CHAPTER 1 - CONCEPTUAL FRAMEWORK OF CORPORATE GOVERNANCE

CONCEPT OF CORPORATE GOVERNANCE

CORPORATE

Corporate or a Corporation is derived from Latin term "corpus" which means a "body".

GOVERNANCE

The root of the word governance is from 'gubernate', which means to steer.

When combined Corporate Governance means a set of systems procedures, policies, practices, standards put in place by a corporate to ensure that relationship with various stakeholders is maintained in transparent and honest manner.

It is to be borne in mind that mere legislation does not ensure good governance.

Good Governance flows from ethical business practices even when there is no legislation

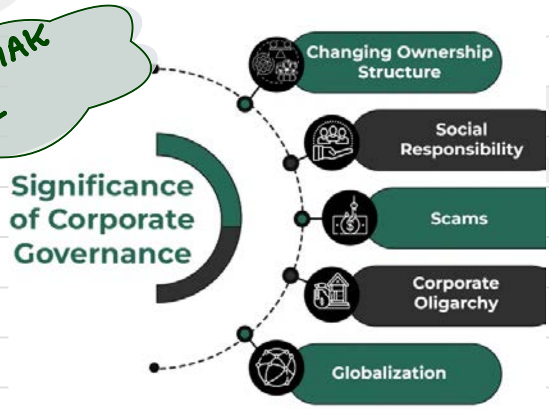
NEED FOR CORPORATE GOVERNANCE

Corporate Governance is needed to create a corporate culture of Transparency, accountability and disclosure.
It refers to compliance with all the moral & ethical values, legal framework and voluntarily adopted practices. T

BENEFITS OF CORPORATE GOVERNANCE

1. Reduced Risk of Corporate Crisis and Scandals
2. Corporate Performance
3. Better Access to Global Market
4. Enhanced Investor Trust.
5. Combating Corruption
6. Easy Finance from Institutions

GYANVARDHAK CAPSULE



VARIOUS DEFINITIONS OF CORPORATE GOVERNANCE

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."(ICSI)

Good corporate governance is about 'intellectual honesty1 and not just sticking to rules and regulations, capital flowed towards companies that practiced this type of good governance."
Mervyn King (Chairman: King Report)

Corporate governance deals with laws, procedures, practices and implicit rules that determine a company's ability to take informed managerial decisions vis-a-vis its claimants - in particular, its shareholders, creditors, customers, the State and employees. (Confederation of Indian Industry (CII)

Corporate Governance is concerned with the way corporate entities are governed, as distinct from the way business within those companies is managed. Corporate governance addresses the issues facing Board of Directors, such as the interaction with top management and relationships with the owners and others interested in the affairs of the company" Robert Ian (Bob) Tricker (who introduced the words corporate governance for the first time in his book in 1984) (James D. Wolfensohn (Ninth President World Bank)

ICSI PRINCIPLES FOR CORPORATE GOVERNANCE

Sustainable development of all stakeholders	*Ensure growth of all individuals associated with or affected by the enterprise on sustainable basis.*
Effective management and distribution of wealth	*Ensure that enterprise creates maximum wealth and judiciously uses the wealth so created for providing maximum benefits to all stakeholders and enhancing its wealth creation capabilities to maintain sustainability.*
Discharge of social responsibility	*Ensure that enterprise is acceptable to the society in which it is functioning.*
Application of best management practices	*Ensure excellence in functioning of enterprise and optimum creation of wealth on sustainable basis.*

GYANVARDHAK CAPSULE

CORPORATE GOVERNANCE AND COMPANIES ACT, 2013

Some of the Provisions of Companies Act, 2013 related to Corporate Governance are:

1. Mandatory provisions related to Independent Directors, Woman Director, Key Managerial Personnel
2. Enhanced disclosures and assertions in Board Report, Annual Return and Directors' Report with regard to Managerial Remuneration, Risk Management, Internal Control for Financial Reporting, Legal Compliance, Related Party Transactions, Corporate Social Responsibility, Shareholding Pattern, Public Money etc.
3. Stricter yet forward-looking procedural requirements for Secretarial compliances and ICSI Secretarial Standards
4. Enhanced scope of Related Party Transactions and introduction of concept of arm's length pricing.
5. Introduction of mandatory provisions regarding Whistle Blower Policy, Audit Committee, Nomination and Remuneration Committee, Stakeholders Relationship Committee, and Corporate Social Responsibility Committee.

ELEMENTS OF GOOD CORPORATE GOVERNANCE

ROLE AND POWERS OF BOARD

Good governance is decisively the manifestation of personal beliefs and values which configure the organizational values, beliefs and actions of its Board. The Board as a main functionary is primary responsible to ensure value creation for its stakeholders.

