Chapter 2

Corporate Governance: Conceptual Perspective

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Ever since the rise of corporations with limited liability, there has been conflict of interests of various stakeholders, and hence, the questions posed to the management were almost always on the satisfaction of those interests. In their seminal work on the separation of ownership from control[1], Berle & Means (1932) propounded that companies ceased to be private property and have become institutions through the corporate device, having absolute property right. This ensued corporate governance debate in early 1930s. What does the term 'corporate governance' connotes and what are its tenets need to be answered so as to delineate various facets that go into the making of a system of corporate governance that seeks to provide framework for the growth and development of companies. Therefore, this chapter makes an attempt to discuss what constitutes a definition of 'corporate governance' and how is it different from other cognate terms such as 'administration' and 'management' so as to clearly identify the contours of corporate governance. Accordingly, the chapter has been divided into four parts. Section one highlights semantics of corporate governance and section two provides importance of corporate governance. Section three narrates extant corporate governance models as they in vogue in different countries. It is followed by the discussion on tenets of corporate governance in section four.

2.1 On the Semantics

Governance: Different from Administration and Management

William Spriegal (1957) and Milward (1960) referred 'administration' as decision-making function and 'management' as execution function. Milward (1960) stated that –

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[1] Agency theory provides a group of descriptive theoretical approaches that seek to provide understanding of a broad class behaviour where agents are not under explicit direction and hence possessing particular obligation, as against the case of law of agency. Agency theory provides framework for understanding dilemmas produced in pervasive agency relations of business – Mitnick, B. M. (1975), The Theory of Agency: The Policing "Paradox" and Regulatory Behaviour, *Public Choice*, No. 24, Winter, pp. 27-42.

"administration is primarily the process and agency used to establish the objective or purpose which an undertaking and its staff are to achieve; secondly, administration refers to plan and to stabilize, the broad lines or principles which will govern actions. These broad lines are usually called policies. Management is the process and agency through which execution of policy is planned and supervised"[2]. While the other thinkers are of the view that 'administration' is a part of management or management and administration are same and they are used interchangeably (Henry Feyol, 1949). However, Brech (1972) differs from this view stating that – "... administration is that part of management which is concerned with the installation and carrying out of the procedures by which it is laid down and communicated, and the process of activities regulated and checked against plans."[3]

This definition states that administration is a part of management and that according to him, 'management' works towards fulfillment of a given purpose or task[4]. If a real distinction has to be seen, one has to put stress on government and non-government business organizations. Government always appoints administrators or bureaucrats[5]. The term 'bureaucracy' is related to the system where well laid rules and regulations are implemented through a system and bureaucrats are not supposed to take any decision till the government takes policy decision on the issue and they are also not liable to achieve any profitable targets like a manager. Therefore, in government parlance, an administrator's job is to administer rules and regulation within the policy framework laid down by the government. On the other hand a manager manages the affairs of a government/ non-government corporate entity with day-to-day decision-making power to utilize the resources to their optimum.

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2 Milward, G. E. (1960), *An Approach to Management*, John Wiley, New York, p.34.

3 Brech, E. F. L. (1972), *Principles and Practices of Management*, Pitman, London, p.29.

4 However, Henry Fayol is of the view that there is no difference between the terms 'management' and 'administration'.

5 "Bureaucracy", as Max Weber pointed out, did not become the dominant mode of human organization in West until the arrival of industrialization.

'Administration' usually considers functioning of those who act within the scope of given rules and regulation and try to establish confidence of the stakeholders in the system. They are cost centers for a government or for an enterprise. 'Governance' on the other hand is a system that involves ethical and legal issues in directing and controlling the whole system. Managers and administrators are accountable to governors. The basic difference between 'administration' and the 'governance' is quite fundamental. 'Governance' sets the system and controlling mechanism by establishing regulations while the function of administration is to see that those regulations are adhered to by the society and its elements. Therefore, the difference is that of makers and implementers between governors and the administrators, respectively.

Governance, seems to be related to the state affairs of the government i.e. governing the society[6]. The concept of governance includes a political power[7]. The widest definition of governance is given in the report of the commission on 'Global Governance Our Global Neighbourhood' (1995) which states, "Governance is the sum of many ways individual and institutions, public or private, manage their common affairs. It is a continuing process through which conflicting or diverse interests may be accommodated and co-operative action may be taken. It includes formal institutions and regimes empowered to enforce compliance as well as informal arrangements that people and institutions either have agreed to or perceive to be in their interest". Interpreted in the context of an enterprise, there are many stakeholders[8] whose interests are conflicting with each other but these interests have to be optimized within a legal and administrative framework that can be regarded as 'governance'

6 The American Heritage dictionary defines governance as, "The act, process or power of governing; government. While the Oxford English dictionary is more comprehensive since it reads as " the act or manner of governing, of exercising control or authority over the actions of subjects; a system of regulations".

7 A World Bank Report on Africa (1989) defines governance as 'the exercise of political power to manage the nation's affairs'.

8 Stakeholders of a corporate entity whose interests are conflicting with each other are shareowners, directors, management, employees, customers, suppliers, government, competitors, society at large, etc.

system. However, a system by which 'governance' can also be spelled out is in terms of 'democracy'. Government elected in democratic[9] way is ultimately responsible to their electoral constituencies. For having a good governance system, the primary responsibility lies on those who elect the 'Governors'. They are entitled to know about those who seek election to the posts. This gives rise to a system where "government is for the people, by the people and of the people". Therefore, the governing body is always elected by the shareholders and the managers are selected by the governing body and shareholders ratify them in general body.

Management is both task and process oriented. Function-wise 'management' may be viewed as a process involving planning, organizing, staffing, directing, and controlling human efforts to achieve organisational objectives. Managers have decision-making power for accomplishing their task as a manager with given resources.

The difference between 'governance' and 'management' lies in the fact that governing body has ultimate power[10] while the managing body is assigned the immediate (executive) power[11] to control. This leads us to yet another basis of differentiating the governance from the management and that is, the decision control and decision execution. The board of directors assume the role of decision control which ultimately is restricted to the direction and affirmation, decision execution is concerned with the day to day decision making, executive process on the part of the management personnel given the resources and situation to optimize the targets fixed by the board. Directing calls for a much higher degree of holistic orientation than managing. Therefore, a functional excellence at management level is different than holistic preview of a business by its leader at the board level. Thus, corporate governance operates in dynamic regulatory environment, structural transformation and self-regulation. 'Governance' relates to creating the overall framework under which the

[9] The word 'democracy' arises from Greek '*Demos*' implying '*The people*'
[10] Responsible for ultimate results.
[11] Responsible for immediate results.

management functions and handles the physical, human and financial resources available to the company to achieve specified results.

