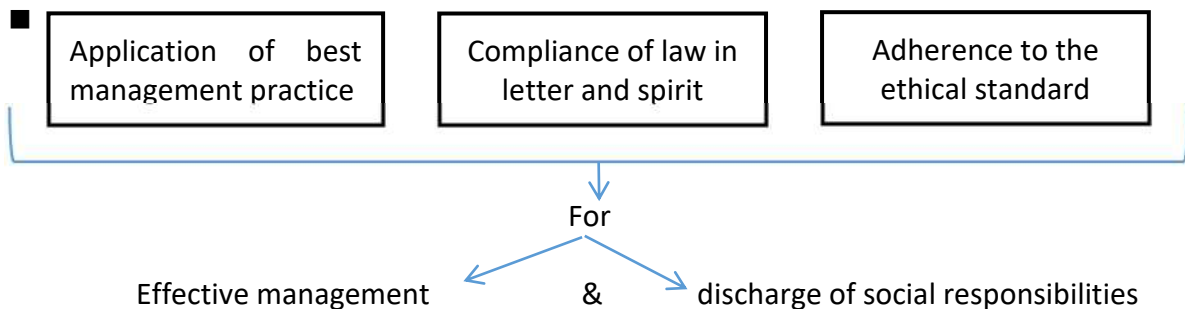


Conceptual Framework of Corporate Governance

Lesson 1

Corporate governance



- Corporate governance is a broad term used to describe the policies, Process, Customs, and Laws that direct the organizations in the way they act or administer and control their operations.
- It works to achieve the goal of organization and manages the relationship with stakeholders.
- The heart of corporate governance is Transparency, Disclosure, Accountability, and Integrity.

Advantages of corporate governance

1. ensures corporate success and economic growth.
2. maintains investors' confidence, as a result of which, company can raise capital effectively.
3. positive impact on the share price.
4. minimizes wastages, corruption, risks and mismanagement.
5. brand formation and development.
6. It ensures organization is managed in a manner that fits the best interests of all.
7. It reduces cost and aids in long term growth of the Company.

Need of corporate governance

- 1) It help to improve the **corporate performance** through quality decision making and succession planning and by encouraging long term prosperity of the company and its source of finance.
- 2) It help the corporate to increase the **investor interest**. Investors are likely to invest openly in those companies which are providing high level of disclosures and transparency.
- 3) Good governance help → to provide better **reach to global market**
→ Attract investment which subsequently lead to greater efficiency in financial sector
- 4) **Combating corruption** through disclosure & transparency. Good corporate governance enables corporation to compete more efficiently and prevent fraud & malpractices within the organisation.
- 5) Improved management accountability & operational transparency
↓
Fulfill investor expectations and confidence
↓
In return, **enhancing enterprise value**.
- 6) It ensure efficient **risk management system** is in place. A transparent & accountable system makes the board aware of the risk involved in a particular strategy.

Elements / scope of good corporate governance.

1. Role and power of the board

Board is primary responsible to ensure value creation for its stakeholders. The absence of clearly designated role and power of board weakens accountability and threatens the achievement of organizational goals. Therefore it is important to clearly identify the role and power of the board.

2. Board skills

To function efficiently and effectively, the board must possess the necessary blend of qualities, skills, knowledge and experience.

Each director should make quality contribution to the organization policies, operations and management.

3. Board appointment

To ensure that the most competent people are appointed on the board, the board position should be filled after making extensive search.

A well defined open procedure must be in place for reappointment as well as appointment of new director.

All new director should be provided a letter of appointment setting out in detail their duties and responsibilities.

4. Board induction and training

Director must have a broad understanding of area of operation of the company business, corporate strategy and challenges being faced by board

Attendance at professional development programme is essential to ensure that directors remain abreast of all developments

5. Board independence

For sound corporate governance, There should be sufficient no. Of independent directors in the board . it ensure that there is no actual or perceived conflicts of interest.

6. Board meeting

Board meetings are the platform for board decision making. Attending board meeting regularly and preparing thoroughly increase the quality of interaction at board meeting.

The effectiveness of board meetings is dependent on carefully planned agendas and providing relevant papers to directors prior to board meeting.

