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Corporate Governance and Corporate Performance: Implications for Transition Economies

Abstract

This paper develops a model of the causes and consequences of corporate governance and corporate performance in India. Corporate Governance as practiced in India has as its primary goal i.e., optimization of the performance of corporate entities within the limitations placed on the corporate work environment by the intensity of investor aspirations on one hand and the compulsions of public interest and situational constraints on the other. Corporate Governance tries to enunciate the responsibility of Board of Directors and Managers, whether defined by the law or not, to ensure good performance. The business world is moving in a more analytical direction with regard to corporate performance management, still many companies allow poor communication and weal collaboration capabilities to hamper their strategy, decision making and execution process. It is clear that good corporate governance has moved from safeguarding the interest only of the shareholders or owners to promoting the interest of all its stakeholders, which include local government, societies, creditors, bankers, employees as well as direct consumers. The paper has been brought out with valid conclusion.

Key words: *Consequences, governance, execution, analytical, aspirations, collaboration.*

Introduction

Corporate governance is a reflection of a company's culture, policies, how it deals with its stakeholders, and its commitment to values. Good corporate governance serves several important objectives such as it enhances the performance of corporations, by creating an environment that motivates to maximize returns on investment, enhance operational efficiency and ensure long-term productivity growth. In the era of liberalization, privatization and globalization, corporate governance is playing an important role. Although many people tend to think about Corporate Governance from a regulatory compliance perspective, we prefer to view it from an economic framework. This is because in a real world, although many companies

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may mange to comply with the regulatory requirements for good corporate governance, their stakeholders are continuing to get a raw deal. Good Corporate Governance is ensuring managers to run the business in the long term interest of the stakeholders and in doing so, ensure that all the other stakeholders are also taken care of. To do this we need to take corporate governance more seriously and find ways to get the wealth destroying companies to, first, improve their capital efficiency and, second, to harvest capital out of these areas so that it can be re-deployed in more productive sectors of the economy. The Indian companies that create wealth, on an average, earn higher MVA / Capital than their comparable peer set (wealth creators) in other economies. The leading Indian MVA companies such as WIPRO, INFOSYS, HLL, RELLANCE, ITC and others can justifiably take a bow!

Definition

"Corporate Governance is the system by which organizations are directed and controlled. The Corporate Governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as board, managers, shareholders and other 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 objectives are set and the means of attaining those objectives and monitoring performance."

Organization for Economic Co-operation and Development (OECD), April 1999 :

"Corporate governance is 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 financial performance, for example, how the corporate owners can secure / motivate that the corporate managers will deliver a competitive rate of return."

Mathiesen (2002)

Objectives of the Study

1. To elucidate the issues pertaining to the board of directors and management.
2. To focus on various models and mechanisms of corporate governance.
3. To recognize the shareholder / stakeholders rights and responsibilities.
4. To summarize the legislations on corporate governance and responsibilities.

Literature Review:

Managers are generating large cash flows but have limited opportunities for value creating (positive NPV) investment projects, which tend to destroy share owner wealth by investing too much capital back into their existing business and / or making ill-conceived and over-priced acquisition forays into unrelated areas. The managers tend to 'fix' the game for their own benefit rather than think of the long-term interest of the shareowners. Many private sector organizations around the world have found the implementation of the EVA framework a far more effective internally driven initiative to improve governance as compared to compliance mechanisms or transaction driven alternatives.

Concept of Corporate Performance

Management:

Corporate performance Management service helps organizations to build a measurement system that bridges the gap between strategy and implementation by tracking operational information. Metrics are identified and defined in a manner that strikes a balance between the need for use and aggregation of existing transactional data, and the complexity of information abstraction. From an operational level, where the transactional data is used, up to the senior executive level, HCL's CPM improves the sustainability of managerial action using the processes, methodologies, metrics and technologies as shown below.

CPM Methodology

Need for Corporate Governance

Due to the separation of ownership from management, the primary responsibility for running a business with integrity and honesty lies with the managers who are accountable to the shareholders and investors. But the company management track record is not clean worldwide including India. A vast majority of Indian corporate are controlled by promoters families which while owning a negligible proportion of share capital in their companies rule them, as if they are their personal kingdoms. This minority misgoverns the majority. In view of this mis-governance, corporate concepts like democratic management, professional management, transparent operations, etc., have become mere myths.

