Department of Commerce

University of Calcutta

Study Material

Cum

Lecture Notes

Paper: CC.304: Business Ethics and Corporate Governance (BECG)

Only for the Students of M.Com. (Semester III)-2020

University of Calcutta

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University of Calcutta

M. Com. Semester III

304. Business Ethics and Corporate Governance (BECG)

MODULE – II CORPORATE GOVERNANCE

- **Introduction:** Governance-Public Governance System-Corporate Governance System-Comparison between them-Definitions of Corporate Governance-Emergence of the Corporate Sector and Need for Corporate Governance-Governance and Management-Good Corporate Governance
- **Theories in Corporate Governance:** Agency Theory-Concepts and Core Principles-Problems or Criticisms-Mechanism to Reduce Agency Cost; Stakeholder Theory-Concept and Core Principles-Criticisms
- **Corporate Mis-governance:** Some Recent Examples - Factors Responsible for Such Mis-governance - Lessons from them-Global Initiatives and Reforms (Some Examples)
- **Legal and Regulatory Framework of Corporate Governance:** Principal Provisions of the Companies Act, 2013 with Respect to Improve Quality of Corporate Governance-Audit Committee and its Role as per the Companies Act, 2013 -SEBI (LODR) Regulations, 2015 (with latest amendment)

Suggested Readings

- A.C. Fernando, *Corporate Governance: Principles, Policies and Practices*, Pearson Education India
- Robert A. G. Monks and Nell Minow, *Corporate Governance,* Wiley.
- Darryl Reed and Sanjay Mukherjee, *Corporate Governance, Economic Reforms and Development,* Oxford University Press
- P. Chattopadhyay, *Corporate Mis-governance,* IAA Research Foundation.
- Bob Tricker, *Corporate Governance: Principles, Policies and Practices*, Oxford University Press
- Swami (Dr.) Parthasarathy, *Corporate Governance: Principles, Mechanism and Practices*, Biztantra (Wiley)
- SEBI (LODR) Regulations, 2015

DETAILED CHAPTER PLAN

1. **Introduction:** (No of Classes: 07)
   - 1.1. Governance-
     - 1.1.1. Meaning and definition of the term
     - 1.1.2. Principal Elements of Governance i.e. Constitution, Legislation, Executive and Judiciary
   - 1.2. Public Governance System-
     - 1.2.1. Concept and definition
     - 1.2.2. Types of Public Governance System i.e. Communistic System, Socialistic System and Democratic System
   - 1.3. Corporate Governance System-
     - 1.3.1. Standard definitions of 'Corporate Governance' *(Definition by the Cadbury Committee Report, OECD and by other two or three authors or sources)*
   - 1.4. Comparison between Public Governance System and Corporate Governance System
   - 1.5. Emergence of the Corporate Sector
     - 1.5.1. Evolution of Corporate Structure and its Characteristics According to Robert Clark (of Harvard Law School) i.e. Limited Liability, Free Transferability, Legal Personality and Centralized Management
     - 1.5.2. Purposes of a Corporation
   - 1.6. Governance and Management-
     - *1.6.1.* Comparison between Governance and Management *(in brief)*
     - *1.6.2.* Comparison between Executives and Directors *(in brief)*
   - 1.7. Good Corporate Governance
     - 1.7.1. Concept of Good Corporate Governance
     - 1.7.2. Need for Good Corporate Governance
     - 1.7.3. Advantages of Good Corporate Governance
     - 1.7.4. Key Elements of Good Corporate Governance as Identified by the OECD
2. **Theories in Corporate Governance:** (No of Classes: 03)
   - 2.1. Agency Theory-
     - 2.1.1. Concepts and Core Principles-
       - 2.1.1.1. Concept of Agency Problem
       - 2.1.1.2. Concept of Agency Cost or Agency Loss
     - 2.1.2. Problems with Agency Theory or Criticisms-
     - 2.1.3. Mechanism to Reduce Agency Cost
   - 2.2. Stakeholder Theory-
     - 2.2.1. Concept and Core Principles-
       - 2.2.1.1. Conflict of Interests between Stakeholder Groups and the Company
     - 2.2.2. Criticisms