To sum up, 'governance' is to set the system, controlling mechanism and frame rules and regulations while 'administration' is to implement and act within the scope of given rules and regulations and 'management' refers to optimum utilization of resources in day to day affairs of an organisation.

Concept of Corporate Governance

A system of government and a system of corporate governance have a commonality of being concerned with checks and balances on the exercise of power and with its peaceful transfer. 'Governance' has two chief elements, i.e., overall supervision of management, and accountability for the conduct and policies of the organization to all stakeholder. Tricker defined it as 'the process by which companies are run' while Cadbury Committee (1992) defined it as 'the system by which companies are directed and controlled'. 'Directing'[12] function sets the goals to be achieved whereas 'controlling'[13] implies working system and criteria to evaluate outcomes. The term 'control' reflects power over the resources and its users. Corporate governance is the exercise of power at the top level of the corporate entity and extends beyond financial control (Ticker, 1995)[14]. Despite the fact that board of directors is the ultimate center of control, the 'control' may vary depending on the relative performance of the firm, as well as on other factors, which are exercised frequently through the ability to hire and fire the CEO (Mizruchi, 1983). Management wields much power and wider control[15] except the market driven results[16] of the company.

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12 To 'direct' means direct someone to do something or to give orders or instructions i.e., to be incharge of something.
13 To 'control' means having an authority or charge, power to influence or guide.
14 In his editorial (Bob Ticker) in *Corporate Governance* Journal, vol. 3, no.2, April, 1995.
15 viz., information on company's market position, financial position, agenda items, minute papers, auditors, company secretary, etc.
16 viz., sales, profits (actual and not inflated) and market capitalization, etc.

2.2 Importance of Corporate Governance

Despite the fact that the importance of corporate governance cannot be denied, it is seen that corporate governance has gone from being ignored, in the past, to being overexposed with the emphasis on form over substance. There has been lack of adequate empirical evidences, which illustrate that good corporate governance enhance the performance of the company. Corporate governance encompasses the entire mechanics of the functioning of a company and attempts to put in place a system of checks and balances between the shareholders, directors, auditors and the management. It refers to an economic, legal and institutional environment that allows companies to diversify, grow, restructure and exit, and do everything necessary to maximize long-term shareholder value. Corporate governance is not just the compliance with the statutory requirements since it is the dynamic interplay amongst companies, shareholders, creditors, capital markets, financial institutions and corporate laws.

In different context and situations, the importance of corporate governance has been highlighted from time to time. In the context of improvement of productivity Alan Greenspan stated, "We could not have achieved our current level of national productivity if corporate governance had been deeply flawed"[17]. Improved corporate governance has a key role to play in helping to limit ubiquitous self-dealing and rent-seeking behaviour by corporate insiders and overcome the obstacles to productivity and growth. It was revealed by a survey that the investors would pay high premiums for shares of those companies that are wellgoverned[18]. Therefore, for enhancing shareholders' wealth, Arthur Levitt[19] emphasized the role of corporate governance by stating that "markets exist by the grace of investors. And it is today's more empowered investors who will determine which companies and which

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17 Remarks by Chairman Alan Greenspan on corporate governance at *the Stern School of Business, New York University,* New York, March 26th, 2002.

18 McKinsey survey of investors' perception indicates that investors are willing to pay more for a company that is well governed, all other things being equal. - (2000), McKinsey & Company (USA): "Investors Opinion Survey", June.

19 The former Chairperson of the US Securities and Exchange Commission, said in a speech at a recent Manhattan conference sponsored by the Federal Reserve.

markets will stand the test of time and endure the weight of greater competition. It serves us well to remember that no market has a divine right to investors' capital". Therefore, it can be said that companies that do not demonstrate strong governance will be viewed as out of date, out of control and out of the market.

It is misinterpreted that corporate governance improves the corporate financial performance directly. In principle the role of corporate governance is to enhance the effectiveness of board that in turn improves the corporate performance of the company in the given constant external environment (viz., market, supplier, customer, government policy, global and national economy, etc.). Since the corporate performance is influenced by several external factors besides the corporate governance and hence its' importance cannot be diluted for the want of sufficient evidence for positive relationship. Further to this, corporate performance cannot be linked either to board structure or to board process in isolation (see figure 2.1).

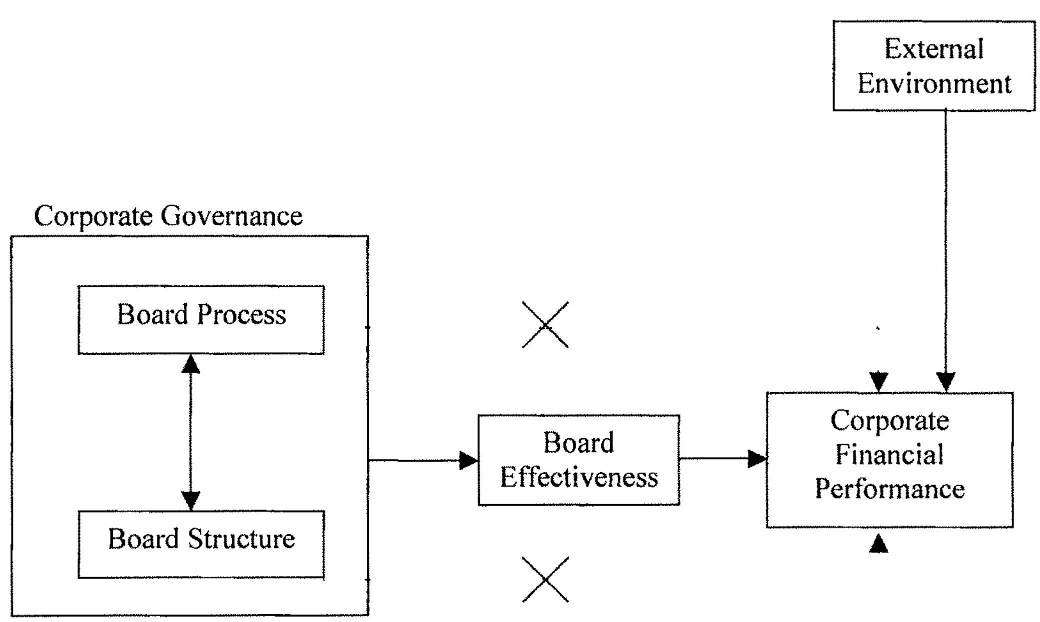

Figure 2.1 : Corporate Governance vs. Corporate Performance

Corporate financial performance is one of the measurement by which board effectiveness can be measured and board effectiveness is the function of the corporate governance, i.e., board structure and board process collectively.

