

## CH-1 INTRODUCTION TO CORPORATE GOVERNANCE

### Meaning

- Corporate governance refers to the mechanisms and processes through which companies are operated and controlled, ensuring accountability, fairness, and transparency in the relationship between a company's management, board, shareholders, and other stakeholders.
- Since corporates or companies are artificial persons, they cannot act on their own. They are dependent on someone who can act for them.
- The shareholders, who have contributed capital for the company, are not entitled to participate in managing the company as it is impractical. They are numerous, widely scattered and have diverse expectations from the company.
- Therefore, most of the laws prevailing worldwide provide that a company shall be managed by /under the direction of its Board of Directors(BOD).
- The Board of Directors is a group of individual that are elected to act as representatives of the shareholders. They run the company on behalf of the shareholders for pursuing the pre-determined objectives.
- The BOD appoints the management (i.e. CEO, managers and senior executives) to run the company under its direction and supervision.
- Thus, separation of ownership from management has given birth to the concept of 'corporate governance'.

### ORIGIN OF CONCEPT CORPORATE GOVERNANCE

- The term 'governance' is derived from Latin word *Gubernare* which means 'to steer'. In the context of companies it means direction and control of a company.
- The idea of corporate governance , owes its roots to Adolf Berle and Gardiner Means,who in their seminal work '*The Modern Corporation and Private Property*'(1932) emphasised the importance of shareholders' rights, transparency in actions and accountability of those who control the corporates.

- It was Robert Ian Tricker, who introduced this term when he released his book titled '*Corporate Governance*' (1984). He is regarded as the Father of Corporate Governance.
- Since then, this term has become the buzzword. The field of corporate governance is continuously evolving. Corporate governance is a multifaced concept and encompasses various definitions.

## **POPULAR DEFINITIONS OF CORPORATE GOVERNANCE**

### **DEFINITION GIVEN BY CADBURY COMMITTEE REPORT (NARROW DEFINITION)**

***'Corporate Governance is the system by which business corporations are directed and controlled. Board of Directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place.'***

Thus this definition identifies only the involvement of three groups in the corporate governance i.e. directors, shareholders and the auditors. That is why it is regarded as a narrow view of CG.

In today's world, there are other interested groups as well such as employees, customers, government, suppliers, local community and others. Thus, let's explore some other definitions of CG which provide a broader view.

### **DEFINITION GIVEN BY ORGANISATION FOR ECONOMIC COOPERATION AND DEVELOPMENT(OECD)(Broader Definition)-**

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

- Thus the above definition identifies other stake holders as important actors . Further it has introduced effective monitoring( and not mere establishing a structure or a system) as an important aspect of corporate governance.

## DEFINITION BY THE INSTITUTE OF COMPANY SECRETARIES OF INDIA

***‘Corporate Governance is the application of best management practices, compliance of law in true letter and spirit and adherence to ethical standards for effective management and distribution of wealth and discharge of social responsibility for sustainable development of all stakeholders’.***

- This definition is quite comprehensive –gives importance to all stakeholders and to sustainable development and covers various aspects of governance like-
- *-application of best management practices,*
- *-compliance of law*
- *-adherence to ethical standards*
- *- distribution of wealth and discharge of social responsibility*

## NEED FOR CORPORATE GOVERNANCE (ABCDEFGG)

- **Activism of regulatory bodies** such as SEBI. SEBI has made corporate governance compulsory for certain companies. This is done to protect the interest of the investors and other stakeholders. Similarly there are several provisions in the Companies Act, on corporate governance.
- **Business journalism-** With the advent of investigating reporting in business journalism, there is focus on reporting, analyzing, and presenting news and information related to business, finance, economy, markets, and industries. Because now companies are being watched closely, there is a need to raise standards of corporate governance otherwise they will get backlash from the public.
- **Corporate Collapses and scams-** Corporate Governance came into prominence in the wake of a series of corporate collapses taken place around the globe. The failure of giant companies-Enron,WorldCom, Xerox,Poly peck, Rolls Royce, Satyam etc shattered the confidence of investors and mounted massive financial losses to the shareholders and other stakeholders. These prompted re-examination of effectiveness of boards given that the board is central to the formulation and implementation of corporate strategies and responsible for oversight over the executives.