LEGISLATION

Clear and unambiguous legislation and regulations are fundamental to effective corporate governance. Legislation that requires continuing legal interpretation or is difficult to interpret on a day-to- day basis can be subject to deliberate manipulation or inadvertent misinterpretation.

BOARD INDUCTION AND TRAINING

Directors must have a broad understanding of the area of operation of the company's business, corporate strategy and challenges being faced by the Board.

BOARD MEETINGS

Directors must devote sufficient time and give due attention to meet their obligations. Attending Board meetings regularly and preparing thoroughly before entering the Boardroom increases the quality of interaction at Board meetings.

MANAGEMENT ENVIRONMENT

Management environment includes setting-up of clear objectives and appropriate ethical framework, establishing due processes, providing for transparency and clear enunciation of responsibility and accountability, implementing sound business planning, encouraging business risk assessment, having right people and right skill for the jobs, establishing clear boundaries for acceptable behaviour, establishing performance evaluation measures and evaluating performance and sufficiently recognizing individual and group contribution.

BOARD SKILLS

To be able to undertake its functions efficiently and effectively, the Board must possess the necessary blend of qualities, skills, knowledge and experience. Each of the directors should make quality contribution. A Board should have a mix of the following skills, knowledge and experience:

CODE OF CONDUCT

It is essential that the organization's explicitly prescribed norms of ethical practices and code of conduct are communicated to all stakeholders and are clearly understood and followed by each member of the organization.

GOVERNANCE FROM INDIAN SCRIPTURES

Some of the relevant principles of RAMAYANA which have a bearing in the modern day society can be summed up in these 5 points:

1. Governance has no inequality, no ups and downs, no differences between rich and poor.
2. The structure of governance should be such that the environment of mutual trust and love is promoted and this means that there is no jealousy or malice amongst the subjects.
3. Governance should promote commitment to duty and doing the duty properly gives ultimate happiness.
4. Governance systems should promote education of one and all, whether man or woman. Education is everyone's right.
5. Governance should promote the good health of all the persons in the society.

Vidur Niti

The word "Vidur" in Sanskrit means "skilled," "intelligent," and "wise." Vidura Niti, or Vidura's Statecraft, is presented as a dialogue between Vidura and King Dhritarashtra, believed to have occurred before the start of the Kurukshetra war. Although many of the qualities and principles discussed are rooted in politics, these teachings can be applied not only to governance but also to daily life. The wisdom shared by Vidura offers valuable insights for personal growth and leadership.

Shantiparva

Shantiparva, meaning the "Book of Peace," consists of 18 parvas (books). It is believed to contain the instructions provided by Shri Bhishma, the eldest member of the Kuru family, also known as "Pitamah," to King Yudhishthira. The book comprises 365 chapters and 13,716 shlokas, and is divided into three sub-parvas:

1. Raja Dharma Parva (Chapters 1-130, 4,716 Shlokas): Discusses the duties of a king and the principles of governance.
2. Apad Dharma Parva (Chapters 131-173, 1,649 Shlokas): Covers the rules of conduct during times of adversity.
3. Moksha Dharma Parva (Chapters 174-365, 7,351 Shlokas): Explains the behavior and principles for attaining moksha (liberation, freedom).

Bhagavad Gita

The emphasis of Bhagavad Gita is "Dharma". Dharma means righteousness; accountability of self, family, organisation and society for order and progress. It is the right path, which will uphold the family, organisational and the social fabric. Hence, it helps in the long-term upliftment of all living beings and ensures welfare of society. Some of the important aspects of governance touched upon in this epic of Mahabharata based on the above ethical principles:-

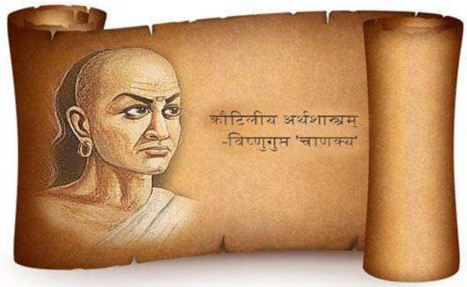
a) Public Interest should be given priority over private or personal interest.

b) Uphold Dharma regardless of conflict of interest, following the principle of "Sva-Dharma" (meaning own dharma), which is unique to that person.

c) Transparency should be maintained in demonstrating the path of Dharma.

Arthashastra

Kautilya's Arthashastra maintains that for good governance, all administrators, including the king were considered servants of the people. Good governance and stability were completely linked. There is stability if leaders are responsive, accountable and removable.