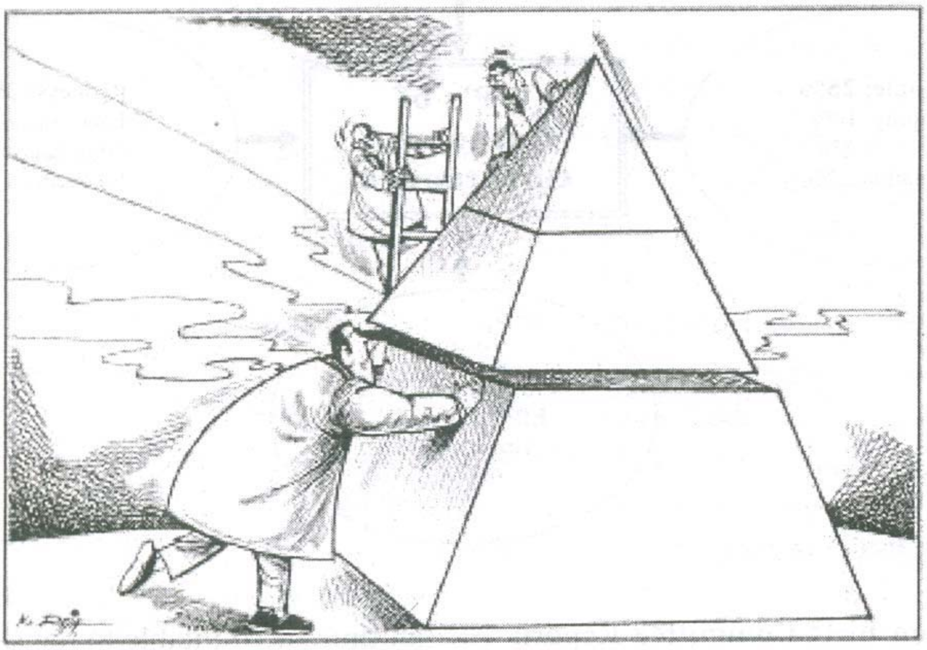
Corporate now have access to opportunities worldwide but at the same time they are also faced with threats of the entry of global players in India. Due to scarcity of resources attention is being given to development of greater and greater skills. There is an increasing awareness that the customers are the most important entity in any business. Also there is a growing realization that good corporate governance is a must not only to gain credibility and trust but also as a part of strategic management for survival, growth and consolidation.

The committee on corporate governance was set up in 1991 by the London Stock Exchange to look into the financial aspects of corporate governance. The committee led by Sir Adrian Cadbury had submitted its report on corporate Governance in December 1992. The report of the committee has activated the corporate Governance movements not only elsewhere but also in India. The recent needs in corporate governance in India have been owing to the following factors:

- Assertion of rights by a new breed of shareholders who are more discerning and objective oriented.
- Significant in increase of Foreign Institutional Investors who expect international Investors who expect international standards in corporate governance, are demanding greater professionalism in the management of India corporate.
- Integration of India with the world economy, which demands that Indian industry, conforms to the standard set of international rules.

Confounding Corporate Governance

Good corporate makes for good business sense. Globally, the process of convergence in corporate governance is gathering momentum due to growing international integration of financial and product markets. Foreign investors and creditors are more comfortable in dealing with economic entities that adopt transparent and globally acceptable accounting and governance standards. Companies that embrace high disclosure and governance standards invariably command better premium in the market and are thus able to raise capital at lower costs. Good corporate governance increases the confidence of the shareholders. This leads to better stock price. Research has shown that good corporate governance brings down the cost of capital for the company. Good disclosure practices lead to a more liquid market for the company. The pyramidal structure and cross shareholdings enable the firm to control the companies lower down. For example, if the company at the top, A, has a 50 per cent holding in subsidiary of B. B has a 50 per cent holding in the subsidiary of C; and so on. Cross shareholdings are horizontal equity positions in firms within the group structure that reinforce the controlling shareholder's voting power. The above example is common in Indian business groups-controlling shareholders. In Indian business groups typically have small equity investments. However, the pyramidal structures and cross shareholdings give them disproportionately large control rights. The pyramidal structure of corporate governance is given below:



(The pyramidal structure of corporate governance)

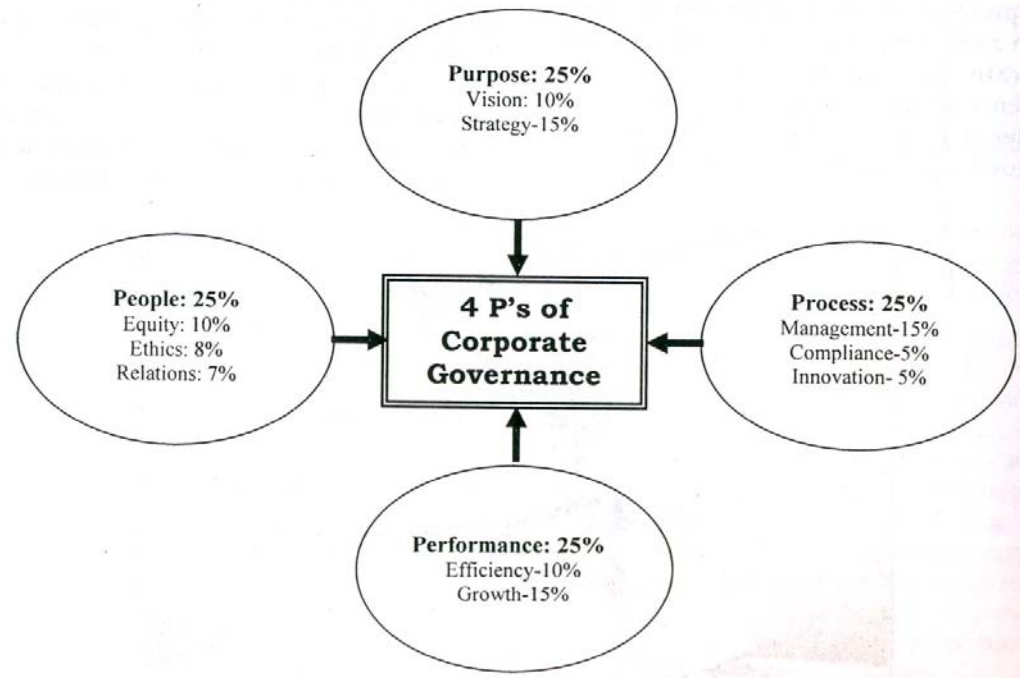
Corporate Governance in India

Good Corporate Governance has become the maha vakya in the boardrooms across the country, and as usual, many years after it became an accepted practice in the West, especially in the U.S., GCG received official blessings through amendments in 2000 to the Companies Act, 1956 (the Act), additional stipulations in the listing agreement and the institution of an annual award on excellence in corporate governance.

It will not be out of place to recapitulate the compelling factors for the acceptance and adoption of GCG in India, which are : (i) compulsions for Indian companies to raise GDRs / ADRs abroad, and also getting their shares enlisted in foreign bourses, particularly at NASDAQ and New York stock exchanges; (ii) significant presence of a large number of Foreign Institutional Investors, who demand greater professionalism in Indian companies; (iii) integration of India with the world economy which entails following a standard set of international norms and standards; (iv) realization by lending institutions which are now subject to rigorous accounting norms, particularly with regard to income recognition and provision against NPSs; and (v) assertion by shareholders of their rights.

