CHAPTER

8 CONCEPTUAL FRAMEWORK FOR CORPORATE GOVERNANCE

INTRODUCTION

8.1 Adolf Browne and Gardiner Means in their seminal work, "*The Modern Corporation and Private Property*" (1932) emphasised the importance of granting voting rights to all the shareholders, ensuring transparency in actions and sufficient accountability of those who control the corporation. The idea of Corporate Governance, thus, owes its roots to Browne and Means. The duties of Board of Directors expanded substantially during this period. Bob Tricker introduced the term 'Corporate Governance' in 1984 and wrote a book with the same title. He is, generally, regarded as the Father of Corporate Governance. In the 1980's and 1990's, many corporate scandals and failures were unearthed in United States and United Kingdom. The Satyam scandal, the biggest ever corporate fraud in India, also had its genesis in corporate governance failure. Consequently, an urgent need is being felt to raise the standard of corporate governance and introduction of comprehensive regulatory framework good corporate governance.

DEFINITION OF CORPORATE GOVERNANCE

8.2 The field of corporate governance is continuously evolving. There is no set definition of the term (Du Plessis, Hargovan and Bagaric; 2010).

Narrow definition

8.2-1 One of the first popular definitions of corporate governance was given by the *Cadbury Committee*. According to the Cadbury Committee Report,

> *"Corporate governance is the system by which business corporations are directed and controlled. Board of Directors is 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."*

This definition reflects a narrow view of corporate governance as it identifies only three groups involved in corporate governance *viz.*, directors, shareholders and auditors. Any corporate in today's world has to deal with other interested groups such as local community, employees, customers, government, suppliers, and others such groups. These groups are called stakeholders. Thus, the above definition limits the scope of corporate governance.

Broader definition

8.2-2 A broader view of the term has been enunciated by *Organization for Economic Co-operation and Development (OECD, 2004)*. It states:

> *"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. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring"*

Thus, the above definition identified '*other stakeholders*' as important actors who are also involved in decision making in various corporates and it introduced the element of '*effective monitoring*' (not mere laying down a governance structure) as an important aspect of corporate governance.

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A more comprehensive definition has been given by *The Institute of Company Secretaries of India*. It states

> *"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".*

Several key phrases in this definition merit attention. These are:

(*i*) ***Application of best management practices*** - It may include laying down of balanced objectives, putting decision-making processes in place, defining clearly roles of key players, designing reporting systems to ensure transparency and accountability, continuous monitoring, etc.

(*ii*) ***Compliance of law in true letter and spirit*** - Systems and procedures should be laid down to ensure strict compliance to applicable laws and regulations applicable to the entity.

(*iii*) ***Adherence to ethical standards for effective management*** - All the stakeholders should make a continuous effort to adhere to maintenance of ethical standards. Code of Ethical Conduct, Whistle blower policy, Policy on Executive Remuneration, Institutionalising of severance practices, are some of the ways to ensure such adherence.

(*iv*) ***Distribution of wealth and discharge of social responsibility*** - Corporates should distribute wealth and discharge their social responsibility by giving ESOPs, building schools and hospitals, skilling women and youth, providing financial support to encourage use of non-conventional uses of energy and adopting other such programmes.

(*v*) ***For sustainable development of all stakeholders*** - Expectations of all the present and future stakeholders (local community, employees, customers, government, suppliers) and needs of the environment should be taken into account while carrying on business activities.

NEED/BENEFITS OF CORPORATE GOVERNANCE

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8.3 The need for establishing good corporate governance practices by introduction of governance codes, designing laws and regulations and reworking theories has been felt since last few years because of the benefits associated with it. The important benefits which can be derived are mentioned below:

(*i*) **Safeguards the money of investors:** Many investors all over the world have lost money in primary as well as secondary markets due to inadequate financial and non-financial disclosures by firms. Good corporate governance ensures transparency and adequate disclosures which are necessary to make an informed decision by the investors and safeguard their money from unscrupulous promoters.

(*ii*) **Ensures success of the corporate:** A corporation is a congregation of various stakeholders such as employees, investors, customers, vendors, government and society at large. For the growth and success of a corporate it is important that interests of various stakeholders do not come in conflict. Good governance practices and transparent structures ensure openness, integrity and accountability. In such situations decisions are taken to ensure a fair deal to all stakeholders and, thus, the success of the entity.

(*iii*) **Gives ease of access to cheap funds**: Good *corporate* governance procedures include putting a check on insider trading, handling of investor grievances efficiently, disclosure of interest by management in financial and non - financial deals and similar practices. Such practices enhance the credibility of the entity and helps to gain as well as maintain the confidence of domestic and foreign investors and financial institutions, who provide long-term funds at reasonable cost.