- **Divorce between ownership and management:** Since in a corporate world, there is separation of ownership and management, owners are unable to exercise effective control over the management of their organisations. This has given the management chance for unfair and unethical practises to serve their vested interests at the cost of stakeholders of the organisation. Hence corporate governance assumes importance as it seeks to protect the interests of shareholders, particularly minority shareholders, by ensuring fair treatment and preventing abuse of power.
- **Expectations of the society-** Today, social responsibility is given a lot of importance. The Board of Directors have to protect the rights of the customers, employees, shareholders, suppliers, local communities, etc and have to be more responsible to the needs and expectations of the society. This is possible only if they use corporate governance. For instance, pollution of environment is no longer tolerated.
- **Financial crises of 2008-** The financial crises of 2008 has renewed focus on corporate governance, once again. The financial crises prompted by the securitisation of sub-prime mortgages in the US had a chain effect owing to the globalisation and led to collapse of various banks and financial institutions around the world. The financial crises was attributed to failures and weaknesses in the corporate governance arrangements. Excessive risk taking prompted by the greediness of the managements of the companies to show fabulous results, and lack of foresightedness of the boards culminated in unfolding of inevitable burst of global financial meltdown. In many cases risk management systems failed due to inadequacies in corporate governance procedures. The crises called for reform on board processes relating to management of risk in particular.
- **Globalisation** - There has been a cult of equity investment around the world with large number of companies trotting the globe to peddle their securities. The significance of good governance in attracting investors has gained recognition. Good governance practices enhance the performance of company and boosts up the investors confidence. Studies have revealed that markets and investors do take note of well governed companies.

## CORPORATE GOVERNANCE : BENEFITS

- **Improving the operational performance**-Good corporate governance standards add considerable value to the operational performance of the company by improving strategic thinking at the top; enabling BOD to take quick and better decisions; constant monitoring of risks that a firm faces; reducing cost of capital; avoiding wastages and by utilizing all resources optimally.
- **Enhancing Transparency and Accountability:** Strong governance practices promote transparency in financial reporting and decision-making processes, reducing the risk of fraud, corruption and misconduct.
- **Reducing Risk:** Robust governance structures help in identifying and managing risks effectively, reducing the likelihood of corporate scandals and failures. It helps in identifying, and mitigating risks associated with ESG (Environmental, Social, and Governance) factors.
- **Protecting Stakeholders Interests-** Corporate governance ensures that managers work in the best interests of corporate owners (shareholders) and other stakeholders.
- **Building Investor Confidence:** Good corporate governance enhances investor confidence and attracts investment by demonstrating a commitment to ethical practices and regulatory compliance.
- **Higher Firm Valuation-** Good corporate governance has a positive impact on the share price of the company. Many researches have proved that investors are ready to pay higher prices for the shares of well managed companies.
- **Reputation and recognition-**Firms following good corporate governance standards gain the trust of the investors, customers and community at large. This helps in improving the company's reputation and helps in brand formation. This image will help the firm prosper in the long run and achieve its goals more quickly.
- **Sustaining Long-Term Growth-** Effective governance contributes to the long-term success and sustainability of a company by fostering good management practices and strategic oversight.

## **DISTINCTION BETWEEN CORPORATE GOVERNANCE AND MANAGEMENT**

1. Corporate governance is the primary responsibility of the Board. Management is the primary responsibility of management team comprising of CEO, and managers at various levels.
2. The governing body or Board of a corporate entity is non-pyramid, non-hierarchic. Each director of the board is on equal footing having equal powers which are exercised as a group in the board meeting. The structure of management is traditionally hierarchial with CEO at the top, divisional heads reporting to him, and managers at the middle and lower levels.
3. Corporate governance is about vision, mission and direction of the entity. Management is about day-to- day operations and implementation of policies and programmes.
4. The focus of governance is on overall control and direction whereas management focuses on performance and results.
5. Governance involves strategic decision-making at a high level, whereas management involves tactical and operational decision-making.
6. Corporate governance is concerned with long-term survival and sustainability of the company whereas Management is concerned with short term and medium-term targets.

## **PILLARS OF CORPORATE GOVERNANCE(TARIF)**

1. **Transparency**-Openness in disclosure of company operations, financial status, and decision-making processes. Ensures that stakeholders have access to timely, adequate and accurate information on all material matters such as financial performance, ownership, risk – so that they can judge whether their interests are being taken care of by the company.
2. **Accountability**-Responsibility of the board and management to act in the best interests of shareholders and other stakeholders.
3. **Responsibility**- Management be responsible for their behaviour and have means for penalising the mismanagement. Encourages compliance with laws and regulations and fosters a culture of ethical behavior.
4. **Independence**- BOD must be independent, strong and non-partisan body where all decision making is based on business prudence. Decisions must be made objectively without any undue influence from large shareholders, dominating CEO etc.
5. **Fairness**-Equitable treatment of all shareholders and stakeholders, including the protection of minority interests. Protect shareholders' rights, prevents exploitation and ensures that all parties have a fair chance to participate in the company's success. Provide effective redressal for violations.