3. **Corporate Mis-governance:** (No of Classes: 07)
   3.1. Concept and Definition
   3.2. Some Recent Examples –
      3.2.1. America's Hall of Shame *(Brief facts about World Com, Enron, Waste Management, Adelphia Communication, Imclone System, Peregrine System, Tyco and Dynegy Scams)*
      3.2.2. Indian Scams *(Brief facts about Harshad Mehta (1992), MNC Efforts at Consolidation of Ownership, Vanishing Companies, M.S. Shoes, Sesa Goa, Rupangi Impex & Magan Industries Ltd, Bad Delivery of Physical Certificates, Plantation Companies, Mutual Fund, C. R. Bansali, Harshad Mehata (1998), I.T, Ketan Parikh, USB Securities and Satyam Scams)*
   3.3. Factors Responsible for Corporate Mis-governance – *(From Indian Perspective highlighting separation of Indian Corporates from Global Developments and other reasonable factors)*
   3.4. Lessons from them- *(Antidotes that reduces unpleasant of Corporate Mis-governance)*
   3.5. Global Initiatives and Reforms (Some Examples)
      3.5.1. The Cadbury Committee (Code of Best Practices and its 19 recommendation be covered in full)
      3.5.2. The Paul Ruthman Committee, The Greenbury Committee, The Hampel Committee, The Combined Code and The Turnbull Committee *(Mention their name as a contributor in the area of Corporate Governance)*
4. **Legal and Regulatory Framework of Corporate Governance:** (No of Classes: 04)
   4.1. Principal Provisions of the Companies Act, 2013 with Respect to Improve Quality of Corporate Governance- *(Clause 166, 149, 188, 135, 139, 92, 211, 245, 177 and 144 in brief only)*
   4.2. Audit Committee and its Role as per the Companies Act, 2013 – *(Its Composition & Roles)*
   4.3. SEBI (LODR) Regulations, 2015 (with latest amendment)
      4.3.1. Preliminary (Chapter 1)
      4.3.2. Principles Governing Disclosures and Obligations of Listed Entity (Chapter 2)
      4.3.3. Common Obligations of Listed Entities (Chapter 3)

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1. INTRODUCTION

Governance: Meaning, definition and Principal Elements

Governance is a system of governing a family, tribe, organization (formal or informal), a territory or a nation. Governance is the exercise of authority to direct, to lead and to control within an organization or any territory. The governance is a broader notion than the Government, whose principal elements include the **constitution, legislature, executive** and **judiciary**. Governance involves interaction between these formal institutions and those of civil society.

The constitutions normally define the nature of governing body, its rights and duties and how its members are elected or selected. A legislature is a deliberative assembly with the authority to make law for a political entity such as a country, city, society etc. Executive is the wing of the government responsible for the day to day management of the state. Judiciary is there to interpret the law framed by legislative assemblies and it has an important role in ensuring better governance.

Governance plays a vital role in sustainable development of the society and helps in developing a culture.

Public Governance System: Concept and definition

Public governance deals in utilization of available resources and its use for the public. Precisely public governance deals with public.

It is to protect the human values and rights, implement the laws in non-discriminatory manner, and ensure transparent public agencies and official decision making.

Public governance system is an effective, impartial and quick judicial system. It includes all citizens in debating public policies and choices.

In a society ultimately citizens become the customers. The primary objective of public governance is to serve the customer or citizen in an effective and efficient manner.

Public governance system has created a legislature structure for the purpose of implementing specific mandate in order to provide better services to the public at large. This structure involves board, department, minister, cabinet, house of assembly and public.

Types of Public Governance System

In public governance system the whole emphasis is given on public, who is vested with the sole authority to decide who will govern the nation. There are three types of public governance system:

Communistic System: The roots of the system can be related with the idea of the Marxism. As per the ideology of communism the working class should govern the system. The entire properties belong to the government and all the citizens should be treated equally.

Socialistic System: It is based on the doctrine of abolishing the private property and exercising social control. Under this system doctrine of social control of property and wealth distribution is believed to be accepted.

Democratic System: In the democratic system of governance people appoint their public representatives to govern the country. As per Abraham Lincoln, Democracy means "Of the people, for the people and by the people."

Corporate Governance System

Corporate Governance: An International Review (1992) defines Corporate Governance broadly as "the exercise of power over corporate entities so as to increase the value provided to the organization's various stakeholders."