2.3 Corporate Governance Models

Usually, ownership and control should go together as a matter of property right. But, this is not true in case of corporatised organizations wherein ownership is divorced from control over resources. The apparatus of governance will keep on changing in tune with change in ownership structure that may either be wholly owned[20] or family owned[21] or closely held or widely held[22]. In case of the family owned corporate organization management and ownership relationship will be stronger while the widely scattered ownership the management will be stronger but the owner will be weak. However, there may be situations where shareholding is widely distributed and therefore small proportion of shareholding control by promoters/ managers would lead to weak ownership and strong managers. Corporate governance structure being dependent on distribution of ownership may appear to be different in shades.

2.3.1 Corporate Governance - International

Corporate governance system in the U.K. and the U.S. is market-oriented capitalism and is characterized by almost complete distinction between the shareowners and the management. The ownership structure thus is mostly **outsider** oriented. Formally, the system of corporate governance provides for a chain of accountability whereby executives are accountable to the board of directors, who are, in turn, accountable to the shareholders (Forbes & Watson, 1993). In this system the institutional investors like insurance companies and pension funds have usually played a passive role. In Germany and France stock markets are relatively smaller and illiquid compared to the U.S. and the U.K. and therefore corporate governance

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20 This type of companies is typical in Asian and South-East Asian countries, viz., India, Korea, Malaysia, etc. where the ownership is concentrated with fewer shares but is powerful against scattered minority shareholders.

21 This type of companies are either private limited or evenif they are publicly traded, the concentration of ownership is so large that the public held negligible shares of the company.

22 Which Mark Roe (1994) explained as 'strong managers, weak owners' and is typical in the U.S., the U.K. and some other European countries.

system is not market oriented. In contrast, the Japanese corporates rely upon trust and mutual relationship and work in a co-operative environment. Therefore, the market for control is absent for banks have the larger shares in companies. Further, much of the differences in corporate governance systems around the world stem from varying regulatory and legal environments (Shleifer and Vishny, 1997).

2.3.2 Corporate Governance - India

In India and other Asian countries, Jensen's model of distinct ownership and management does not exist in majority of organisations. In India, the ownership structure is mostly **insider** oriented wherein the concentrated ownership is in the hands of either with an individual (usually a promoter) or family or group or financial institutions or corporate cross holdings[23]. The control is maintained through pyramidal form of ownership. The number of corporate entities, which reflect the pure outsider model, is relatively less in India. Despite Indian economy has grown and business units have become ever larger, *de facto* shareholder control has diminished due to wide dispersal, and hence a few shareholders have sufficient stakes to influence the choice of board of directors or CEOs. And the vast majority of dispersed corporate shareownership is for investment and not to achieve operating control of a company. In India, the distinction between managers and directors is practically negligible or absent because of prevailing family fiefdoms in the board where the family members of promoters are executive management and promoter himself is holding the board chair.

In insider system of corporate governance, the fundamental conflict is not between the management and shareholders but it is between controlling shareholders (or blockholders) and dispersed minority shareholders, i.e., strong concentrated shareowner and weak minority dispersed shareholders. In this model, the managers are most likely to collude with block holders to expropriate the minority shareholder wealth. By doing so both managers and

[23] Which is again controlled by promoters' own group companies or trust, etc..

blockshareholders fetch incentives as management is compensated lucratively and managers pursue objectives that are more profitable to the blockshareholders by diverting resources to other companies owned by the blockshareholders (Becht, 1997 and Barca, 1997). However, in this collusion the minority shareholders at times, even have to forego the dividend payments.

India is still in an inchoate stage of corporate governance system, despite there are arrays of new codes and legal amendments introduced since 1997. The irony of new proposals and recommendations on corporate governance is that despite having insider system in majority of companies the rules and codes of an outsider system have been adopted without internalizing the cultural differences of carrying out the business. Cadbury Code (of the U.K.) and most recently Sarbanes Oxlay Act, 2002 (of the U.S.) both are good for an outsider system where the management leader is solely responsible for any misgovernance[24] and a non-executive director may be able to solve the problems of agency. However, it has also been argued that the remedy of the blockholder "monitoring" may be worse than the disease of managerial opportunism. Worse yet, in many forms of concentrated ownership, the blockholder is a family group, and the line between the blockholder "monitor" and the management team (which may also involve family members) often melts down. On such occasions, minority shareholders may experience the worse of both worlds, i.e., self-dealing of blockholders who overlap with a family-based management. In India, there are three types of corporate governance models that are differentiated on the basis of the formation and nature of companies that are explained as under:

Corporate Governance in Private Sector

In India, as explained above, there exists an insider model of ownership. Corporate governance structure is single tier with a mix of non-executives and executives. The board

24 This includes mis-statements of accounts and annual reports, misappropriation and diversion of funds, etc.

positions are either coveted or through election by the shareholders. However, election by the shareholders has remained as a mystery for most of the shareholders because the same non-executives get elected term after term despite declining corporate performance year after year. Promoters are in control of the situation and decide over who should or should not be elected since the boardroom is full of friends and family members. Family fiefdom is deep rooted in private sector as the sons, grandsons and great grandsons are unquestionable future successors of the corporate empires. Another type of private sector companies is multinational companies wherein the parent companies decide the course of board level and top management level appointments. The board members are nominees of parent company and are foreigners in majority cases. The corporate governance system and structure is basically as per the Companies Act, 1956, Sick Industrial Companies (Special Provisions) Act (SICA), 1985, and Listing Agreement[25] of stock exchanges. The direction and control in the private sector companies lies with the largest shareholders.

Corporate Governance in Public Sector Units (PSUs)

PSUs are largely dependent on the government policies just like the private and joint sector enterprises. However, the administrative ministry and the concerned ministries[26] have substantial control over these enterprises as far as direction and control are concerned[27]. Its' altogether a bureaucratic set up which control the governance at PSUs. Directors are appointed by the Government (Central/ State) with the help of Public Sector Enterprise Board and the concerned Administrative Ministries. Its' not only the decision making process or control functions but the most of the public sector undertakings are dependent on the concerned ministries of the government even in their day to day activities. At PSUs

25 only for those who are listed on the stock exchanges.

26 e.g. Petroleum ministry, Power, Steel, etc.

27 Decisions like appointment of board of directors, management personnel, investment and divestment policies, spin-off, merger of two PSUs, utilization of funds, etc. is decided by the concerned ministries, department of divestment and other ministries whereas in case of private sector these decisions are taken by the board members.

positions of Chairman-cum-Managing Director are combined in most of the organizations which is an executive position. The CMD's position in PSUs is just like the CEO's position of the private sector companies because they are more involved in day-to-day activities of the organization and reporting to the concerned ministries. While the corporate governance is all about direction and control, it boils down to operational control only since it leads to: (a) Controlling the appointment or removal of the management including the CEO/MD; (b) controlling the performance of the management; and (c) controlling the financial budgetary provisions.