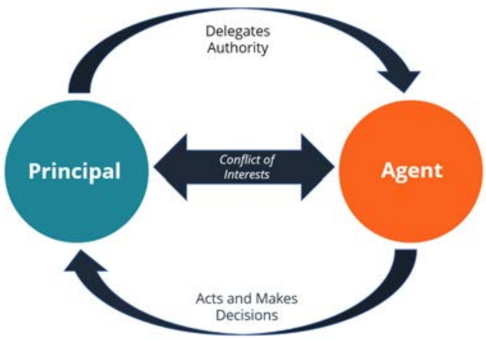
KAUTILYA'S FOURFOLD DUTY OF A KING			
RAKSHA	VRIDDHI	PALANA	YOGAKSHEMA
literally means protection, in the corporate scenario it can be equated with the risk management aspect.	literally means growth, in the present day context can be equated to stakeholder value enhancement	literally means maintenance/comp 1 iance, in the present day context it can be equated to compliance to the law in letter and spirit.	literally means well being and in Kautilya's Arthashastra it is used in context of a social security system. In the present day context it can be equated to corporate social responsibility.

CORPORATE GOVERNANCE THEORIES

Agency theory is an economic theory that describes the relationship between a principal and an agent. It's used to understand how to structure contracts to address conflicts of interest and risk preferences between the two parties.

How does agency theory work?

1. The principal delegates decision-making authority to the agent.
2. The agent is expected to act in the principal's best interests.
3. The agent receives an incentive, such as a fee, for their wor



According to <u>Shareholder theory</u>, a corporation is viewed as the property of its shareholders or stockholders. They have the right to manage or dispose of this property as they see fit, aiming to maximize returns on their investment. While the primary goal of shareholders is to earn a return, their role has evolved beyond just seeking profits. Shareholders are now expected to oversee the corporation's operations and ensure that the company and its management adhere to ethical and legal standards set by the government. This broader responsibility is crucial for maintaining corporate governance and compliance.

According to <u>Stakeholder theory</u>, the company is viewed as an input-output model, where various stakeholder groups, including creditors, employees, customers, suppliers, the local community, and the government, must be considered. From this perspective, a corporation exists to serve the interests of these groups, not just the shareholders.

The term 'steward' refers to someone who manages another's property or estate. In the context of a corporation, it is used to describe the role of guardianship, where managers and employees are entrusted with the responsibility of safeguarding the corporation's resources, property, and interests in the absence of the owners. Stewardship theory is value-based, emphasizing that managers and employees act as caretakers who must protect the corporation's assets and not use them for personal gain. It adopts a social approach to human nature, highlighting the ethical duty to act in the best interests of the corporation and its stakeholders.

CORPORATE GOVERNANCE – CONTEMPORARY DEVELOPMENTS IN INDIA

Aspect	Development	Description
Regulatory Framework	Companies Act, 2013	The Companies Act, 2013 has strengthened corporate governance in India by implementing provisions related to board composition, disclosures, and independent auditing.
Board Independence	Independent Directors	Introduction of the requirement for independent directors on the board of listed companies to enhance objectivity in decision-making and reduce conflicts of interest.
Disclosure & Transparency	Clause 49 of Listing Agreement (Replaced by SEBI Listing Obligations and Disclosure Requirements)	Mandatory disclosure requirements for listed companies, including the financial performance, governance practices, and any related party transactions to ensure transparency.
Audit Committees	Mandatory Audit Committees	The establishment of audit committees in companies with independent directors to oversee financial reporting and auditing processes.
Minority Shareholder Protection	SEBI's Takeover Regulations	The Securities and Exchange Board of India (SEBI) regulations ensure that minority shareholders are protected during mergers, acquisitions, or substantial share transfers.
Ethical Practices	Business Responsibility and Sustainability Report (BRSR)	Introduction of the BRSR (replacing the Business Responsibility Report) to monitor corporate social responsibility and sustainability practices.
Whistleblower Mechanisms	Whistleblower Policy	The requirement for listed companies to adopt a whistleblower policy to protect employees who report unethical behavior or violations of law within the organization.
Leadership Roles & Diversity	Board Composition	Encouraging diversity in board composition, including gender diversity, to improve decision-making and foster varied perspectives in corporate governance.
Corporate Social Responsibility (CSR)	Mandatory CSR Provisions	The introduction of mandatory CSR spending under Section 135 of the Companies Act, 2013, requiring companies to allocate a percentage of profits towards social causes.
Protection of Investor Interests	SEBI's Investor Protection Measures	SEBI has introduced multiple investor protection measures, including regulations on insider trading, market manipulation, and mandatory disclosures to safeguard investors.
E-Voting	Introduction of E-Voting for Shareholders	The introduction of electronic voting systems for shareholders to enhance their participation in decision-making processes during annual general meetings (AGMs).

CORPORATE GOVERNANCE – CONTEMPORARY DEVELOPMENTS IN INDIA

The development of corporate governance in India can be broadly categorized into pre-liberalization, economic liberalization, and post-scandal periods, with key milestones including the CII Code (1998), Clause 49 (2000), and the Companies Act 2013.

