables investors to participate in the scheme by way of subscription and to receive profits or income or produce arising from the management of such property. Under the SEBI Act and Regulations framed thereunder, no person can carry on any CIS unless he obtains a certificate of registration from SEBI. All existing CISs were required to apply for registration by 14 December 1999.

VII. **Regulation of foreign investments:** The government has allowed foreign institutional investors (FIIs) such as pension funds, mutual funds, investment trusts, asset or portfolio management companies etc. to invest in the Indian capital market provided they are registered with SEBI. The GOI has now permitted joint venture stock broking companies to have non-Indian citizens on their boards of directors.

VIII. **Introduction of compulsory rolling settlement:** In keeping with international best practice, SEBI has introduced compulsory rolling settlement of select scrips on 10 January 2000. In June 2000, SEBI introduced derivatives trading. As far as internet trading is concerned, SEBI has prescribed minimum technical standards to be enforced by stock exchanges for ensuring safety and security of transactions via the internet.

Rolling Settlement has been extended to all scrips on all the stock exchanges with effect from 31 December 2001. SEBI has further decided to shorten the rolling settlement cycle from present T+5 to T+3 for all listed securities from 1 April 2002. The markets have now moved to T+2 settlement from 1 April 2003.

IX. **One point access to investors:** In July 2002, SEBI launched a centralized internet based filing system for listed companies called EDIFAR (Electronic Data Information Filing and Retrieval System), which requires companies to post disclosures as per the listing agreement with the stock exchange on the EDIFAR website at the same time as they submit them to the exchange. The objective of EDIFAR is to provide investors simultaneous, one-point access to key information on all listed companies. Beginning July 2002, SEBI has been posting all orders passed by its chairman against errant companies and market intermediaries on its website. This provides useful information to investors.

X. **Introduction of takeover codes:** With regard to mergers and acquisitions, SEBI has made several investor-friendly amendments to the takeover code time and again. For example, preferential allotments were brought under the ambit of takeover code in September 2002. This would stop the practice of promoters making preferential allotments to avoid making an open offer to other shareholders. Acquirers also have to disclose their holding more frequently, which increases transparency.

XI. **Trading of government securities through screen-based system:** With a view to encouraging wider participation of all classes of investors, trading in government securities through a nationwide screen-based trading system of the stock exchanges, in the same manner in which trading takes place in equities, was launched on 16 January 2003, initially on Bombay Stock Exchange (BSE), National Stock Exchange (NSE) and Over the Counter Exchange of India (OTCEI).

XII. **Delisting guidelines:** The market regulator has issued the SEBI (Delisting of Securities) Guidelines, 2003 on 17 February 2003. The guidelines provide that companies can delist from stock exchanges only by offering an exit rout to remaining shareholders through a ‘reverse book building’ process. This mechanism would leave the option of pricing to the investors and would be totally transparent to the market.

Central listing authority: To bring about the uniformity in scrutinizing listing applications across the stock exchanges and to strengthen the listing agreements, SEBI has, in April 2003, established the Central Listing Authority in Mumbai. There shall be eight other members of the Authority, all of whom shall hold office for a period of 3 years. They shall discharge the following functions:

(i) Processing the application made by corporates, mutual funds, or collective investment schemes

(ii) Making recommendations as to listing conditions.

XIII. **Derivative trading:** The Central Government lifted the prohibition on forward trading in securities by a notification issued on 1 March 2000 rescinding the 1969 notification. With the enabling enactment of the Securities Laws (Amendment) Act, 1999 in December 1999, trading in stock index futures started in June and July 2001 respectively. Single stock futures have also been introduced since 9th November 2001. Interest Rate Derivatives trading was formalized on the stock exchanges with the launch of futures on 10-year zero yield coupon bond and zero-coupon notional T-Bill in June 2003.