In PSUs none of the above three functions are carried out by the board. Appointment, performance appraisal, training, compensation decisions and the financial budgetary control are not carried out by the board but are done by the Administrative Ministry, albeit some dovetailing of financial powers down the line. The board is carrying out the management function only.

Corporate Governance in Public Sector Banks (PSBs)

The corporate governance structure of banks in India has the elements of the "outsider" model of the U.S. and the U.K. where there is separation of ownership and management. Corporate governance in PSBs is complicated by the fact that effective management of these banks vests with the government and the boards of banks operate merely as functionaries. The ground reality is that the Government performs simultaneously multiple functions *vis-à-vis* the PSBs, such as the owner, manager, quasi-regulator and sometimes even as the super-regulator. Governance structure at PSBs is a formal structure of relationship between the Government, Reserve Bank of India, board of directors and management[28]. Government is the significant shareholder of the PSB and also the sole regulator of their activities. The functioning of board of directors of PSBs is regulated by RBI/ Ministry of Finance as per

[28] Reddy, Y.V. (2002), "Public Sector Banks and The Governance Challenge: Indian Experience", *RBI Bulletin*, May, p. 339.

Nationalised Banks (Management and Miscellaneous Provisions) Scheme 1980. Board of directors is not only vested with the powers of general superintendence and direction but also management of day-to-day affairs and business of the bank.

To improve corporate governance in PSBs, RBI is following the recommendations of Basel Committee. Each PSB board has a maximum of 15 members[29] and is ordinarily required to meet at least six times a year[30]. The important board committees set up by PSBs under Government of India and RBI guidelines are: management committee of the board (MCB), audit committee, asset-liability management committee and investor grievance committee. Audit committee of PSBs has 3 members wherein Director-Nominee of GOI shall be the Chairman and the Director-Nominee of RBI and one executive director of the bank are the other members. Members of asset-liability management committees are: 1-executive director and 4-general managers. 2 members of investor grievance committee are Director-RBI Nominee (who is the chairman) and 1 executive director of the bank.

Corporate Governance in Joint Sector

Changing imperatives of economic development forced the government to constitute R.C. Dutt Committee that suggested yet another model of public-private partnership, whereby needed flexibility and entrepreneurship was imparted to the PSUs by retaining the public accountability. R. C. Dutt Committee (1969) suggested the model of joint sector[31] wherein government sector, private sector and public participation was envisaged by offering a

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[29] Maximum 2 – WTDs, 2 Official directors representing the Central Government and the RBI, maximum 2 directors from the specified institution having not less than 51% of paid up capital held or controlled by Central Govt., 2 employee directors representing workmen and non-workmen (i.e., Officers), the chartered accountant director, max. 6 directors to be nominated by the Central Govt. or elected by the shareholders – under section 9(3) of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980.

[30] As per Nationalised Banks (Management and Miscellaneous Provisions) Scheme, 1980.

[31] After Industrial Licensing Policy Enquiry Committee (Dutt Committee) the concept of 'joint sector' came into existence that would apply to new projects (after 1969) only with an arbitrary formula of 26% of government (or its agencies), 25% by private collaborating group and 49% by the public. There was a policy – wherein financial institutions could reserve an option to convert a part of their loans into equity shares.

maximum of 49% of equity to the general public so as to make the joint sector companies accountable to the discipline of the financial market and the legislature.

In any organization ownership, control and the top management decide the type of organization. The term 'joint sector' is applied to an undertaking when both ownership and control (which should be distinguished from day to day management) are effectively shared, individually or jointly, between public sector agencies on the one hand and a private group on the other[32], i.e., joint ownership, joint control and professional management. Sharing of managerial power and ownership were the corner stones of the joint sector system.

Legal Framework of Corporate Governance in India

Indian companies are regulated by various legislations. The most important being the Companies Act, 1956 (as amended upto 2002), the Securities and Exchange Board of India Act, 1992 (SEBI Act) and regulations made thereunder. The Companies Act, 1956 deals with the corporate affairs right from incorporation to dissolution whereas the SEBI Act seeks to protect the investors' interest. Additionally, public sector undertakings and public sector banks are regulated by specific legislations by which they were created, viz., State Bank of India under State Bank of India Act, 1955, The Associate Banks of SBI under the State Bank of India (Associate Banks) Act, 1959, Nationalised Bank (Management and Miscellaneous Provisions) Scheme, 1980 and The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980.

Part VI of the Companies Act, 1956 is on "Management And Administration" wherein topics related to meeting and proceedings, managerial personnel, directors, their remuneration, audit, etc. are covered under sections 146 to 424. The Companies Act, 1956 itself has not differentiated between the management team and the governing body. Conceptually, 'governance' is different than the 'management and administration'. Growing scams in the

[32] Gupta, L.C. (1974), *Corporate Management and Accountability – Towards a Joint Sector*, Mac Millan, Institute for Financial Management and Research, Madras, p.1.

financial market led the SEBI to appoint Kumar Mangalam Birla Committee to suggest ways and means to provide an order to the corporate governance system so that investors' interest is well protected by the regulator. Recommendations of Narayanamurthy Committee and Naresh Chandra Committee are following the suit by seeking more transparent and accountable behaviour from the management.

Under such regulatory and legislative framework the corporate management has to work under the surveillance of corporate board that provides the strategic direction and control the appointment and the end results by setting the targets for the management.

2.4 Tenets of Corporate Governance

Proponents of corporate governance suggest that good corporate governance does not mean good financial performance but an efficient system of corporate governance builds the corporate entity. Basic objectives of corporate governance have always been proposed as 'maximization of shareholder value'. Berle & Means (1932) also opined that the controlling activity ultimately must guarantee the returns to shareholders. However, stakeholder theory suggests that the interest of stakeholders be kept in mind because stakeholders are the cause for which the organization exists. Setting corporate governance objectives, using ethical means to reach those objectives and disclosure on corporate governance are three basic pillars on which rests the system of corporate governance. They provide a framework that guides directors in discharge of their governance function and enhance the credibility of their respective corporate entity. Therefore, it is quite imperative to understand this system in its details to see the elements of corporate governance, which are important to enhance credibility of a corporate entity.

