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Nature & Effectiveness of Corporate Governance : A Review of Literature

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ABSTRACT

Self governance of corporates has been observed to be playing a crucial role in their success. Since it is increasingly being adopted by rising number of companies in India's corporate sector on the basis of an underlying reason that it has a role to play in removing the major problem of agency in the conduct of business. This paper aims to introduce the relationship between corporate sector and corporate governance and also the concept of corporate governance & its relevance in eradicating several inefficiencies.

KEYWORDS : Corporate Governance, Corporate Regulations in India

Introduction

1.1. Corporate Sector and Corporate Governance

Corporate Sector

Corporate sector enjoys place of pride in the modern business. It has carved out a niche for itself so far as mobilizing huge public resources and their deployment in the large scale projects is concerned. The management of these corporations is, therefore, a subject of paramount importance and concern, all the more so, as the divorce of ownership from management is the unique features of this form of business ownership.

The traditional view about the corporations is constricted, narrow and incorrect. The modern corporation is really a private unit with public obligations. It cannot be concerned solely with profit maximization. Such a kind of change in thinking about the role of a company coupled with various factors like increased competition for capital, internationalization of capital markets, liberalization of domestic economies in different countries and the rise of professionalism have brought about a sea change in corporate objectives. Under these influences, the modern corporation has come to be perceived as a caring entity discharging its social and economic obligations. The focus has, thus, shifted from mere profitability to the adoption of good quality corporate governance system.

As Per the Companies Act, 1956

In simple language, a company is an association or collection of individual's people or *"warm-bodies"* or else contrived "legal persons" (or a mixture of both). Company members share a common purpose and unite in order to focus their various talents and organize their collectively available skills or resources to achieve specific, declared goals. Companies take various forms such as:

Voluntary associations which may be registered as a Non-profit organization

A group of soldiers

Business entity with an aim of gaining a profit

Financial entities and Banks

A company or association of persons can be created at law as legal person so that the company is itself can accept Limited liability for civil responsibility and taxation incurred as members perform (or fail) to discharge their duty within the publicly declared*"birth certificate"* or publishedpolicy.

Because companies are legal persons, they also may associate and register themselves as companies - often known as a corporate group. When the company closes it may need a *"death certificate"* to avoid further legal obligations.

1.1.2. Corporate Governance

Corporate Governance refers to the way a corporation is governed. It is the technique by which companies are directed and managed. It means carrying the business as per the stakeholders' desires. It is actually conducted by the board of Directors and the concerned committees for the company's stakeholder's benefit. It is all about balancing individual and societal goals, as well as, economic and social goals.

Corporate Governance is the interaction between various participants (shareholders, board of directors, and company's management) in shaping corporation's performance and the way it is proceeding towards. The relationship between the owners and the managers in an organization must be healthy and there should be no conflict between the two. The owners must see that individual's actual performance is according to the standard performance. These dimensions of corporate governance should not be overlooked.

Corporate Governance deals with the manner the providers of finance guarantee themselves of getting a fair return on their investment. Corporate Governance clearly distinguishes between the owners and the managers. The managers are the deciding authority. In modern corporations, the functions/ tasks of owners and managers should be clearly defined, rather, harmonizing.

Corporate Governance deals with determining ways to take effective strategic decisions. It gives ultimate authority and complete responsibility to the Board of Directors. In today's market- oriented economy, the need for corporate governance arises. Also, efficiency as well as globalization is significant factors urging corporate governance. Corporate Governance is essential to develop added value to the stakeholders.

Corporate Governance ensures transparency which ensures strong and balanced economic development. This also ensures that the interests of all shareholders (majority as well as minority shareholders) are safeguarded. It ensures that all shareholders fully exercise their rights and that the organization fully recognizes their rights.

Corporate Governance has a broad scope. It includes both social and institutional aspects. Corporate Governance encourages a trustworthy, moral, as well as ethical environment. Some of the benefits of Corporate Governance are as follows:

Good corporate governance ensures corporate success and economic growth.

Strong corporate governance maintains investors' confidence, as a result of which, company can raise capital efficiently and effectively.

It lowers the capital cost.

There is a positive impact on the share price.

It provides proper inducement to the owners as well as managers to achieve objectives that are in interests of the shareholders and the organization.

Good corporate governance also minimizes wastages, corruption, risks

and mismanagement.

It helps in brand formation and development.

It ensures organization in managed in a manner that fits the best interests of all.

1.2. Scope and Significance of Corporate Governance

The scope and significance of corporate governance in India increased sizably in the recent period, particularly following the economic reforms. As Indian corporate are finding new space in domestic and global markets for business growth, their interaction with the financial markets and investing community too witnessed significant surge. In this process, corporate governance came as an effective instrument for companies to communicate with the various types of stakeholders in general and investors in particular.