(*iv*) **Lays foundation for good corporate citizenship:** Good corporate governance aims at enhancing welfare of all the stakeholders and creating sustainable value for them and also maintaining a balance between economic and social benefit. Adoption of these good practices convert any entity for being a mere 'corporate' to a good 'corporate citizen.'

(*v*) **Attaches Global Perspective:** In an era in which trade barriers have being progressively removed and capital flows are crossing shores, good corporate governance is an important consideration for foreign institutional investors and also for those who bring in foreign direct investment. These inflows are very important for economic growth of any country.

Corporate governance has, thus, become a critical area of focus for various stakeholders including Government and market participants.

THEORIES OF CORPORATE GOVERNANCE

8.4 A key feature of modern day corporations is separation of ownership and control. Such a separation gives rise to some corporate governance issues. Beginning from 1980's, many theories have been proposed by to explain and address corporate governance problems that arise due to such separation. Some of the important theories are:

- Agency/Shareholder theory
- Stewardship theory
- Stakeholders' theory.

8.4-1 Agency/Shareholder theory

(*i*) ***Concept*** **-** Jensen and Meckling (1986) defined the Agency/Shareholder relationship *"as a contract under which one or more person (the principals) engage another person (the agents) to perform some service on their behalf which involves delegating some decision-making authority to the agent"*

(*ii*) ***Who is the principal*** **-** In the context of corporates, shareholders (principals) define the objectives of the company.

(*iii*) ***Who is the agent*** **-** Board of Directors (BODs) and managers are considered as agents. Shareholders delegate their power to BODs and who in turn delegates it to managers. BODs is accountable to shareholders.

(*iv*) ***Assumptions***-

- Divergence of interest of shareholders and Board of Directors - Agency theory assumes that the interests of principles and agents diverge and both of them seek to promote their own interest.
- Information asymmetry **-** BODs have a better access to information about entity's position *vis-a-vis* shareholders.
- BODs have a fiduciary relationship with the shareholders.
- Shareholders are interested in maximizing wealth while managers may succumb to self-interest and, unless restricted from doing otherwise, would be interested in protecting and enhancing his pay and perks. This conflict of interest leads to Agency problem where the important issue is how to ensure that agent acts in the best interests of the principal.
- Agency problem results in Agency costs, for example, monitoring costs in large corporations (Shleifer & Vishny, 1998) and 'bonding costs' (example is the bond provided by the agent to principal.)

(*v*) ***Some ways to reduce agency cost*** **-** The shareholders (principal) need to ensure that agents act in the best interest of shareholders and not abuse their power. Some of the ways to reduce agency cost are:

- Fair and adequate financial disclosures
- Appointment of independent directors.
- Appointment of credible independent auditors.
- Board Committees to check issues like excessive remuneration, appointment of knowledgeable directors, etc.
- Formation of Audit Committees.

(*vi*) ***Ownership pattern and agency problem*** **-**

- The way of handling Agency problem depends on the ownership pattern of corporates in each country.

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- If ownership structures are dispersed and the investors disagree with the management or are dissatisfied with its performance, they exit and it may result in reduction in share prices.
- In countries in which there is concentrated ownership of equity and there are large dominant shareholders, they control the managers and expropriate minority shareholders in order to gain private control benefits (Spanos, 2005). The role of regulatory agencies and government to keep board of directors and management in check becomes very important.

(*vii*) ***Limitations***:

- The Agency/Shareholder theory puts too much emphasis on shareholders and ignores the interest of other stakeholders.
- It does not have universal application. It has better applicability in US and UK markets and is not suitable for countries which have companies with large family and/or institutional holdings.
- The theory assumes the employees to be individualistic and of bounded rationality where rewards and punishment are the only things which matter to them (Jensen & Meckling,1976). It, certainly, is a myopic view of human beings.

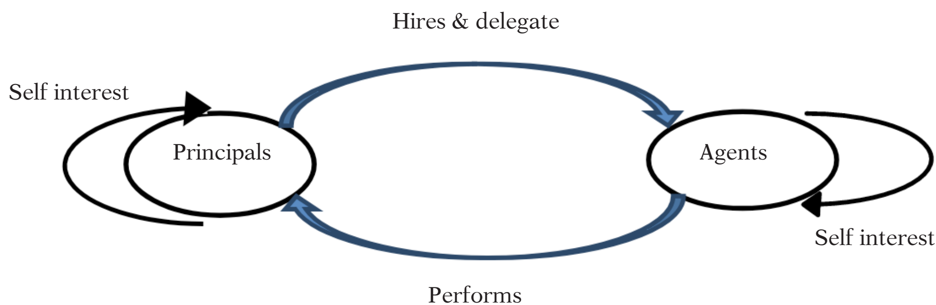

FIGURE 8.1 : THE AGENCY/SHAREHOLDER THEORY ADAPTED FROM ABDALLAH AND VALENTINE (2009)

8.4-2 Stewardship theory

(*i*) ***Concept*** - There is no conflict of interest between the shareholders and BoD and managers.