2.4.1 Corporate Governance Objectives, Strategy and Policy

A corporation is an abstraction exists only in the eyes of law. As a legal personality it does the business through its agents. Agents act within the scope of objectives fixed by its members. Because of separation between ownership and control (Berle & Means, 1932) the management has been made accountable to the shareowners. Despite weak/ absence of shareholder activism in Indian corporate scenario, there has been negligible few number of irate shareholders demanding chairman's resignation when the company failed to even maintain the shareholder value as compared with the previous year[33]. Shareholders are the residual claimants of an organization and whatever maximizes shareholder value must necessarily maximize corporate prosperity, and best satisfy the claims of creditors, employees, shareholders and the state[34]. As against the 'agency theory', a stakeholder theory[35] which regards the corporation as a 'social institution' wherein it's the society for which organizations come into existence and therefore it's the responsibility of the organization to see the well-being of various constituencies of the society who have direct or indirect or even conflicting stake in the corporation[36].

Wealth maximization for shareholder value may remain the core of good corporate governance but the use and maintenance of natural resources do have impact on the company as it is directly related to the social well-being and purpose for existence of society. Survival of the society guarantees the survival of the corporation as the survival of the corporation is

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33 Voltas shareholders demanded resignation of the company's NED chairman when the company incurred a loss of Rs. 16 crores. – (1997), "Voltas Shareholders want Tobaccowala to quit post", *The Indian Express*, Vadodara, September 25th, p.9.

34 Abstract from CII report (1997) on 'Desirable corporate governance Practices'.

35 Wherein the corporation is responsible to a wider constituency of stakeholders rather than shareholders only.

36 viz., employees, managers, consumers, suppliers, shareholders, creditors and the general public. These stakeholders constitute almost the whole society and therefore, we have to consider "Corporate Social Responsibility" under corporate governance.

because of society[37]. Therefore, protection of environment and serving the weaker section of society are part of corporate social responsibility within the scope of corporate governance.

Maximisation v/s Optimization

"A corporation is the financial and contractual playing field for a number of individual dealings, and it has no existence independent of those dealings" – Peter A. French[38]. And therefore the conflict of interest arises when there is in existence the relationship between two or more entities, the judgment of one may jeopardize the interest of the other, interest of the entities is competing with each other.

As expounded by many authors and academicians on the subject, the researcher differs from the concept of "maximisation of interests". 'Maximisation' means the highest point to be achieved. However, that maximization level is only in terms of quantity and may not guarantee a quality. Optimization is a tendency to achieve maximisation of quantity but with quality. Therefore, the equation for optimisation can be written as under:

Optimisation $= m \times q$

Here, "*m*" is equal to maximization of returns (i.e., quantity) and "*q*" is equal to quality of corporate governance (on the scale of 0.0 to 1.0 or 0% to 100%). For '*q*', any thing less than 1.0 means the quality of governance is compromised somewhere. Therefore, it is the best results with quality that matters. Under maximization of the returns for the shareholders, one may tend to violate the law and keep other stakeholders' interest aloof, viz., the Government (in terms of loss of revenues) and employees (by reducing the workforce without thinking the long term implications on the society), etc. In this theory of optimization, we are of the opinion that "*q*", in the above equation, is meant to enhance the

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37 Drucker stated, "Society, community, family are self-contained and self-sufficient; they exist for their own sake. But all organisations exist to produce results on the outside." – Drucker, Peter F. (1994), *Post-Capitalist Society,* Harper Business, New York, p. 54.

38 Werhane, Patricia H. and R. Edward Freeman (1997) (*ed.*), *The Blackwell Encyclopedic Dictionary of Business Ethics*, Blackwell Publishers Ltd., Oxford, U.K., p. 149.

quality of returns to the owners (shareholders) that are best possible within the boundaries of legal framework enhancing the other stakeholders' value and ultimately the corporate value. Optimization of the returns is thus the function of self-consciousness and self-regulation that establishes the ethical practices in achievement of results.

Corporate Governance Objectives

Corporate governance committees, worldwide, had stated the corporate governance objectives as maximization of shareholder value[39]. Companies in India in majority had declared their corporate governance objectives as "enhancing the shareholder value", however, there are many companies that have declared their objectives of corporate governance as thrust on transparency and accountability. However, enhancement of the stakeholder value and creation of corporate value were missing from the corporate governance objectives, as stated in the annual reports of FY2000-01, of Indian companies. Taking all stakeholders into consideration, at the back-drop of shareholder theory versus stakeholder theory, it is always argued that the stakeholders are the beneficiaries of the organization and the organization can not remain aloof from the interest of the stakeholders since they provide the necessary resources to the organization. As far as shareholder wealth maximization is concerned, Rappaport (1999) introduced the concept of 'superior shareholder-value-added' approach (i.e. SVA), which is based entirely on cash flows and does not introduce accounting distortions and puts a value on changes in the future cash flows of a company or business unit whereas shareholder value measurement is based on residual income that is distributed to the residual claimants. We hear less on enhancement of

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[39] viz. Kumar Mangalam Birla Committee set up by SEBI had clear objectives of safeguarding the investors' interest whereas "the Cadbury Committee on financial aspects of corporate governance had been set up by its sponsors i.e.,Financial Reporting Council, the London Stock Exchange, and the accountancy profession, because they were concerned at the low level of confidence both in financial reporting and the ability of auditors to provide the safeguards which the users of company reports sought and expected"- Charkham, Jonathan (1995), *Keeping a Good Company – A Study of corporate governance in Five Countries*, Oxford University Press, Oxford, p.249.

corporate value in corporate governance debates wherein shareholder wealth maximisation is given the highest importance or the corporate social responsibility as the second most preferred subject to talk about. However, what is missing is the concept of 'creation of corporate value' which requires basic clarity in the minds of the management personnels and corporate governors that 'creation of corporate value' is fundamentally based on return on resources and resource based expansion wherein investments are done on the long-term based fundamental analysis. Once the objectives are fixed for 'creation of corporate value' the other objectives are easier to achieve, viz., shareholders wealth maximisation because it will lead to the sustainable wealth creation in a long run. India followed socialistic pattern of governance and therefore, the public sector undertakings and banks had two competing objectives of shareholder wealth maximization and also to fulfill objectives of well-being of the society.

Therefore, an effort was made to enquire into the corporate governance objectives pursued by the respondent companies. Respondents were asked to rank the objectives according to their priorities. 89 valid responses on the basis of weighted scores is tabulated in table 2.1.

Table 2.1 : Sectorwise Preference of 'Corporate Governance Objective'

C G Objectives	Sector						Overall	
	Joint		Private		Public			
	Scores	Rank	Scores	Rank	Scores	Rank	Scores	Rank
Maximization of Shareholder Wealth	4	2	141	2	32	1	189	2
Maximization of Stakeholder value	8	1	130	3	30	3	168	3
Creation of Corporate Value	8	1	150	1	31	2	189	1

Analysis of the table reveals that 'creation of corporate value' was assigned as first rank by all companies as an objective of the corporate governance of companies, followed by 'maximization of shareholder wealth' and the 'maximization of stakeholder value' at second and third positions respectively. Objectives of creation of corporate value certainly on a long term enhance the corporate value, which in turn will be beneficial to the long-term shareholder value. Further, sectoral analysis points out that the joint sector did not have any particular preference while deciding corporate governance objectives. 'Creation of corporate value' ranked at number one by private sector whereas public sector respondents chose 'maximisation of shareholder wealth'. Possibly, this is owing to their guiding philosophy.