Rating Scores for 4p's of Corporate Governance

Corporate governance mechanisms differ between countries. The governance mechanism of each country is shaped by its political, economic and social history as also by its legal framework. Despite the differences in shareholder philosophies across countries, good governance mechanisms need to be encouraged among all corporate and non-corporate entities. Following figure indicating the rating scores for 4P's of corporate governance:



Kumar Mangalam Birla Committee Report:

The objective of the committee was "enhancement of the long-term shareholders' value while at the same time protecting the interests of other stakeholders." The key recommendations of the report were:

1. Board of Directors :

It provides leadership, strategic guidance and objective judgment independent of management to the company and exercises control over the company, while remaining at all times accountable to the shareholders. The Board has five basic responsibilities:

- Overseeing Strategic Development and Planning.
- Management Selection, Supervision and Upgrading.
- Maintenance of Good Member Relations.
- Protecting and optimizing the Organizations' Assets.
- Fulfilling Legal Requirements.
- Attendance of each director at the BoD meetings and the last AGM.
- Number BoD meetings held, dates on which held.

2. Audit Committee

- Brief description of terms of reference.
- Composition, name of members and Chairperson.
- Meetings and attendance during the year.

3. Remuneration Committee

- Brief description of terms of reference.
- Composition, name of members and Chairperson.
- Attendance during the year.
- Remuneration policy.
- Details of remuneration to all the directors, as per format in main report.

4. Shareholders Committee

- Name of non-executive director heading the committee.
- Name and designation of compliance officer.
- Number of shareholders complaints received so far.
- Number not solved to the satisfaction of shareholders.
- Number not solved to the satisfaction of shareholders.
- Number of pending share transfers.

5. General Body Meetings

- Location and time, where last three AGMs held.
- Whether special resolutions were put through postal ballot last year.
- Details of voting pattern
- Procedure for postal ballot.

6. Disclosures

- Disclosures on materially significant related party transactions i.e. transactions of the company of material nature, with its promoters, the directors or the management, their subsidiaries or relatives etc. that may have potential conflict with the interests of company at large.
- Details of non-compliance by the company, penalties, and strictures imposed on the company by Stock Exchanges or SEBI or any statutory authority, on any matter related to capital markets, during the last three years.

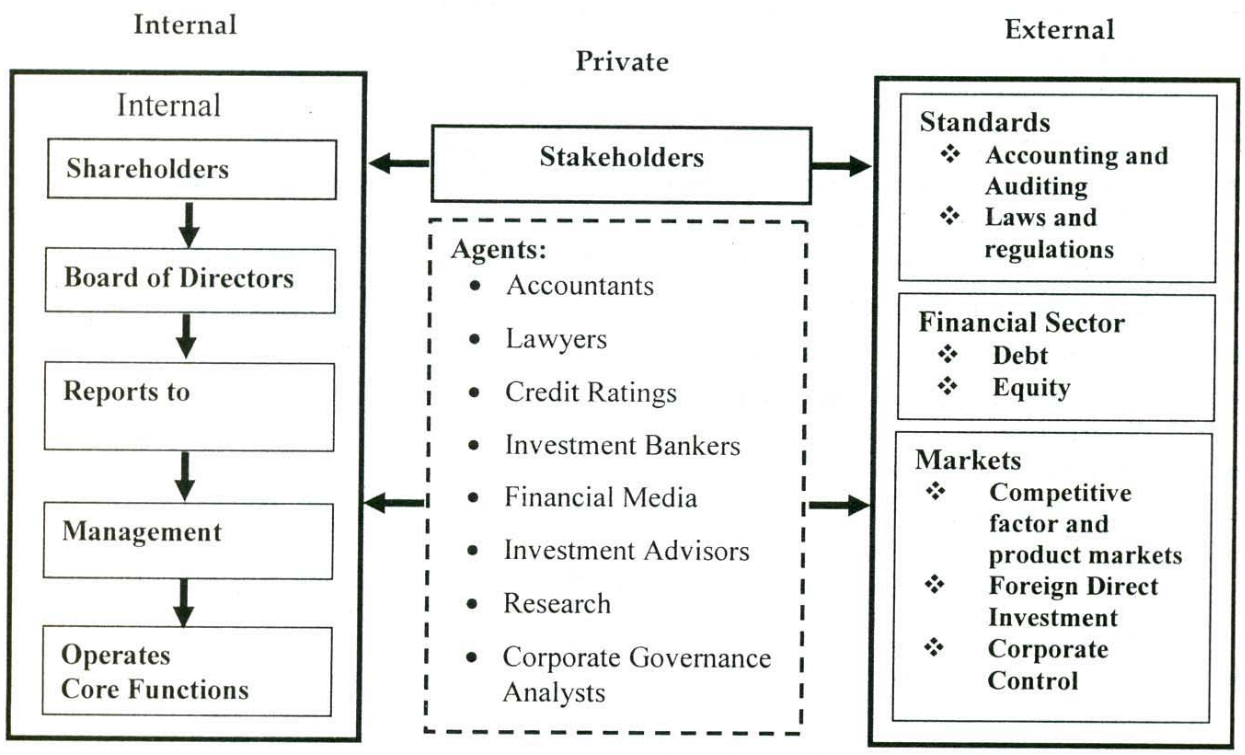
7. Means of communication :