As per the Cadbury Report (1992) "Corporate Governance is the process by which companies are directed and controlled."

According to the Organization for Economic Cooperation and Development (OECD) "Corporate Governance refers to the private and public institutions, including laws, regulations and public institutions, which together govern the relationship, in a market economy, between corporate managers and entrepreneurs, on the one hand, and those who invest resources in corporations on the other."

Robert Monks and Nell Minow (2001) define Corporate Governance as "the relationship among various participants in determining the direction and performance of corporations. The primary participants are the shareholders, the management and the board of directors."

Thus, management runs the business; the board of directors ensures that it is being well run and in the right direction.

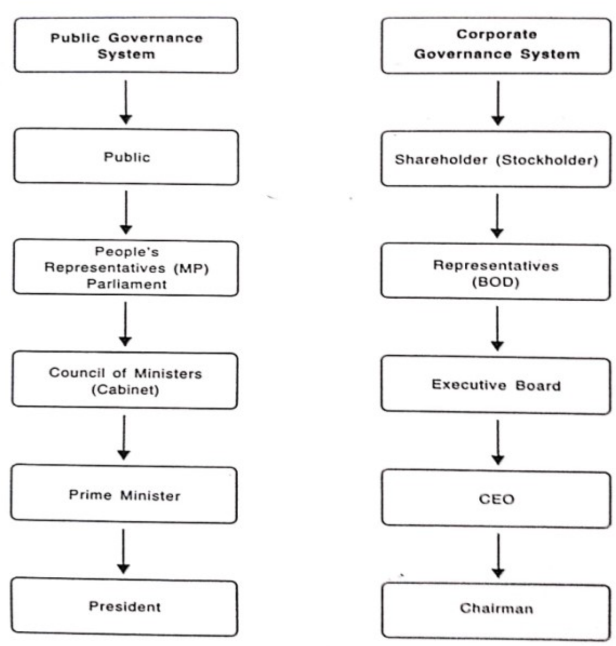
Corporate governance is emerging out as the movement to build up the systematic, transparent and value based governance culture in business and corporate world. It is absolute reflection of public governance system.

Comparison between Public Governance System and Corporate Governance System

Under the public governance system, the public choose their representatives from each constituency through election and voting system. The winner candidate is selected as Member of the Parliament (MP). All the members of the parliament among themselves decide the cabinet and cabinet decides the Prime Minister. Again, the President of India is elected by all the members of both the houses of parliament and state legislative assemblies by constituting the Electoral College. Here it is important to note that the cabinet is the legislative body, which take decision but cannot execute the decision taken by it.

There are similarities between public governance system and corporate governance system. As the public governance system is governance of the public affairs by the elected people's representatives, corporate governance system is governance of affairs of a company by the stakeholders. In public governance system, public choose and elect their representatives, similarly the shareholders have rights to elect their representatives in the Board of Directors in a company. The Board of Directors is very similar to the Council of Ministers or cabinet which is involved in decision making but not responsible for implementation of these decisions. The Board of Directors decides the Chief Executive Officer (CEO) or Managing Director (MD) of the company. The CEO is just like the Prime Minister, who is responsible for executing the decisions taken by the Board of Directors. If Chairman and Managing Director (MD) is the same, then separate CEO is appointed.

These similarities can be depicted as under:



Emergence of the Corporate Sector

Following three radical developments were added at the beginning of the late nineteenth century:

1. The far larger firms were needed than previous norm and technological advancement led to new economies of scale resulting in accommodating huge number of human resources
2. Broader source of capital mobilization emerged in comparison to the past.
3. The private ownership of investment property had to be "accepted as a social norm".

These developments are hardly considered revolutionary in the present days but it was radical even a century ago when it was assumed that most property would belong to the state, the church or a select number of wealthy people.

In the eyes of law corporation is a fictional 'person'. What made it so essential is answered by Dean Robert Clark of Harvard Law School. According to Robert Clark the four characteristics essential to the vitality and appeal of the corporate form are:

1. Limited liability for investors;
2. Free transferability of investor interests;
3. Legal personality; and
4. Centralized management.

Limited liability:

The notion of limited liabilities goes back to 2000 BC, when merchants provided the financing for seagoing vessels. It means corporation is separate from its owner and employees. The primary advantage of investing in stock is the certainty that the risk of loss is limited to the extent of amount invested. With limited liability comes limited authority.

