# Corporate governance

# Introduction

- **Corporate governance** is the set of processes, customs, policies, laws, and institutions affecting the way a corporation is directed, administered or controlled. Corporate governance also includes the relationships among the many stakeholders involved and the goals for which the corporation is governed.
- The report of India's SEBI Committee on Corporate Governance defines corporate governance as the "acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as **trustees on behalf of the shareholders**. It is about commitment to values, about ethical business conduct and about making a distinction between personal & corporate funds in the management of a company."
- Effective corporate governance systems promote the development of strong financial systems which in turn have positive effect on economic growth.

# Popularly espoused principles of Corporate Governance

- **Rights and equitable treatment of shareholders**: Organizations should respect the rights of shareholders and help shareholders to exercise those rights. They can help shareholders exercise their rights by effectively communicating information that is understandable and accessible and encouraging shareholders to participate in general meetings.
- **Interests of other stakeholders**: Organizations should recognize that they have legal and other obligations to all legitimate stakeholders.
- **Role and responsibilities of the board**: The board needs a range of skills and understanding to be able to deal with various business issues and have the ability to review and challenge management performance. It needs to be of sufficient size and have an appropriate level of commitment to fulfill its responsibilities and duties. There are issues about the appropriate mix of executive and non-executive directors (Clause 49 of the Listing Agreement to the Indian stock exchange formulated by SEBI)

- **Integrity and ethical behavior**: Ethical and responsible decision making is not only important for public relations, but it is also a necessary element in risk management and avoiding lawsuits. Organizations should develop a code of conduct for their directors and executives that promotes ethical and responsible decision making. It is important to understand, though, that reliance by a company on the integrity and ethics of individuals is bound to eventual failure. Because of this, many organizations establish Compliance and Ethics Programs to minimize the risk that the firm steps outside of ethical and legal boundaries.
- **Disclosure and transparency**: Organizations should clarify and make publicly known the roles and responsibilities of board and management to provide shareholders with a level of accountability. They should also implement procedures to independently verify and safeguard the integrity of the company's financial reporting. Disclosure of material matters concerning the organization should be timely and balanced to ensure that all investors have access to clear, factual information.

# Clause 49

- As per Clause 49, **for a company with an Executive Chairman, at least 50 per cent of the board should comprise independent directors**. In the case of a company with a non-executive Chairman, at least one-third of the board should be independent directors.
- It would be necessary for chief executives and chief financial officers to establish and maintain internal controls and implement remediation and risk mitigation towards deficiencies in internal controls, among others.
- Clause VI (ii) of Clause 49 requires all companies to submit **a quarterly compliance report to stock exchange** in the prescribed form. The clause also requires that there be a separate section on corporate governance in the annual report with a detailed compliance report.
- A company is also required to obtain a certificate either from auditors or practicing company secretaries regarding compliance of conditions as stipulated, and annex the same to the director's report.
- Composition of an audit committee

- Clause 49 of the SEBI guidelines on Corporate Governance as amended on 29 October 2004 has made major changes in the definition of independent directors, strengthening the responsibilities of audit committees, improving quality of financial disclosures, including those relating to related party transactions and proceeds from public/ rights/ preferential issues, requiring Boards to adopt formal code of conduct, **requiring CEO/CFO certification of financial statements and for improving disclosures to shareholders**. Certain non-mandatory clauses like whistle blower policy and restriction of the term of independent directors have also been included.

# Mechanisms and controls

- Corporate governance mechanisms and controls are designed to reduce the inefficiencies that arise from moral hazard and adverse selection. For example, to monitor managers' behavior, an independent third party (the external auditor) attests the accuracy of information provided by management to investors. An ideal control system should regulate both motivation and ability.

❑ **Internal corporate governance controls**

- Internal corporate governance controls monitor activities and then take corrective action to accomplish organisational goals. Examples include:
- **Monitoring by the board of directors**: The board of directors, with its legal authority to hire, fire and compensate top management, safeguards invested capital. Regular board meetings allow potential problems to be identified, discussed and avoided.
- **Internal control procedures** are policies implemented by an entity's board of directors, audit committee, management, and other personnel to provide reasonable assurance of the entity achieving its objectives related to reliable financial reporting, operating efficiency, and compliance with laws and regulations. Internal auditors are personnel within an organization who test the design and implementation of the entity's internal control procedures and the reliability of its financial reporting.

- **Balance of power-** presence of non executive directors, Chairman and CEO should be different.
- **Remuneration**: Performance-based remuneration is designed to relate some proportion of salary to individual performance. It may be in the form of cash or non-cash payments such as shares and share options, superannuation or other benefits.

# External corporate governance controls

- External corporate governance controls encompass the controls external stakeholders exercise over the organization.

❑Examples include:

- competition
- debt covenants
- demand for and assessment of performance information (especially financial statements)
- government regulations
- media pressure
- takeovers