Corporate Governance involves a set of relationships between a company's management, its Board, its shareholders and other stakeholders. Corporate Governance provides a principled process and structure through which the objectives of the company, the means of attaining the objectives and systems of monitoring performance are also set. Corporate Governance is a set of accepted principles by management of the inalienable rights of the shareholders as a true owner of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, ethical business conduct, and transparency and makes a distinction between personal and corporate funds in the management of a company. Corporate governance today became an essential part of the culture that defines better run companies and those held in esteem by the investors and stakeholders. As the rigor of the regulation intensified, governance standards began to be codified and formed an important part of the evaluation and assessment process. Clause 49 of the Listing Agreement of the Stock Exchanges and DPE Guidelines on Corporate Governance are the key instruments that drive compliance of the corporate governance standards and practices by companies.

1.3. Significance of Problem-why is there a need of corporate Governance?

Corporate governance is perhaps the toughest part of corporate handling. It requires an ideal control system which can regulate both motivation and ability. At one end of the spectrum are the shareholders as owners of the business entity since they provide the ultimate risk capital. At the other end are the "managers" or the "executive directors" of the company who are in control of its day-to-day affairs. As the elected representatives of the shareholders it is the collective responsibility of the board of directors to direct operations of the company in a manner that is best suited to the interests of the company. As the owners of business, the shareholders are expected to monitor and evaluate operations of the company as well as the performance of the entire board of directors and in particular the effectiveness of the full time or executive directors.

Corporate governance mechanisms differ between different countries. The governance mechanism in each country is shaped by its political, economic and social history. The governance practices adopted in any country reflect the national ethos and value systems adopted in that country over a long period of time. In most of the countries the corporate form of organization did not evolve and emerge through a natural business process. Hence different countries have assimilated it their own way. The predominant form of corporate governance in India is much closer to the East Asian "insider" model where the promoters dominate governance in every possible way. A distinguishing feature of the Indian diaspora is the implicit acceptance that corporate entities belong to the "founding families" though they are necessarily considered to be their private properties.

Despite all the differences among shareholders philosophy across different countries in regard to corporate governance mechanisms there is no denying of the fact that good governance is the time need of changing world. While multilateral organizations like World Bank and ADB have shown keen interest in the subject of corporate governance, the intellectual lead has been given by the OECD (Organization for Economic Cooperation and Development) in evolving a set of cogent principles of corporate governance. OECD has come out with a set of clearly defined principles, which it hopes, will be useful to all countries irrespective of their stages of development, legal systems, institutional frameworks and traditions. But roughly there is the requirement of some corporate governance control. It requires two types of corporate governance i.e. internal corporate governance and external corporate governance.

While there are adequate levels of checks and balances in the system to prevent frauds, it is the slack attitude of each institution responsible for upholding corporate governance that made such a fraud possible. Unless heavy fines and strict liabilities are provided for, if not in the statute then in the internal code of conduct, each of these institutions, namely the internal audit committee, the independent directors and the external auditors could continue to remain "rubber stamps" approbating all management actions. The Satyam scandal has reiterated the importance of checks on related party transactions. Stringent checks and balances on these ought to be incorporated into the Indian corporate and securities laws to prevent transactions like Maytas in future. Pending statutory incorporation, companies can incorporate adequate checks and balances in their code of conduct as a measure of ensuring good corporate governance. It is natural to expect an enhanced level of security of the financial and governance aspects of Indian companies, and to a lesser extent, any Asian-based companies. The role of corporate counsel will assume added pressures, with a higher emphasis on preventing frauds.

1.4. Review of Literature

McColgan (2001) gave a very broader view of agency theory and corporate governance. The major interest of his research was to cover the area that where the interests of managers diverge from those of the interests of shareholders. He kept in view the agency relationship and the agency cost which arises from these relationships. He extended the work of Jensen and Meckling (1976) who defined the agency relationship as a type of contract in which the principal keep the agent to carry out the services of the firm on his behalf. The agency problem arises due to the different interest and the conflict between the ownership and control as principal delegate some decision making authority to the agent. Jensen and Meckling (1976) argued that this delegation authority reduces the value maximizing decisions taking by the manager in the firm.

Himmelberg , Hubbard and Palia. (1999), argued Jenson and Meckling (1976) by saying that principal agent problem are not similar in all firms rather they are different in different firms, different industries and also in different cultures. Himmelberg et al. (1999) said that Jenson original theory "nexus of contract' suggest the same. McColgan (2001) agreeing with the authors said that agency problem can be reduces by the help of effective corporate governance mechanism which can be important in reducing the agency cost and the ownership problems in the firms. The governance should be design according to the firm environment as one general mechanism can be more important for some firms and less important for other firms. Okeahalam and Akinboade (2003) reviewed the issues and challenges of corporate governance in Africa. They presented the reason for their review that many of the non-financial corporations failed in the United States and in Asia due to the non-efficient corporate governance. They said that Africa can learn great from the experiences of these countries and may improve the governance for its corporate sector.

Okeahalam and Akinboade (2003) conducted the review by studying a contribution on the corporate governance in Africa and said that the modern concepts of separation of management from the ownership make the corporate governance an important issue for research. The interests of people who control the organizations are differing from those who invest in the company by external finance. Also the principal agent problem and the interest of shareholders can only reduce through the effective corporate governance.