Free transferability:

Transferability is ability to transfer one's holding freely. Stock is as liquid as cash. Shareholders can sell the stock immediately when they think that stock is losing its value. It is also function of limited authority.

Legal personality:

A corporation lives on for as long as it has capital. Action that would result in a penalty for an individual, have no such result when the individual commits them as a part of a corporation. It can own property including real estate, copyrights and other assets.

Centralized management:

In a corporation the power to determine the company's overall direction is given to the directors and the power to control its day to day operation is given to the managers. Limited authority is given to investors. In order to allow the company to operate with maximum efficiency the shareholders give up the right to make decisions on all, except the most general issue faced by the company.

Purposes of a Corporation

Corporations do not just determine what goods and services are available in the market place but they also determine the quality of the air we breathe and the water we drink and even the places where we live. The standard of living of people in the society is grossly determined by the success of a corporation. Thus the purposes of a corporation are as under:

1. **Human Satisfaction**
   Corporations provide an outlet for the satisfaction of essential human drives. Through corporations, skills and experience can be competitively marketed and rewarded according to their contribution to value.
2. **Social structure**
   History of human civilization shows that human beings have created social structure in order to extend cooperation. Corporations offer lasting and resilient social structure. e.g. during medieval era whole gross national product of the continent was devoted to construction of magnificent houses of worship viz. churches etc.
3. **Efficiency and Efficacy**
   Corporations enable people to get things done. It translates an idea into a product. The challenge has been to adapt the corporate form to the needs of society. e.g. in order to assure better control by America of its fuel needs, the US congress created the United States Synthetic Fuel Corporation in 1980 and attempted to use private sector personnel and techniques to solve a public problem.
4. **Ubiquity and Flexibility**
   Corporations give individuals a greater and more lasting sphere of action. Corporation continues despite the death or retirement of its founder or highest officer. An individual may decide to refrain from certain risky action for several reasons.
5. **Identity**
   Corporations have life, and even citizenship, of their own, with attendant rights and powers. They are entitled to protection against the taking of their property without due process of law. They are entitled to freedom of speech. They have significant political capital and therefore, they are powerful participants in the deliberations our law makers.

Governance and Management

The work of Board of Directors or governing body is associated with the governance of the organization. The work of executive management team is within the periphery of the management.

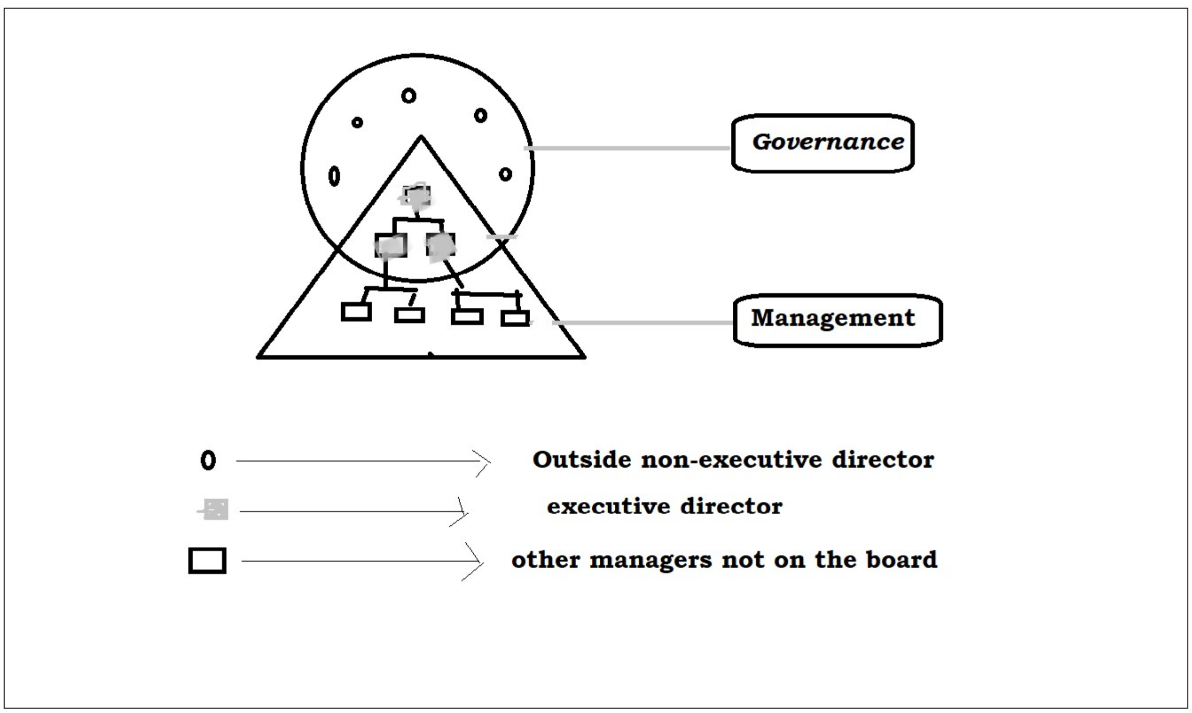
The pattern of governance of a company is more important than the way of its management. Basically, management runs the business; the Board of Directors ensures that it is being well run and run in the right direction.

