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Corporate Governance – The Need for Long-term Sustainability

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INTRODUCTION

The term 'governance' literally means directing, controlling and managing activities. Corporate governance (CG) means directing, controlling and managing any given business enterprise. Thus, corporate governance is the structure and process of :

(i) Monitoring management performance;

(ii) Ensuring accountability and responsibility of management to shareholders;

(iii) Motivating management to add value for shareholders investment; and

(iv) Protecting the rights of common investor.

Corporate governance has lately attracted a good deal of corporate and public interest because of its apparent importance for the economic health of corporations and society in general. Different people have come up with different definitions from time to time which cover all aspects related to it. Some of the important definitions are accepted instead of one :

OECD in 1999 defined CG as the system by which business corporations are directed and controlled. The CG structure specifies the distribution of rights and responsibilities among different participants in the corporation like board, managers, shareholders, stakeholders and spells out the rules and procedures for making decisions on Corporate affairs. By doing this, it also provides the structure through which the company's objectives are set and the means of attaining those objectives and monitoring performance.

Corporate Governance, as stated by 'Financial Times' in 1997, is the relationship of a company to its shareholders or more broadly its relationship with society.

Mathiesen in 2002 referred Corporate Governance as a field in Economics that investigates how to secure / motivate efficient management of Corporations by the use of incentive mechanisms, such as contracts, organizational designs and legislation. This is often limited to the question of improving performance, e.g., how the Corporate can secure / motivate that the Corporate managers will deliver a competitive rate of return.

Effective CG system implies real participation of shareholders and co-ordination of the different viewpoints of the different stakeholders. For effective CG the prerequisite conditions are education, technical, core competency, effective communication and MIS (internal as well as external).

EFFECTIVE AND SOUND CORPORATE GOVERNANCE SYSTEM

It meets the following main objectives of the firm :

(i) Optimal utilization of resources for enhancing the value of the Enterprise.

(ii) Ethical behaviour of the Enterprise towards protection of the rights of all stakeholders.

Further, effective Corporate Governance adds value to the organization in the following ways :

(i) Good CG provides stability and growth to the Enterprise.

(ii) Good CG, demonstrated by adoption of good Corporate practices, builds leaders.

(iii) Effective governance reduces perceived risks, consequently reducing cost of capital.

(iv) In the knowledge driven economy excellence in soft skills like management will be the ultimate tool for the Corporates to leverage a competitive advantage in the financial market.

(v) Adoption of good corporate practices promotes stability and long-term sustenance of stakeholders relationship.

(vi) A good Corporate citizen becomes an icon and enjoys a position of pride.

(vii) Potential stockholders aspire to enter into relationships with enterprises whose governance credentials are exemplary.

Indian companies have to adopt the best global practices to become competitive global players in the competitive environment of today. Confederation of Indian Industries (CII) has developed a code of CG for Corporates which still has not been given a second look by the Indian companies. CII has given suggestions that the stock exchanges can make adherences to the Corporate Governance code a prerequisite for listing but in vain.

Infosys is the first Indian company which has adopted the US GAAP, disclosures of EVA, value of its human resources, value of its brand, risk management policies and the overall CG practices.

MAIN GUIDELINES FOR EVALUATING THE CORPORATE GOVERNANCE PRACTICES AT INFOSYS

Business

(i) Conducting the affairs of a company so that there is fairness to customers, employees, investors, vendors, government and society at large.

(ii) Positive economic profit.

(iii) Enhancing shareholder value.

Governance

(i) Board to comprise adequate number of non-executive directors.

(ii) Clearly defined roles and responsibility of members of the Board.

(iii) Regular meetings by the full board with complete information being provided to all the Directors.

(iv) Transparent procedure for fresh appointments to the board by the Nomination Committee.

(v) Remuneration of Executive Directors to be fixed by a Compensation Committee.

(vi) Audit Committee to periodically conduct review of effectiveness of the system of internal controls and report to shareholders.

(vii) Attractive levels of compensation to non- executive directors along with compensation linked to Company performance.

Financial Performance

(i) Comprehensive evaluation of financial performance in the Annual Report.

(ii) Non-diversion of funds.

(iii) Use of public issue/ rights issue proceeds strictly for purposes for which the same was raised.

(iv) Return of cash flows in excess of investment and liquidity requirements.

(v) Constant monitoring of risks and adopting strategies aimed at de-risking the business.

(vi) Variable compensation package to top management and senior executive linked to shareholder value.

(vii) Maintenance of sound internal controls including internal audit, statutory audit.