- Half-yearly report sent to each household of shareholders.
- Quarterly results.
- Which newspapers normally published in.
- Any website, where displayed
- Whether it also displays official news releases; and
- The presentations made to institutional investors or to the analysts.
- Whether MD & A is a part of annual report or not.

8. General Shareholder information :

- AGM: Date, time and venue.
- Financial Calendar
- Date of Book closure.
- Dividend Payment Date.
- Listing on Stock Exchanges.
- Stock Code.
- Market price Data: High, Low during each month in last financial year.
- Performance in comparison to broad-based indices such as BSE Sensex, CRISIL.
- Registrar and Transfer Agents.
- Share Transfer System.
- Distribution of shareholding.
- Dematerialization of shares and liquidity.
- Outstanding GDRs / ADRs / Warrants or any Convertible instruments.
- Plant Locations.
- Address for correspondence.

Corporate Governance Framework



(The Internal and External Architecture)

Why Corporate Governance Fails ?

1. Ineffective leadership.
2. Incompetence of the board members.
3. Lack of mutual trust.
4. Time deficit.
5. Constant change
6. Less predictability in decision making;
7. Need for quicker decisions.
8. Superficial commitment to vision, mission and values.

OECD Annotations to Indian Connotations

The principles of corporate governance is not something new today, as it existed for centuries and the need is felt today as a matter of necessity and protecting the greater interests of the investors. What sought to be achieved as a measure of self-regulation is becoming more by way of prescription of law and today it is becoming imperatively necessary that compliance to the prescribed conditions for corporate governance is a must for a listed entity. The issue is well addressed by different reports of the committee in and around the globe and they are being revisited now and then. For the developing countries, the lessons and experiences elsewhere are becoming a mantra and so too the regulators have become cautious to prescribe different set of codes on corporate governance. Among the notable global reports on Corporate Governance, the Organization for Economic Co-operation and Development (OECD) Principles of Corporate Governance is becoming a benchmark for identification of good elements, though there is no single model of good corporate governance.

Principle-1	Ensuring the Basis for effective Corporate Governance Framework
Annotation	The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.
Principle-2	The Rights of Shareholders and Key Ownership Functions
Annotation	The corporate governance framework should protect and facilitate the exercise of shareholders' rights.
Principle-3	The Equitable Treatment of Shareholders
Annotation	The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.
Principle-4	The Role of Stakeholders in Corporate Governance
Annotation	The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.
Principle-5	Disclosure and Transparency
Annotation	The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.
Principle-6	The Responsibilities of the Board
Annotation	The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and board's accountability to the company and the shareholders.

Conclusion

To conclude, corporate governance is not only an effective means of investor protection, but also carries wide implications for the operations and fund raising ability of companies themselves and the development of globalised trading of securities, as well as the world economy as a whole. The financial sector reform and corporate restructuring are pre-requisites for establishing economic stability. As the Indian corporate scene is gradually transforming to cope with globalization, liberalization and privatization, stakeholders are getting restless to prevent corporate board from offering them inferior deals. Effectiveness of corporate governance system cannot merely be legislated by law neither can any system of corporate governance be static. As competition increases, technology pronounces the death of distance and speeds up communication; the environment in which firms operate in India also changes. In the recent years, the regulators and legislators have intensified their focus on how businesses are being run.

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