(*ii*) ***Who is a steward*** - According to stewardship theory top management acts as stewards for the organization. Davis, Schoorman & Donaldson (1998) has stated, "a steward protects and maximises shareholders' wealth through firm performance, because by so doing, the steward's utility functions are maximised".

(*iii*) ***Assumptions*** -

- Managers are trustworthy individuals and so are good stewards of the resources entrusted by them by the shareholders.
- Senior managers have superior access to important information and are, thus, able to make informed decisions.
- The theory holds "Theory Y" view of managerial motivation.

(*iv*) ***Role of shareholders and stewards*** -

- The shareholders trust the stewards and give them autonomy.
- Employees or executives act to ensure the shareholders' returns are maximized
- Stewardship theory sates that in order to protect their reputation and retain trust of the shareholders, executives and directors will work to maximize financial performance of the entity as well as shareholders' profits. (Daily, et al., 2003). Mechanism such as ESOPs, high bonuses and good compensation are there to ensure benefits of good financial performance are shared between shareholders and stewards. Indeed, this can minimize the

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Agency/Shareholder costs incurred for monitoring and controlling behaviours (Davis, Schoorman & Donaldson, 1997).

- The theory suggests unifying the role of CEO and the chairman.

(*v*) ***Benefits*** -

- Trust is high and stewards are motivated to work in the interest of the organization.
- New ideas can be implemented leading to growth of the firm.
- Agency costs get automatically reduced.

(*vi*) ***Limitations*** -

- While Agency/Shareholder theory paints agent as self-centered, stewardship theory paints an excessively benevolent picture of the steward who is ready to subordinate his interest to that of shareholders.
- This theory takes into account interest of only employees and shareholders and does not refer to interest of other stakeholders.
- Causal relationship between governance and financial performance cannot be assessed using this theory.

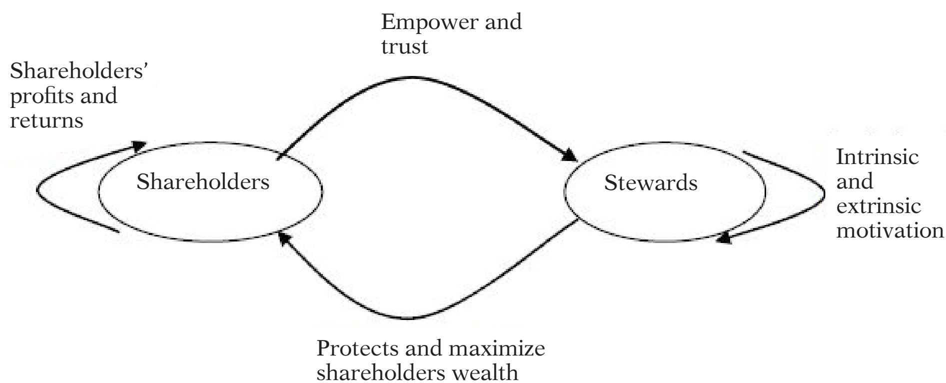

FIGURE 8.2 : THE STEWARDSHIP THEORY ADAPTED FROM ABDALLAH AND VALENTINE (2009)

8.4-3 Stakeholder Theory

(*i*) ***Concept*** - Stakeholder theorists suggest that managers in a network of relationships to serve. According corporate strategies should be designed to take care of interest of all the stakeholders.

(*ii*) ***Who is a stakeholder*** -

- A stakeholder is defined as any person/group which can affect/be affected by the actions of a business (Freeman,1994). It includes shareholders, employees, customers, suppliers, creditors, competitors and even the wider community. These all are stakeholders.
- The stakeholders are, generally, split into two groups- primary stakeholders and secondary stakeholders. The existence and survival of organization depends on relationship of business with primary stakeholders. The secondary stakeholders (not included within the box in figure 8.3) have a peripheral yet significant involvement with the business.

(*iii*) ***Diversified Board structure*** - The stakeholders can have their representatives appointed on the Board of Directors who will look after their interest.

(*iv*) ***Stakeholders and CSR*** - Stakeholder theory implies that it can be beneficial for the firm to engage in certain corporate social responsibility activities that stakeholders other than shareholders perceive to be important. Without such activities these stakeholders might withdraw their support from the firm (Mitchell, Agle, & Wood, 1997). Thus, even in situations when a firm seeks to serve its shareholders as a primary objective, its success in doing so will certainly be affected by other stakeholders.

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