7. Strategy setting

The objective of the company must be clearly documented in a long term corporate strategy.

8. Monitoring the board performance

The board must monitor and evaluate its combined performance and also that of individual director at periodic interval.

The board should established a mechanism for reporting the results of board's performance evaluation.

9. Risk management

Risk is an important element of corporate functioning and governance. There should be a clearly established process of identifying, analyzing and mitigating risks, which could prevent the company from effectively achieving its objectives.

Appropriate control in the form of risk management must be put in place.

Evolution of corporate governance

Agency theory

In agency theory, the owners are the principals. But principals may not have knowledge or skill for getting the objectives executed.

Thus, principal authorizes the managers to act as 'Agents' and a contract between principal and agent is made.

Under the contract of agency, the agent should act in good faith. He should protect the interest of the principal and should remain faithful to the goals.

The main thrust of the Agency Theory is that the actions of the management differ from those required by the shareholders to maximize their return.

Shareholder Theory

According to this theory, it is the corporation which is considered as the property of shareholders. They can dispose off this property as they like. They want to get maximum return from this property.

So the directors must protect such property and directors are responsible for any damage or harm done to their property i.e., the corporation.

The role of managers is to maximize the wealth of the shareholders. They, therefore should exercise due diligence, care and avoid conflict of interest.

Stakeholder Theory

According to this theory, the company is seen as an input-output model and all the interest groups which include creditors, employees, customers, suppliers, local-community and the government are to be considered. From their point of view, a corporation exists for them and not the shareholders alone.

Different stakeholders have different self-interest. The interests of these different stakeholders are at times conflicting. The directors and the corporation are responsible to mediate between these different stakeholders interest.

This theory assumes that stakeholders are capable and willing to negotiate and bargain with one another. This results in long term self interest.

[Managers play an important role here. They are faithful to all stakeholders, not just stockholders.]

Stewardship Theory

The word 'steward' means a person who manages another's property or estate. Here, the word is used in the sense of guardian in relation to a corporation (this theory is value based).

The managers and employees are to safeguard the resources of corporation and its property when the owner is absent.

They are like a caretaker. They should not use the property for their selfish ends.

The managers should manage the corporation as if it is their own corporation. They are not agents as such but occupy a position of stewards.

Thus, under this theory, first of all values as standards are identified and formulated. Second step is to develop training programmes to achieve excellence. Thirdly, moral support is important to fill any gaps in values.

IFRS Sustainability Disclosure Standards

IFRS S1

The objective of IFRS S1 is to require an entity to disclose information about its sustainability-related risk and opportunities that is useful to peoples in making decisions relating to providing resources to the entity.

IFRS S1 requires an entity to disclose information about all sustainability-related risks and opportunities that could reasonably be expected to affect the entity's cash flows, its access to finance.

IFRS S1 prescribes how an entity prepares and reports its sustainability-related financial disclosures so that the information disclosed is useful to users in making decisions relating to providing resources to the entity.

In particular, an entity is required to provide disclosures about:

- 1) the governance processes, controls and procedures the entity uses to monitor, manage and oversee sustainability-related risks and opportunities;
- 2) the entity's strategy for managing sustainability-related risks and opportunities;
- 3) the processes the entity uses to identify, assess, prioritise and monitor sustainability-related risks and opportunities; and
- 4) the entity's performance in relation to sustainability-related risks and opportunities, including progress towards any targets the entity has set or is required to meet by law or regulation.

IFRS S2

The objective of IFRS S2 is to require an entity to disclose information about its climate-related risks and opportunities that is useful to peoples in making decisions relating to providing resources to the entity.

IFRS S2 requires an entity to disclose information about climate-related risks and opportunities that could reasonably be expected to affect the entity's cash flows, its access to finance.

IFRS S2 applies to:

- A. climate-related risks to which the entity is exposed, which are:
 - i. climate-related physical risks; and
 - ii. climate-related transition risks; and
- B. climate-related opportunities available to the entity.