Measure of Shareholder Value

However, measure of shareholder value has been an area of debate that seeks the answer to the question 'which is an appropriate parameter for measuring shareholder value?' Responses of 89 respondents are presented at table 2.2. Few respondents chose more than one criterion therefore the number of responses to each criteria exceeded the number of respondents.

Table 2.2: Sectorwise Frequency Distribution for Measures of 'Shareholder Value

Criterion for measuring shareholder value	Sector			Total
	Joint	Private	Public	
Share price & growth of the co	3	32	7	42
Return on resources	1	24	4	29
EVA		22	4	26
Resource based expansion		6		6
Share price		2	2	4
Others*		3	1	4
No of respondents	3	71	15	89

* Others – EPS, ROCE, Book value, Cash Value Added

Analysis of the Above table reveals that 47.2% (i.e., 42 out of 89) respondents used 'share price and growth of the company' followed by 'return on resources' (32.6% respondents) and 'EVA' (29.2% respondents) as parameters to measure shareholder value. Positive or negative change in equity share price implies increase/ decrease in the wealth of shareholders, impounding the available information according to the efficiency level of the market (Gupta, 1985). Sectorwise analysis illustrates that each sector used 'share price and growth of the company' as a criterion to measure 'shareholder value', over the much hyped 'EVA', revealing no sectoral differences in the preferred measure of shareholder value.

For the objectives to be achieved, companies list out their priorities to form strategies.

Strategy for Corporate Governance

Companies form strategies to govern their corporates with already set out objectives. Out of many strategies companies may adopt one or two on the priority basis over the other strategies. These strategies ultimately will have to deliver the results for the longterm sustainable value creation. On an ordinal scale respondents ranked their choice of underlying stimulants to form corporate governance strategy. The data collected in this regard is presented in table 2.3.

Table 2.3: Ranking of Priorities to Form Corporate Governance Strategy

Stimulus	Joint		Private		Public		Overall	
	Scores	Rank	Scores	Rank	Scores	Rank	Scores	Rank
Return on total corporate resources	10	2	282	1	78	1	370	1
Return on Investment	11	1	268	2	61	2	340	2
Economic value added	0	6	255	3	55	4	310	3
Maximisation of market share	6	3	188	4	60	3	254	4
Management of risk	3	4	144	5	49	5	196	5
Any other	1	5	24	6	12	6	43	6

88 respondents ranked stimulants for corporate governance strategies formed by them. Depending upon the objectives 5 criteria were selected which revealed the corporate governance strategies to achieve the set objectives. Overall analysis shows that companies assigned rank one to 'return on total corporate resources' followed by 'return on investment'. Not surprisingly, 'economic value added' is assigned third rank followed by 'maximisation of market share'. However, certain other factors were also considered by some of respondents to form strategy of corporate governance, viz., bringing transparency in the working, cash value added, fairness to shareholders, increasing shareholders wealth, increasing stakeholders wealth, maintain present market share, and maximisation of all stakeholder value. Strategies pursued by corporates would affect their investment choices. This is in conformity with the assertion of Gupta (2000)[40] that EVA is not a measure of

[40] Gupta, L. C. (2000), *Return on Indian Equity Shares,* The Society for Capital Market Research and Development, New Delhi, p. 63.

corporate resource maximization, it is rather a tool to evaluate managerial performance internally where organizational structure is Strategic Business Unit (SBU) asset structure.

A further sectorwise analysis points out difference of strategy adopted for the achievement of corporate governance objectives. Rank one given to 'return on investment' by joint sector signifies the increased emphasis on flexibility and profitability rather than profitability and accountability.

Private and public sector companies assigned rank one to the stimulant 'return on total corporate resources' and rank two to 'return on investment'. As far as private sector was concerned the said stimulant was in conformity with its corporate governance objective, i.e., 'creation of corporate value' whereas the same stimulant shifts the focus of the corporate governance objective of public sector companies which was 'maximisation of shareholder wealth'. Joint sector did not give any weightage to economic value added and in public sector it was regarded as one of least preferred stimulants for setting the corporate governance strategy. This seems to be the outcome of changing aspirations of administrative ministries with respect to public sector enterprise in the wake of liberalization and privatization policies ushered in since 1996. Additionally, it was noted that all sectors did not give any weightage to the 'management of risk' as one of the key factor in deciding their strategy.

Investment Policy

In public sector undertakings, it is the Administrative Ministry that approves the company's capital budget, long term borrowings and investment proposals. Therefore, within the ambit of such decisions the board members decide the investment policy. Investment policy of any organization effects returns to shareholders. Such policy decisions are the key to sustainable wealth creation. The fact is that the outcome of a particular decision in long run, depends upon many factors whereas policy decision will only help optimize the chances of positive outcome. To this end, respondents were asked to reveal their preferences with respect to the propellant of investment decision. Table 2.4 presents the analysis of responses.

Analysis of ranks assigned for investment policy discloses that 'long term based fundamental analysis' was accorded first rank by respondents. It was followed by 'government policy' at number 2 and closely followed by 'attractiveness of strategy' at number 3.

Table 2.4: Ranking of Criteria Considered While Deciding an Investment Policy

Criterion	Joint		Private		Public		Total	Overall Ranks
	Scores	Ranks	Scores	Ranks	Scores	Ranks		
Long-term based fundamental analysis	12	2	411	1	73	1	496	1
Government Policy	21	1	164	3	70	2	255	2
Attractiveness of strategy	12	2	193	2	46	3	251	3
Medium Term Outlook	4	3	157	4	37	4	198	4
View of current Management Ability	3	4	150	5	32	5	185	5
Corporate Control	0		113	6	15	7	128	6
Short term trading to maximize total return	0		84	7	25	6	109	7

However, while deciding investment policy 'view of current management ability', 'corporate control', and 'short term trading to maximize total return' were least preferred factors. Some more criteria considered for investment policy that was preferred by one or two companies only were: business policy of the competitors, customer focus, prevailing market conditions and future prospects. There were 3 companies that responded - no investment is done in other companies or no investment policy exists right now, one company invests in its own projects.

The sectoral considerations underlying the investment policy were not different except in case of joint sector enterprise where state governments were calling shots and hence these policies were the guiding forces. However, irrespective of sector Government policy was a major determinant of investment policy may be due to funding reasons and legal cover provided for such avenues.