Okeahalam and Akinboade (2003) stated that the organization systems, practices, process and rules of governing institutions are concerned closely with the corporate governance so there is a need to find those relationships that regulate, create or determine the nature of relationship through those relationships. Corporate governance implies that companies should balance between the interests of shareholders with stakeholders at all levels of organization. Okeahalam and Akinboade (2003) stated that Africa is highly influenced by mismanagement, corruption in business environment, therefore effective corporate govern-

ance can create the transparency and safeguard against these threats facing by the companies to promote the foreign investment by foreign traders and companies. The authors stated that research publication in the area of corporate governance is very low and suggested that the research should be promoted in both empirical and theoretical ways.

Farinha (2003) conducted the theoretical and empirical literature review to find out the true nature and consequences of corporate governance. The main focus of his literature was to find out the reasons of conflict between manager and shareholders in organizations with respect to ownership mechanism.He also tried to find out the link between the corporate governance and the value of the firm. Farinha (2003) argued that major problem in organization arises with the relationship of principal and agent relationships and a different approach of manager than the shareholders. The perspective of the manager remains with the limited cash-flows thus managers focus lies with the short term perspective on investment whereas shareholders stuck with the quick return of cash flows. Risk preference is also a major source of conflict between the principal and the agent. Shareholders associated with the market risk and the risk of stock returns whereas managers always concerned with the company risk because their survival depends on the firm risk. The area of corporate governance is lacking with the external disciplining devices.

The firms through the effective corporate governance can implement these devices which includes the composition of the board of directors, increase number of shareholders, maximize the inside ownership and by providing different financial policies and compensation packages.

Filatotchev, Lien and Piesse (2004) studied the Corporate Governance and Performance in Publicly Listed, Family-controlled Firms in Taiwan. They analysed the effects of the structure of ownership and board characteristics on performance in large, publicly traded firms which are controlled by family controlled firms. The authors argued that firms located in East Asia, operate with a distinctive culture and in different legal and institutional environments than west and Europe, These culture differences may have a strong impact on governance-performance relationships suggested by the study of agency and strategy research. The authors did not find a direct association between family ownership and managerial entrenchment and extraction of the private benefits of this control, which might be the negative cause to financial performance. The authors also identified the differences in corporate governance effects which are associated with different types of institutional shareholders. Filatotchev, Lien and Piesse (2004) suggested that foreign investors may attract to the Taiwan markets by the process of globalization which may lead to good corporate governance being imported by the domestic firms in Taiwan.

The results of their study also find that family control over the executive board is the major determinant to the performance. Becher and Campbell (2004) studied the corporate governance of bank mergers and acquisitions. He was of a view that during these mergers and acquisitions the CEOs negotiates for their own interests whereas the outside directors of the company face the financial problems. The corporate governance of independent companies affected a lot. Becher and Campbell (2004) made empirical investigation to find out the effects of personal benefits and the merger premiums by taking a sample of 146 mergers of large US banks in 1990s. They targeted the two thousand directors and executives during these mergers and found that target's merger premium is inversely related to the number of target directors who are retained during these mergers. This also implies for the corporation size, incentives, payment methods and bidder returns. The 3 study found that the interests of target director relatively lies with the size of the company rather than performance and they exercise their bargaining power with the acquirer which counters the interests of shareholders interest in the merger.

Novikova (2004) studied the impact of internal corporate governance system on firm's innovative activities and addressed the question that how much firms internal corporate governance system varieties with the type and efficiency of firm's innovative activities. Novikova (2004) listed out major participative actors for the firms which are the board, the shareholders, the managers and the other stakeholders for the companies. He defined the institutions as the rules and procedures use to make decisions on corporate affairs of the firm. Novikova (2004) designed his research on the definition of OECD which defines corporate governance in a narrow term as a relationship between a company and its shareholder whereas in broader term the relationship between the company and the society.

Kowalewski, Stetsyuk and Talavera (2007) studied the corporate governance practices in determining the dividend policy in Poland. Jensen (1986) said that dividends can reduce the agency costs because of the distribution of free cash flows that can be spent on the unprofitable projects by the firm's management. Gompers, Ishii, and Metrick (2003) in their research on agency cost also said that agency cost is the strengthen relationship between the shareholders rights and its associated with the corporate governance. Kowalewski et al. (2007) studied the view of many authors in their extensive literature on the topic and found that by empirical implications that corporate governance is an important determinant for explaining the dividend policies.

They also found that larger asset retain companies and highly profitable firms without good investment opportunities pay more dividends whereas the high risks and indebt firms pay low dividends. In Poland the companies with strong corporate governance practices and strong shareholder rights pays higher dividends and it mitigates the agency problems in the Poland. Another study conducted by Cueto (2007) to find out the role of ownership mechanism and corporate governance practices in emerging markets of Latin America. In context of weak shareholder protections the corporate governance mechanism affects the firm value, the liquidity of market and the organization of industries. Cueto (2007) proposed that the relationship between the corporate governance mechanism and the firm's value and the effects of ownership structure and among the liquidity of the stock market must be explored.