XIV. **Demutualization and corporatization of regional stock exchanges:** In year 2004, the Securities Contract (Regulations) Act (SCRA) was amended through the promulgation of an ordinance to make corporatization and demutualization of stock exchanges mandatory. The ordinance has been issued on the basis of the recommendation of a group under the chairmanship of Justice M. H. Kania, former Chief Justice of India, to advise the government on the issue of corporatization of stock exchanges. The amendment not only requires separation of ownership and trading rights, it also requires that the majority ownership rests with the public and those without any trading rights. Also through these conditions, the government has signalled a major shift in its earlier stand that stock exchanges should be self-regulating agencies of their members. It now desires that they should be externally regulated.

10.10 SEBI'S SHORTCOMINGS

There is no denial to the fact that SEBI has come a long way since its inception in acquiring more powers and wielding great authority in regulating the Indian capital market. It suffers from certain lacunae too. There is a lack of adequate and necessary power on the part of SEBI to be

more effective in its working. In contrast to SEC (Securities and Exchange Commission), the counterpart of SEBI, it has been entrusted with less penal powers. Although, the size of the Indian capital market is mammoth, and to handle it, it need more powers so as to identify any delinquency, if any. Moreover, SEBI does not have direct oversight over auditing and accounting profession which makes it handicap so as to nip the problem in the bud.

10.11 SUGGESTIONS

In the light of above shortcomings in SEBI, these are a slew of measure that would improve its working explained as below:

- Working of stock exchange must be closely monitored.
- To insist the corporate to submit the extensive information on a regular basis.
- To penalize the members of stock exchange who are violating the laws.
- To debar the wrongdoers from any participation in the market
- To make rules about the manipulative practices
- To move court for checking insider trading.
- To prosecute a company and its directors *suo moto,* even without receiving complaints by any aggrieved investor in respect of supplying inadequate and incorrect information.

In view of the backdrop of the competitive globalized market environment When only the fittest will survive and capital being a scarce resource, it is but natural that corporates will explore ways to acquire additional funds and in this background, it is imperative that apart from reviewing the existing SEBI guidelines, the concerned ministry gives additional authority-judicial or executive to punish the rule breakers to the market regulator.

10.12 SUMMARY

SEBI was created for protecting the interests of the investors and developing the stock market. In due course of time, SEBI has been granted more powers and authorities in its areas of operation. Powers given by the government are for prudential regulation and not for control. The Indian corporate world is predominantly dominated by its promoters with 40% of the equity in their hands and shareholders are the minority and weak group. The internal capital market has dominated the external capital market. Instances of expropriation of equity from one company to another are detrimental to interest of small investors. Financial institutions are not monitored effectively, and lack of transparency in financial reporting results in corrupt practices. Due to

concentrated dominance and control of the internal capital market, stock exchange is not strong. Hence, SEBI must be entrusted with more powers to be effective in the capital market.

10.13 SELF –ASSESSMENT EXERCISE

Fill in the blanks for the following statements:

a). SEBI is authorized to regulate the stock exchange working, monitoring of the members of ……..and the diverse players in the capital market.

b). The powers granted by the Government to SEBI are for prudential regulation and not for ……..

c). SEBI's focus is on provision of timely availability of high quality price sensitive information to the market participants so as to enable investors take ……decision and ensure efficient price discovery

d). The GOI has now permitted joint venture stock broking companies to have ……on their boards of directors.

e). SEBI ensures that the market is……., transparent and safe so that investors are at ease to carry out transactions.

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10.16 ANSWERS TO SELF –ASSESSMENT EXERCISE

These are the answers for the self-assessment exercise as follows:

a). Stock exchanges

b). Control.

c). Informed

d). Non-Indian citizens

e). Fair

10.17 MODEL QUESTIONS

1). Critically analyze the role of SEBI as a capital market regulator in India.

2). Discuss the role and objectives of SEBI in detail.

3). Discuss the role of SEBI in promoting Corporate Governance in India. Explain its role in special reference to primary and secondary markets in India.

4). What are the shortcomings you observe in working of SEBI? Describe.

5). What are the suggestions for improvement of working of SEBI? Elaborate.