An entity is required to provide disclosures about:

1. the governance processes, controls and procedures the entity uses to monitor, manage and oversee climate-related risks and opportunities;
2. the entity's strategy for managing climate-related risks and opportunities;
3. the processes the entity uses to identify, assess, prioritise and monitor climate-related risks and opportunities;
4. the entity's performance in relation to its climate-related risks and opportunities, including progress towards any climate-related targets it has set, and it is required to meet by law or regulation.

CONCEPT OF MANAGEMENT Vs. OWNERSHIP

Theoretically, shareholders own the company and hence the company ought to work according to the directions of the shareholders. However, it is not practically possible for each shareholder to participate in the decision making process on a day-to-day basis. therefore, they elect a board of directors to make broad corporate policy.

Companies allow for the separation of ownership and management. That means that owners don't need to be managers and managers don't need to be owners.

(In most small corporations, the owners typically manage the company but it is not necessary that owners run the company or are even involved in the day-to- day operations of the company.)

CONCEPT OF MAJORITY RULE Vs. MINORITY INTEREST

As a company is an artificial person, it functions through the board of directors who is guided by the wishes of the majority, subject to the welfare of the company as a whole.

It is, therefore, a main rule of company law that prima facie a majority of members of the company are entitled to exercise the powers of the company and generally to control its affairs.

in the case of Foss v. Harbottle wherein it was held that the Courts would not generally interfere with the decisions of the company.

Exceptions:- the court may interfere in breaches of charter documents, fiduciary duty, frauds, oppression and inadequate notice to the shareholders.

Governance from indian scriptures

There are 3 main scriptures from ancient times which has greatly influenced modern day corporate governance.

1) Ramayana :- the 5 principles which had been adopted in modern days corporate governance.

- Governance has no inequality, no difference between rich and poor;
- Good governance should produce an environment to promote confidence in each other;
- It promote commitment to duty and doing the duty properly give ultimate happiness;
- Governance should promote education for all;
- Promote good health of all the person in the society.

2) Bhagavad gita :- it emphasised on dharma which means accountability of self, family, organisation and society for order and progress.

There are many learnings taken from it in modern day corporate governance, which are as follows

- Public interest should be given priority over personal interest.
- Uphold dharma regardless of your conflicting interest.
- Transparency should be maintained in the path of dharma.

Arthashastra :- Arthashastra was literally meant to deal with the discipline of politics.

The scope of Arthashastra is wide enough to cover the nature of government, law, civil and criminal court systems, ethics, economics, theories of war, nature of peace, and the duties and obligations of a king.

Few imp aspects to which king must give attention

- King is a servant of kingdom
- Leader should be responsive and accountable
- Strict ethical guidelines and code of conduct
- Emphasis of stakeholder concepts
- Effective administration

Uday kotak committee

Aim improving standards of corporate governance of listed companies in India.

With the aim of improving standards of Corporate Governance of listed companies in India, the **Committee was requested to make recommendations to SEBI on the following issues:**

1. Ensuring independence of Independent Directors and their active participation;
2. Disclosures pertaining to Related Party Transactions;
3. Issues in accounting and auditing practices by listed companies;
4. Improving effectiveness of Board Evaluation practices;
5. Addressing issues faced by investors on voting and participation;
6. Disclosure and transparency related issues, if any;

The Committee submitted to SEBI its report of recommendations as follows:

- 1) Composition and Role of the Board of Directors
- 2) The Institution of Independent Directors
- 3) Board Committees
- 4) Promoters and Related Party Transactions
- 5) Disclosures and Transparency
- 6) Accounting and Audited related Issues
- 7) Investors participation in Meetings of Listed Entities
- 8) Capacity building in SEBI for enhancing Corporate Governance in Listed Entities

National Guidelines on Responsible Business Conduct (NGRBC)

The principles of NGRBC are-

1. Businesses should conduct themselves with integrity in a manner that is Ethical, Transparent and Accountable.
2. Businesses should provide goods and services in a manner that is sustainable and safe
3. Businesses should respect and promote the well-being of all employees.
4. Businesses should respect the interests of and be responsive to all their stakeholders.
5. Businesses should respect and promote human rights.
6. Businesses should make efforts to protect and restore the environment.
7. Businesses should promote growth and equitable development.
8. Businesses should provide value to their consumers in a responsible manner.
9. Businesses, when engaging in influencing public and regulatory policy, should do so in a manner that is responsible and transparent.