(viii) Full disclosure of related party transactions.

(ix) Disclosure of revenues and net income by business segments.

(x) Management statement accepting responsibility for the integrity and objectivity of financial statements.

(xi) Report by management that the Company is a growing concern.

(xii) Provision of a Management discussion and analysis section in the Annual Report as additional information to shareholders.

(xiii) Full and complete disclosure of donations to political parties.

(xiv) Refraining from selective dissemination of financial data of financial analysis only.

(xv) Company not facing any charges for violation or non-compliance with statutory bodies.

(xvi) Prompt payment of statutory dues and timely submission of statutory returns.

Investor Relations

(i) Efficient share transfer mechanism.

(ii) Investor related information to be provided in the Annual Report.

(iii) Use of technology with investors.

(iv) Timely communication of any adverse situation faced by the Company.

(v) Company should have in place a policy on insider trading and information on the movement in shareholdings of Directors and Senior Executives during the period to be provided in the Annual Report.

Corporate Citizen

(i) High morale and low attrition rate.

(ii) Active participation in community development programmes.

(iii) Measures adopted aimed at pollution control.

(iv) Fiduciary duty to forefront.

(v) Fair and ethical business practices.

(vi) Allow market for corporate control to function smoothly by refraining from adopting anti-takeover mechanisms like poison pills, and golden parachutes.

FACTORS AFFECTING CORPORATE GOVERNANCE PRACTICES

Interaction : Effective interaction between the board, management, the external auditor and the internal auditor is needed.

Board Purpose : Board of Directors must understand the purpose is to protect the interest of the Company's stockholders while considering the interests of the other investors.

Board Responsibilities : Main responsibility of the Board is to monitor CEO, Overseeing Company's strategy and monitoring risks and the Corporation's control system.

Expertise : The directors should possess relevant knowledge of industry, company, functional area and governance expertise. All directors should receive detailed orientation and continuing education to assure that they achieve and maintain the necessary level of expertise.

Leadership : Both the Board Chairman and CEO should have a separate role.

Disclosure : Proxy statements and other board communications should reflect board activities, policies and transactions in a transparent and timely manner.

Committees : The nominating, compensation and audit committees of the Board should be composed of independent Directors.

Internal Audit : All public companies should have an effective, full time internal audit function that reports directly to the Audit Committee which is accountable to the Company.

GAAP : The current GAAP financial reporting model is becoming increasingly inappropriate for U.S. investors specially the public companies. The industrial age model currently used, should be replaced or enhanced so that tangible and intangible resources, risks and performance of information - age companies can be effectively and efficiently communicated to financial statement users. The new model should be developed and implemented as soon as possible.

Audit Committees : The Audit Committee of the Board of Directors should be composed of independent Directors with financial, auditing, company and industry expertise. These members must have the will, authority and resources to provide diligent oversight of the financial reporting process. The Audit Committee should select the external auditor, evaluate external and internal auditor performance and approve the audit fee.

Fraud : Corporate management should face strict criminal penalties in all fraudulent financial reporting cases. The Securities and Exchange Commission should be given the resources it needs to effectively combat financial statement fraud. The board, management and auditors all should perform fraud risk assessments.

Audit Firms : Audit firms should focus primarily on providing high quality audit and assurance services and should perform no consulting- for audit clients. Audit firm personnel should be selected, evaluated, compensated and promoted primarily based on technical competence not on their ability to generate business.

Analysts : Analysts should not be compensated (directly or indirectly) based on the investment banking activities of their firms. Analysts should not hold stock in the companies they follow and their firms.

Ability of the Board : The ability (knowledge and skill) of the Board of Directors to supervise the management in the most effective manner determines the effectiveness of the board. A board that does not have members with right specializations lacks this ability.

Commitment Level of Individual Board Members : The quality of a Board depends on the commitment of individual members to tasks which they are expected to perform as board members.

Quality of Corporate Reporting : The quality of corporate reporting depends on the transparency and the timeliness of Corporate Communication with shareholders. This helps the shareholders in making decisions and in correctly evaluating the management in its stewardship function.

ROLE OF BOARD

The Board of Directors provides the leadership and strategic guidance, objective judgement of management to the company and exercises control over the company, while remaining all times accountable to the shareholders. The measure of the Board is not simply whether it fulfils its legal requirements but more importantly, the board's attitude and the manner it translates its awareness and understanding of its responsibilities. An effective CG is one, which allows the board to perform these dual functions efficiently. The Board of Directors of a company, thus, directs and controls (the management) of a company and is accountable to the shareholders.