Not only corporate governance objectives and strategy but also ethical values play an important role in corporate governance. Ethics has come to occupy the center stage in the discourse of corporate governance owing to increasing financial scams, compromising behaviour of auditors leading to mega-collapse of organizations like Enron, Worldcom, Xerox in the U.S.

2.4.2 Ethical Issues in Corporate Governance

Ethics refers to those values that help in making a choice of right over wrong. In the context of business, ethics would mean those values that govern the business transaction of persons and organisations as well as of persons within organisations. Debate on corporate governance has come to fore owing to decline in moral values, weakening of institutional systems and poor enforcement of laws. Therefore, the urge for corporate governance is to enhance the quality of texture of corporate ethics and therefore the overriding principle is welfare of the corporation and that of its stakeholders.

Effective corporate governance requires a proactive, focused state of mind on the part of directors, the CEO and senior management, all of them must be committed to business success through demonstration of the highest standards of ethical responsibility/ business ethics. The term ethics when used in the context of business becomes ethics that refers to the moral, principles and rule of conduct applied to the business world (Dhingra & Singh, 2000). Business whose objectives are detrimental to the interest of society is regarded as unethical. According to Taeusch (in encyclopaedia of the social sciences) business ethics becomes identified with sound economic policy, honest cost accounting, adequate and accurate business knowledge, sound credit arrangements and the necessity of securing a fair profit. Corruption is the main evil of all economies where the developed or developing economies are no exceptions.

The task for corporations is to build up and maintain corporate credibility – to stay in the global markets (Chakraborty, 2000). The ethical issues in corporate governance are related to asymmetrically distributed accounting information, insider trading, auditors giving other professional services to an organization apart from their auditing services, filtered information given by management to the Board members, inflated results declared in the annual reports[41], etc. Thus, Olivencia Report in Spain was an attempt to draft an 'ethical code' containing number of practices and principles. The primary constituents reflecting the characteristics of good corporate governance has been stated by proponents of corporate governance are discipline, transparency, independence, accountability, responsibility, fairness and social responsibility. Importance of highest standards of ethical practices can be gauged from the fact that mostly shareholders do not agitate against the existing management so long as they adhere to ethical practices and do not mismanage. – R.H. Patil[42]

Organization being an abstraction, ethical values of people in an organization collectively outlines the ethical values of an organization.

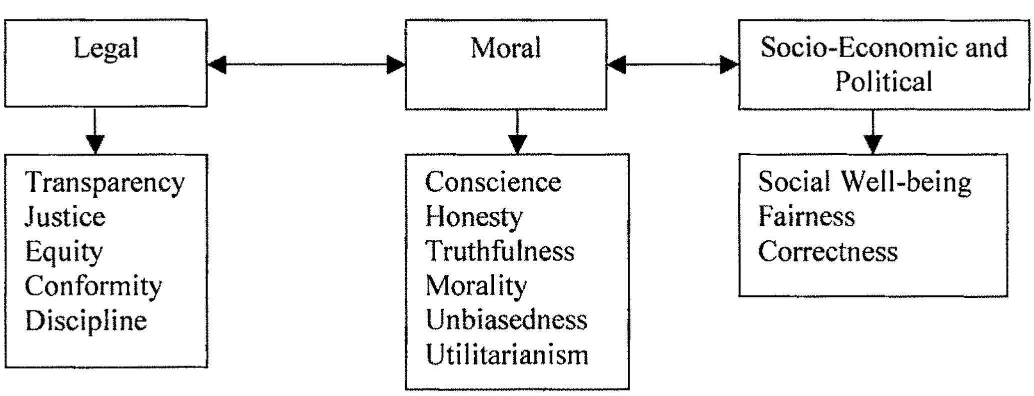

Figure 2.2 : Ethical Value Model

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[41] The examples of Enron and World.Com, the US based companies, will be right to explain the point. Both the companies were darlings of the wall street that used to inflate the revenue and decrease the expenses by doing accounting jugglary that ultimately led both the companies to bankruptcy and the accounting firm Arthur Anderson's destruction. Both companies' directors were prosecuted for their misdeeds.

[42] Standing Committee on International Financial Standards and Codes: Advisory Group on Corporate Governance

The culture, legal and political systems provide the necessary inputs for the formulation of belief system of the people that in turn shapes the business ethics. Hence, value (moral), culture (socio-economic and political) and legal system are vital constituents of ethics. Under this triumvirate pillars, we classified ethics in the context of business in figure 2.2.

To determine the ethical values of an organization, it was asked to respondents to rank the ethical values of their organization. There were 14 ethical values mentioned in the questionnaire. Apart from that companies were free to mention any other ethical values than the foregoing. Analysis of 83 companies' responses on the weighted score is presented at table 2.5. Out of the 14 foregoing ethical values 'transparency' was ranked at no.1 followed by 'fairness' and 'honesty' at no.2 and 3 respectively. By clubbing the scores as per ethical value model (as shown at figure 2.2) legal factor scored highest, i.e., 2896; moral factor scored 2362; and socio-economic and political factor scored 1648 points, which indicates that the ethical values of organization were based on legal compliance.

Table 2.5: Overall Ranking of Core Ethical Values of Organizations

Core Ethical Values	Weighted Scores	Overall ranking
Transparency	1001	1
Fairness	868	2
Honesty	638	3
Equity	623	4
Discipline	542	5
Social Well-being	466	6
Justice	463	7
Truthfulness	446	8
Morality	425	9
Conscience	418	10
Correctness	314	11
Unbiasedness	288	12
Conformity	267	13
Utilitarianism	147	14
Any Other	71	15

There were 3 respondents who stated that all values mentioned as above are equally important and one without other is incomplete. However, 7 respondents stated some more ethical values of their organization as: ownership by employees, trust, integrity, customer satisfaction/ meeting commitments to customers, investors' value, speed of response, team playing, and zeal to excel. These values can further be clubbed together as per the ethical value model at figure 2.1.

Though, corporates would have set their corporate governance objectives, strategies and policies and have their ethical values but the right reflection of those objectives, strategies, policies and ethical values can be seen from the quality of disclosure.

2.4.3 Disclosure on Corporate Governance

Transparent disclosure of information is yet another pillar of a good corporate governance system. Disclosure on corporate governance supplies information on management's activities, decision-making and stewardship. A strong disclosure regime is pivotal feature of market-based monitoring of companies and is central to shareholders' ability to exercise their voting rights[43]. 'Disclosure' like any other function of management provides benefit and incur cost and hence an organization must need an 'information disclosure strategy' (Lev, 1992). However, available literature on corporate governance suggests four types of general disclosure trends as follows:

a. Voluntary Disclosures

Voluntary disclosures (where outside force is absent for making disclosures mandatory) signify positive image of organisations that is long lasting. Such organization is seen as responsible corporate entity by the society and its employees that ultimately lead to creation of corporate value.