Comparison between Governance and Management

There is difference between governance and management. A chief executive has overall responsibility with other managers reporting to him. Authority and responsibility is delegated downwards with matching accountability expected upwards in return. In an organization, as per hierarchy we know that who reports whom. But where is the board?

The Board is neither the part of the management structure nor it is a hierarchy. Every director has equal responsibility and similar duties and power under the law. There is no 'Boss' of a board.

Executive directors hold the managerial role in addition to their responsibilities as a member of the Board of Directors.



The Board and Management

Comparison between Executives and Directors

Executives	Directors
Executives are employees of the company	Directors are not employees of the company
Executives are covered by the employment law	Directors are covered by the company law
Executive may be of two types viz. Executive Director and Executive not on the Board	Director may be of two types viz. Executive and Non-Executive (Again non-executive may be *independent* non-executive and *not independent* non-executive)

Good Corporate Governance

Concept

The terms '*Governance'* and *'Good Governance'* are used in the literature of corporate governance. Another term '*Bad Governance'* is now-a-days recognized as one of the root causes for prevailing corrupt practices in our societies or corporations. The nation and corporations both must provide good governance to benefit all their stakeholders. Good governance is the pre-condition for receiving loan, aid etc from foreign institutional investors, international financial institutions, donors etc.

Good corporate are not born but they are made by collective efforts of all stakeholders. Only law and regulation cannot change corporate to behave better to benefit all concerned. Director and management prompted by the shareholders and inspired by societal values play important role in this regard. The company and its all officers including the board of directors and other officials should strictly follow a code of conduct.

Good corporate governance goes hand in hand with increased transparency and accountability.

Need for Good Corporate Governance

Good corporate governance is very helpful to restore investors' confidence in the market. In last few years Malaysia, Japan, Russian Federation and other countries have been affected by a lack of confidence in investors at the market place. Hence, improved corporate governance has been introduced featuring the following characteristics:

1. Improved share price performance
2. Potential for outperformance in developing economies
3. Attraction for investors

4. Powerful development tool
5. Positive relationship between corporate governance and corporate performance
6. Transparency in operation
7. Accountability of managers and governors

Advantages of Good Corporate Governance

Good corporate governance ensures better management structure and system with the company. In many developing countries promoters are directly involved in the management of the company they promote. In India, promoter families are having much dominance on the business enterprises. Now, in the wake of globalization this trend is changing. Adoption of modern management strategies, advanced techniques and financial accounting system by the companies in developing countries results in delegation of authority, improved attention to human resource policy and use of modern management information system in place of age old centralized decision-making structure. The use of good corporate governance has the following advantages:

1. Creation and enhancement of a corporation's competitive advantage
2. Enabling a corporation perform efficiently by preventing fraud and malpractices
3. Providing protection to shareholders' interest
4. Enhancing the valuation of an enterprise
5. Ensuring compliance of laws and regulations

Key Elements of Good Corporate Governance as Identified by the OECD

The Organization for Economic Development and Cooperation (OECD) has identified the following seven key elements of Good Corporate Governance:

1. The rights and obligations of shareholders
2. Equitable treatment of shareholders
3. The role of stakeholders and corporate governance
4. Transparency, disclosure of information and audit
5. The board of directors
6. Non-executive members of the board
7. Executive management, compensation and performance

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