The Board directs the company, by formulating and reviewing the company's policies, strategies, plan of action, risk policy, annual budgets and business plans, setting performance objectives, monitoring implementation and corporate performance and overseeing major capital expenditures, acquisitions and divestitures, change in financial control. It controls the company and the management by laying down the code of conduct, overseeing the process of disclosures and communications, ensuring that appropriate systems for financial control and reporting and monitoring risk and in place evaluating the performance of the management. It is accountable to the shareholders for creating, protecting and enhancing wealth and resources for the company and reporting them on the performance in a timely and transparent manner. However, it is not involved in day-to-day management of the company which is the responsibility of the management.

THE NEW CORPORATE CEO MUST LOOK FOR TEN WAYS TO IMPROVE CG

CEO must

(i) schedule regular meetings of the non- executive board members from which you and the other Executives are excluded.

(ii) explain fully how discretion has been exercised in compiling the earnings and profit figures.

(iii) initiate a risk- appetite review among the non-Executives.

(iv) check the non- Executive Directors are independent.

(v) audit non-Executives performance and that of the Board.

(vi) broaden and deepen disclosure on corporate websites and in annual reports.

(vii) lead by example, reining in a company culture that excuses cheating.

(viii) find a place for the grey and cautious employee alongside the youthful and visionary one.

(ix) make Compensation Committees independent.

(x) not avoid risk.

CORPORATE GOVERNANCE RATING SERVICES OF ICRA

ICRA has developed a new product – Corporate Governance Ratings for the Indian market. CGR would indicate ICRA's current opinion on the relative level to which an organization accepts and follows the codes and guidelines of the Corporate Governance practices. Corporate Governance is defined as the distribution of rights and responsibilities among different participants in an organization, such as the Board, Managers, shareholders and other stakeholders. The focus of ICRA's CGR will be on Corporate's business practices, and quality of disclosure standards with respect to the requirements of regulators, and interests of its financial stakeholders, i.e., its shareholders, lenders and creditors. ICRA recognizes that the implementation of the codes of corporate governance should be true in letter and spirit.

Methodology Adopted by ICRA

For the rating of the Corporate Governance practices of an entity the following methodology is adopted by the ICRA :

1. Parameters

The rating is based on the core principles of corporate governance practices organization for Economic and Development–OECD countries. These are fairness, transparency , accountability and responsibility. The codes and standards, which are applicable, have been defined in detail in the various Committees constituted by SEBI and RBI. The various requirements and parameters that would be considered by the ICRA are :

(a) Ownership structure
(b) Management structure
(c) Quality of financial reporting and other disclosures
(d) Fulfilment of interests of the financial stakeholders.

Besides these broad parameters, ICRA would evaluate a number of sub-parameters for assigning CGR. ICRA's CGR ratings would fall between CGRI, indicating highest level of corporate governance in the Indian context to CGR7 indicating poor level of Corporate Governance.

2. True Implementation

ICRA while evaluating an organization on the CGR scale of 1-7 would consider whether the codes and guidelines have just been followed for statutory compliance or the organization has implemented the concept of Corporate Governance in spirit as well. ICRA would be benchmark organization against the codes and standards of corporate governance as spelt out by the securities of the Exchange Board of India for the listed companies.

3. No Conventional Rating

ICRA's CGR will not have any direct linkage with its conventional credit rating. A credit rating is a current opinion on the relative ability of an issuer to meet its debt obligations as per items, whereas a CGR is a current assessment of various company practices and procedures relative to the codes and standards of Corporate Governance. While a CGR can affect the attractiveness of a company to potential investors (debt or equity), it is not intended to be an opinion on specific financial obligation, credit qualify capital market valuation or operational performance .CGR is not an audit or a financial advice or its a recommendation to take any financial decision. Further, CGR is not to be interpreted as an indicator of statutory compliance.

4. Exercise

For the purpose of carrying out the CGR exercise, ICRA would have a detailed interaction with the senior management of the company, its Borad of Directors including nominee and independent Directors, key shareholders, auditors and other financial stakeholders. The information which ICRA will pursue to collect copies would include Annual reports, intra year financial reports, MIS reports, Memorandum, Articles of Association, documents filed with statutory authorities, records of AGM/ EGM, minutes of the Board meetings, record of penalties, files or other violations relating to the abuse of shareholder rights and other relevant documents which would be case specific.