[43] with dispersed minority ownership, if shareholders are unhappy, they will just sell their shares (exit) since they do not have the incentive, or the means available to them (voice), to engage in direct monitoring function of the entrenched management/ largest shareholders.

b. Market Induced Disclosures

Adoption of disclosure norms of other countries becomes necessary whenever a company seeks foreign alliance, investment, raising of capital and hence listing on foreign stock exchanges. In such situations, the company in its home country may be required to disclose reconciliation of information under two accounting regimes such as Indian Accounting Standards and U.S. Accounting Standards. This is exemplified by corporates like Infosys and Wipro as they are listed on U.S. stock markets.

c. Disclosure Under Mandatory Requirements

Companies are forced to adopt disclosure norms on corporate governance because the same has become mandatory by the concerned legislation of a country or by the market regulator. E.g. Adoption of disclosure norms as per new Cl.49 in the listing agreement by the publicly listed companies in India or those who seek listing for the first time.

d. Fraudulent Disclosure

The fraudulent disclosure is the type where those who are having control over the information misuse the same to deceive those who seek right information to take further steps against entrenched management to save their investments and create long term value, if possible. Fraudulent disclosure is made by the management to: remain entrenched to the firm; show that they are law abiding whereas they are not since the adherence to law either is a costly affair or is destructive to the image of an organization vis-à-vis management; c) to save face for the time being in a hope that the situation will become alright after sometimes; and get more investments by deceiving the investor community. Examples:

1. US securities regulator blasted the worldcom for lack of information in its disclosure about the fiasco gripping the company.

2. Drug giant Merck and Co. recorded revenues of $12.4 billion from the company's pharmacy unit over a period of three years that the unit never actually collected, according to a filing with the SEC.

Fraudulent disclosures are probably the one or the only one reason to the present debate on corporate governance worldwide.

Unfortunately, in India the third situation is more prominent and companies are made to accept the disclosure norms for the protection of investor community, which quite often leads to the fourth situation. Presence of stronghold of business families and concentration of ownership in the hands of such business family promoters, CEO hubris, information asymmetry by the entrenched management team, etc. Mandated India Inc. To do disclosure under mandatory compliance[44]. In their draft report, the KBC was also of the opinion that "under the Indian conditions a statutory rather than voluntary code would be far more purposive and meaningful" (para 1.7). The lack of willingness to do voluntary disclosure by the Indian companies can be estimated from the fact that in 1997 when the committee appointed by CII recommended the 'desirable code for corporate governance'[45], only 13 companies out of 116 sample companies had voluntarily included the section on corporate governance in their annual report of 1998-99 whereas this number was only 8 in the FY1997-98 before the recommendations of CII committee were published. Despite many Indian companies were members of CII, there was no mechanism to mandate compliance with its recommendation for disclosure. CII code was thus suffering from lack of force and effect in India since the voluntary good action is an exceptional phenomenon instead of being a common practice.

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[44] The code tends to favour greater transparency on all aspects of corporate governance, particularly, executive and director compensation, directors' independence, shareholding pattern, formation and functions of Board Committee, etc. with a strong emphasis on the protection of shareholder rights.

[45] Popularly known as Omkar Goswami Report.

Table 2.6: Frequency Distribution of Disclosure on Corporate Governance Made in the Annual Reports for the Period from FY1997-98 to FY2000-01

BSE Group	Sector	Year				Total Cos
		FY 97-98	FY 98-99	FY 99-00	FY 00-01	
A	Private	8	13	32	74	79
	Public			6	17	17
	Total of A	8	13	38	91	96
B1	Joint				1	3
	Private			5	9	15
	Public			1	2	2
	Total of B1			6	12	20
Total Disclosures on CG		8	13	44	103	116

Thereafter, came the recommendations of Kumar Managalam Birla Committee (KBC) to formulate stringent rules for mandatory adoption of the code of good corporate governance practices and its disclosure in the annual report of the company which was followed by inclusion of such recommendations in the listing agreement vide Cl. No. 49. Though, the KBC report was made public by February 2000, it became mandatory for the companies whose stocks were listed in the group A of BSE to include a separate section on corporate governance in the annual report of FY2000-01. Out of 96 'A' group companies 39.6% companies (i.e. 38 out of 96) included the partial or detailed disclosure on corporate governance in their annual reports of FY1999-2000 as a first step in the direction. In the annual report of FY2000-01, 94.8% companies (i.e. 91 out of 96) made disclosures on corporate governance. Majority of companies viewed it as a mandatory ritual that has to be completed for being remained in the *caste*[46]. According to SEBI, "90% of the erstwhile 141 'A' group companies, had fully met all requirements"[47].

Conclusion

The term 'governance' differs from 'management' and 'administration'. 'Governance' is the system of directing and controlling mechanism while 'administration' is related with the compliance of rules and regulations and is older than 'management' by precedent. Concept

[46] For being remained in the *caste* – means to remain listed on the stock exchange.
[47] (2001), "SEBI Moots Charter for Audit Committees", *The Financial Express*, Mumbai, December 5th, p. 10.

of 'management' came into being owing to the emergence of need to optimum utilization of resources of the organisation. 'Corporate governance' deals with the corporate affairs in the interest of the stakeholders of the corporation. Though, the importance of corporate governance cannot be denied yet it has gone from being ignored, in the past, to being overexposed with the undue emphasis on form over substance. In India the corporate governance models differ in three sectors, viz., public sector, private sector and joint sector, depending on their shareholding pattern. Corporate governance in public sector banks differs in structure from that of non-banking public sector units. Notwithstanding the ownership and control differences, every organization sets its objectives. As for objectives 'maximization of shareholder value' has been propounded as the touchstone of corporate governance, without sacrificing the interest of other stakeholders. However, a single objective of 'shareholder wealth maximisation' will diminish the purpose of existence of large corporations. Owing to changing economic landscape the variants are shifting from shareholder value to corporate value with out differentiating between operating tools of the two. Hence, rankings amongst sectors have varied. In India, certainly the investment is not done to gain the 'corporate control' by majority of companies but only a few companies may still go for it. Since corruption is the main evil of all economies, ethical practices are the key to gain the trust of investor community and also the other stakeholders. Variables that relates to ethical dimensions of corporate governance, in Indian companies, are 'transparency', fairness, honesty and equity. Hopefully, a wel-lead down corporate governance objectives, policies and strategies when combined with the ethical practices and transparent disclosure norms will be sufficed to guarantee a long term perpetual existence of an organization.