1. Pre-Liberalization Era (Pre-1991):

1.1 Limited Focus: During this period, India had a mixed economy with significant government control over industries, leading to a limited focus on corporate governance in the private sector.

1.2 Socialist Policies: The socialist policies of the time, along with government control, meant that corporate governance issues were less prominent compared to the current era.

2. Economic Liberalization and Initial Reforms (1991-2000):

2.1 CII Code of Corporate Governance (1998): The Confederation of Indian Industry (CII) played a key role in promoting corporate governance by developing and releasing a code of corporate governance.

2.2 Kumar Mangalam Birla Committee (1999): This committee, formed by SEBI, focused on strengthening corporate governance practices and making recommendations to address issues like transparency and accountability.

2.3 Clause 49 (2000): SEBI incorporated the recommendations of the Kumar Mangalam Birla Committee into Clause 49 of the listing agreement, which outlined specific requirements for corporate governance practices for listed companies

3. Scandals and Strengthened Regulations (2000-2010)

3.1 Naresh Chandra Committee (2002): This committee was formed to assess the prevailing corporate governance norms and enhance and strengthen such practices.

3.2 Narayana Murthy Committee (2003): The committee focused on independent audits and board monitoring of management, as well as financial and non-financial transparency.

3.3 Satyam Scandal (2009): The Satyam scandal highlighted the importance of strong corporate governance and led to further regulatory reforms and stricter enforcement.

3.4 The Companies Act, 2013: This act was a significant step in strengthening corporate governance framework in India, with provisions for independent directors, audit committees, and other governance mechanisms.

CORPORATE GOVERNANCE – CONTEMPORARY DEVELOPMENTS IN USA

The development of corporate governance in the USA can be broadly characterized by key legal milestones, including the Securities Act of 1933 and the Securities Exchange Act of 1934, followed by the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

Detailed breakdown of the stages:

1. Early Foundations (Pre-1930s): Corporate governance in the US initially focused on state corporate law, with minimal federal oversight.
2. Post-Crash Reforms (1930s): The Securities Act of 1933 and the Securities Exchange Act of 1934 were enacted in response to the stock market crash of 1929, establishing the Securities and Exchange Commission (SEC) to regulate the securities industry and protect investors.
3. Evolving Regulations and Scrutiny (1970s-2000s): During this period, there was a growing emphasis on corporate accountability and transparency, with various regulations and guidelines emerging to address issues like conflicts of interest and insider trading.
4. Post-Enron and WorldCom (2002 onwards): The scandals involving Enron and WorldCom led to the passage of the Sarbanes-Oxley Act of 2002, which significantly strengthened corporate governance requirements, including enhanced financial reporting and auditor independence.
5. Dodd-Frank Act (2010): The Dodd-Frank Act, enacted in response to the 2008 financial crisis, further expanded the scope of corporate governance regulations, addressing issues like executive compensation, financial stability, and consumer protection.
6. Ongoing Evolution: Corporate governance continues to evolve, with ongoing discussions and reforms aimed at improving transparency, accountability, and stakeholder engagement.

CORPORATE GOVERNANCE – CONTEMPORARY DEVELOPMENTS IN UK

The development of corporate governance in the UK can be characterized by a move from a focus on shareholder value to a broader approach encompassing stakeholder engagement and ethical business practices, with the UK Corporate Governance Code playing a key role.

Detailed look at the stages:

1. Early Focus on Shareholder Value: Initially, corporate governance in the UK focused primarily on maximizing shareholder value, with a strong emphasis on financial performance and accountability to investors.
2. The Rise of the UK Corporate Governance Code (formerly Combined Code): The Financial Reporting Council (FRC) published the UK Corporate Governance Code, which sets standards of good practice for listed companies, covering areas like board composition, remuneration, shareholder relations, accountability, and audit.
3. Evolution and Expansion: The Code has evolved over time, reflecting changing priorities and best practices, including increased emphasis on stakeholder engagement, sustainability, and ethical business conduct.
4. Emphasis on Stakeholder Engagement: The focus has expanded beyond shareholders to include other stakeholders, such as employees, customers, and the wider community, recognizing the importance of long-term sustainability and social responsibility.
5. Climate Governance: The UK Corporate Governance Code has also seen the inclusion of climate-related issues, with the FRC emphasizing the importance of climate-related reporting and the need for boards to understand and oversee climate-related risks.
6. Focus on Diversity, Inclusion and Equal Opportunity: The code has been amended to promote diversity, inclusion and equal opportunity, without referencing specific groups.
7. Ongoing Development: The FRC continues to review and update the Code, ensuring it remains relevant and effective in promoting good corporate governance practices.