BENEFITS OF THE METHOD

ICRA's CGR is expected to benefit the corporates in the following manner :

1. **Credible Opinion :** ICRA's efforts have resulted in developing a credible opinion on the corporate management quality and responsiveness towards the interest of all its financial stakeholders.
2. **Improved Perception :** ICRA's efforts have provided better opportunities for improved perception of investors which may, in turn, influence the corporate's valuation and facilitate raising of funds at favourable terms.
3. **Compliance :** Though CGRT is not an indicator of statutory compliance , a higher CGR rating may also improve the comfort level of the statutory authorities and regulators.
4. **Standing :** ICRA's corporate governance rating can be used as a check to determine the relative standing of the company with respect to the benchmarks of best corporate practices in the industry and country.

ICRA will provide its CGR ratings on a formal request of corporates. A CGR rating once accepted will be subjected to regular periodic reviews. During these reviews ICRA would incorporate the changes in corporate's position on various parameters in the assigned CGR. For withdrawal of the CGR rating , the corporate would have to provide a written request to ICRA giving a notice period of one year for withdrawal.

A GLOBAL LOOK ON THE FINANCIAL SYSTEMS AND CORPORATE GOVERNANCE

Despite the apparent convergence of financial systems, there are still some notable differences among countries in terms of corporate governance, which refer to the means whereby companies are controlled. US and UK are often viewed as prototypes of a market-oriented financial system, whereas Germany, France and Japan are generally regarded as typical representatives of bank centered (the continental European and Japanese or CEJ type of financial system). In AS countries institutional investors (pension funds, mutual funds, university and other non- profit endowments make up an important part of financial system, whereas in CJ countries banks dominate the picture. Equity finance is important in AS countries and institutional shareholders exert a great deal of corporate control. The accepted objective is to maximize shareholder value and boosting the return on capital employed in stressed. According to an expert advisory panel OECD, the Asian economic crisis can be traced to weak Corporate Governance. And quote "nobody was watching (asian) management, they were growing for the sake of growth with no concern for shareholder value."

Corporate governance refers to the means by which companies are controlled, is heavily influenced by the nature of the financial system. Unlike US firms, banks play a vital role in the governance of European and Japanese countries. With universal banking a commercial bank not only performs investment banking services but also takes major equity positions in client firms.

SURVEY REPORTS CLEARLY DESCRIBING SOME OF THE IMPORTANT FEATURES OF CORPORATE GOVERNANCE

Table 1

Principal Barriers for the Implementation of Proper Corporate Governance Policies within the Company

% of Respondents Choosing as Highest or Second Highest Barrier	
Cultural and managerial hostility to whistle blowing on dubious practices	51
Increased focus from shareholders and investors on operating cashflow	34
Lack of financial understanding on the part of senior executives and the board	30
Lack of financial understanding on the part of managers and middle managers	27
Lack of business understanding on the part of external auditors	26
Lack of business understanding on the part of the board	23
Technology constraints make it difficult to get a decent integrated picture of the financial accounts quickly	21
Cost of implementing and communicating corporate governance policies throughout the organization	20

Source : Economist Intelligence Unit Online Survey, July 2002

Table 2

Average Corporate Transparency Scores in Each Country*

	US	UK	Germany	France	Japan
Average scores	0.5	1.1	1.3	1.2	0.4

Source : The Economist Intelligence Unit, 2002

* Ten companies in each country were marked for transparency on 29 items of governance information according to the following scale :

0 - Information not there

1 - Information there but hidden

2 - Information easily found but hard to understand / incomplete

3 - Information easily found, understandable and complete

Table 3

How much confidence do you have in the following to rectify irregularities in financial reporting within the organization, if they are uncovered?

	% of Respondents				
	1 Complete Confidence	**2**	**3**	**4**	**5 No Confidence at All**
Senior Management	41	40	13	6	1
The Board of Directors	33	40	20	6	1
The CFO	42	31	18	8	0
The Audit Committee	25	34	23	13	1
External Auditors	22	33	27	14	4
Internal Auditors	19	31	26	13	5

Source : The Economist Intelligence Unit Online Survey, 2002

CONCLUSION

Thus, it can be concluded that Corporate Governance has attracted a good deal of corporate and public interest because of its apparent importance for the economic health of corporations and society in general. Effective CG system implies real participation of shareholders and co-ordination of the different view points of different stakeholders. It takes special place in corporate management when we refer to public companies. Also, the effective and sound Corporate Governance system results in the enhancement of the value of the enterprise. Ethical behaviour of the enterprise contributes towards protecting the rights of the stakeholders.

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