Development of Corporate Governance in Union Kingdom (UK)

Greenbury Report

Formed to make recommendations on Directors' Remuneration.

its major findings were as under:

- Constitution of a Remuneration Committee comprising of Non- Executive Directors
- Responsibility of this committee in determining the remuneration of CEO and executive directors
- Responsibility of the committee in determining the remuneration policy.
- Level of disclosure to shareholders regarding the remuneration of directors'.
- Remuneration should be linked to performance.

Higgs Report

review the roles of independent directors and of audit committees.

The resulting Report proposed that:

1. at least half of a board be comprised of non- executive directors;
2. that the non-executives should meet at least once a year;
3. that a senior independent director be nominated and made available for shareholders to express any concerns to; and
4. that potential non-executive directors should satisfy themselves that they possess the knowledge, experience, skills and time to carry out their duties with due diligence.

Sarbanes-Oxley Act of 2002

passed to protect shareholders and the general public from accounting errors and fraudulent practices in enterprises, and to improve the accuracy of corporate disclosures

SOX Section 302 - Corporate Responsibility for Financial Reports

- 1) CEO and CFO must review all financial reports.
- 2) Financial report does not contain any misrepresentations.
- 3) Information in the financial report is “fairly presented”.
- 4) CEO and CFO are responsible for the internal accounting controls.
- 5) CEO and CFO must report any deficiencies in internal accounting controls, or any fraud.
- 6) CEO and CFO must indicate any material changes in internal accounting controls.

SOX Section 401 - Disclosures in Periodic Reports

All financial statements and their requirement to be accurate and presented in a manner that does not contain incorrect statements.

SOX Section 802 - Criminal Penalties for Altering Documents

This section specifies the penalties for knowingly altering documents in an ongoing legal investigation, audit, or bankruptcy proceeding.

SOX Section 806 - Protection for Employees Who Provide Evidence of Fraud

This section deals with whistleblower protection.

SOX Section 906 - Corporate Responsibility for Financial Reports

Section 906 addresses criminal penalties for certifying a misleading or fraudulent financial report. & penalties can be \$5 million in fines and 20 years in prison.

UK Corporate Governance Code, 2018

Principles provided in this code :-

1. Board leadership and company purpose

Principle A.

effective and entrepreneurial board, whose role is to promote

- long-term sustainable success of the company,
- generating value for shareholders and
- contribute to society

Principle B.

Board should establish company's

Purpose

Values

Strategies

Director must act with integrity & promote desired culture.

Principle C.

Ensure that necessary resources are in place to meet company objectives & measure performance against them.

Effective framework to assess the risk & manage it should be implement.

Principle D.

The board should ensure effective engagement with, and encourage participation from shareholder and stakeholder.

Principle E.

Workforce policies & practices should be consistent with company's values & should support it long term sustainable success.

2. Division of responsibilities

Principle F. Chairperson will be leading the board he should ensure that directors receive clear, accurate & timely information so that effective contribution can be made from their end.

Principle G. Appropriate combination of executive & non executive directors
Clear division of responsibilities between board leadership and executive leadership.

Principle H. Non executive director should provide sufficient time to meet their board responsibilities.

Principle I. Company secretary should support that policies, process, information, resources should be in place required to function effectively & efficiently by board.

3. Composition, appointment & succession and evaluation.

Principle J.

- Appointment should be in a formal & transparent manner
- effective succession plan should be maintain.
- Both appointment and succession planning should be based on merit

Principle K. Board & its committees should have a combination of skill, experience & knowledge.

Principle L. Annual evaluation of board as well as individual director.

4. Audit ,risk and internal control

Principle M. Formal & transparent policy should be established to ensure the independence & effectiveness of internal and external auditors.

Principle N. Fair balance & understandable assessment of company,s position & prospect.

Principle O. Determination of principal risks which company is willing to take in order to achieve long term strategic objectives.

5. Remuneration

Principle P. It should be design to promote long term sustainable success

Principle Q. Director,s remuneration should be based on company's and their individual performance.