Corporate Governance

Corporate Governance – An Introduction

Over the last few years, the corporate world all around the globe has witnessed a vibrant debate on corporate governance. The roots of this debate can be traced to a string of corporate and financial accounting scandals and a series of governance failures. These incidents covered a wide range of abuses including the basic theft of assets, the misuse of pension funds, share price manipulations etc. All this calls for special attention, so as to improve corporate governance standards, on the part of:

- *The Government*, which has to make regulations and ensure its compliance to ensure good corporate governance;
- *The Corporate world*, which needs to comply with the regulations and do justice to its social responsibilities; and
- *The society*, which has to define the values that go on to become the yardstick for acceptable corporate behaviour, and thus form the basis for the regulations to be made.

While we continually say that we need to ensure good corporate governance, we need to understand what corporate governance means. Sir Adrian Cadbury in 'Global Corporate Governance Forum', World Bank, 2000 outlined, *"Corporate Governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society***".** This statement, an absolutely inclusive one, highlights the essence of corporate governance: ***ethical business behaviour in every sphere and with all constituents***.

While businesses exist to serve their stakeholders (including shareholders), they also exist to serve their greater society and civilization. Since amongst all stakeholders, shareholders are residual claimants, the objective of 'good' corporate governance can be talked of as: *maximizing long-term shareholder value*. This objective follows from a premise that, in well performing capital and financial markets, whatever maximizes and sustains long-term shareholder value must necessarily maximize corporate prosperity and best satisfy the interests of creditors, employees, shareholders, the society and the State. If any of the interests of all these stakeholders is not satisfied, it may badly affect the long run maximization of the shareholders' value.

Why Corporate Governance?

Corporate governance is a critical ingredient in maintaining a sound financial system and a robust economy. Corporate governance is of fundamental importance, at all levels viz.

a. At the national level:

As barriers to the free flow of capital fall, it becomes imperative to recognise that the quality of corporate governance is relevant to capital formation and that sound corporate governance principles is the foundation upon which the trust of investors is built. Corporate governance represents the ethical the moral framework under which business decisions are taken. Thus, any investor, when making investments across the borders or even otherwise, wants to be sure that not only are the capital markets or enterprises with which they are investing are being run competently but they also have good corporate governance. Consequently, lack of sound corporate governance practices in any country can badly affect the confidence of foreign investors, in turn causing damage to the amount of foreign investments flowing in.

Further, corporate governance is one of the key factors that determine the health of the financial system and its ability to survive economic shocks. Corporate governance is not just an essential ingredient for financial stability rather it is also a critical feature in the longer-term performance of the economy.

As a matter of fact, one of the key drivers of how well or poorly an economy performs depends on where its resources are invested and how well they are utilized. Since most of the economies in the world are capitalistic, the decision as to allocation of resources and their efficient utilization is largely affected by the investment and management decisions of hundreds of companies. In turn, the quality of these investment and management decisions substantially depends on the quality of corporate governance in each company. Thus, it becomes only a formality to state that standard of corporate governance in any country has major implications for the common man, employees, shareholders, customers, government, banks and the economy as a whole.

b. <u>At the company and individual level</u>:

It is self evident that sound corporate governance is essential to the well being of an individual company and its stakeholders, particularly its shareholders and creditors. We need only remind ourselves of the many companies, across the world, whose financial difficulties and, in some cases, ultimate demise have been substantially attributable to weak corporate governance. On the other hand, there are several areas of self-interest that should drive companies to embrace more effective governance. These areas are:

1. Effective governance helps to minimize reputational risks and thus, protecting the brand;
2. It helps to instill trust in customers and vendors;
3. It also helps to assure effectiveness and integrity of a company's business processes.
4. Further, in many cases, the punishment, in terms of penalties or imprisonment, for white-collar crimes are now in excess for such criminal acts such as armed robbery, assault, and negligent murder. Even to escape such punishments, ensuring corporate governance compliance is a must.

<u>Corporate Governance and Insurance Industry - a special focus</u>

Apart from the usual reasons, as mentioned above, that make corporate governance to be ensured in any industry, there are other reasons as well, from the regulators' and economy's point of view, that make it all the more important that good corporate governance be ensured in the insurance industry.

These include:

- Firstly, insurance sector is next only to the banking industry in terms of importance among the economic barometers of the nation. While the banking industry is creating assets and consequently national wealth, the insurance industry is ‘protecting’ such wealth to the tune of several billions of rupees.

  Further, insurance industry also serves many other important economic and societal functions. For instance, since insurance is available and affordable, banks can make loans with the assurance that the loan’s collateral (property that can be taken as payment if a loan goes unpaid) is covered against damage. This increases availability of credit in the economy.

- Secondly but most importantly, the financial and accounting concepts relating to insurance contracts are riddled with unique and specialized concepts including heavy influence of the bottom lines by various estimations such as reserving, estimation of IBNR claims, estimation of IBNER claims etc. All this makes preparation of financial statements of insurance companies very judgmental in nature, and thus, opens to personal bias and manipulations.

Given the sheer importance of insurance industry to any economy and the high degree of vulnerability of insurance accounts to judgments or manipulations and bias, we think it would be not be unfair to state that ensuring good corporate governance in the insurance industry is as important as in the banking industry, the heart of any financial system.

Factors affecting Corporate Governance

Major factors that determine the level of corporate governance in any country include:

a. Regulations and their enforcement:

Since corporate governance failures have proved to be harmful not just for the organisations but also for the economy and the general public at large as well, there have been public pressures on the government and regulatory authorities to reform business practices and increase transparency. Consequently, it has become a part of the government’s duty to ensure accountability and responsibility in corporate behaviour. Effective disposal of this responsibility basically revolves around two things:

- First, the designing of regulatory commands i.e. the regulations and laws to ensure good corporate governance; and
- Second is the enforcement of regulations.

On the designing of regulations part, already policymakers around the world have adopted numerous reform measures. For instance, in July 2002, the United States Congress passed the ***Sarbanes-Oxley Act*** into law so as to restore investor confidence following well-publicised bankruptcies that brought chief executives, audit committees, and the independent auditors under heavy scrutiny.

The Sarbanes-Oxley Act, commonly known as SOX, was passed in the wake of a myriad of corporate scandals. What these scandals had in common was skewed reporting of selected financial transactions. For instance, companies such as Enron, WorldCom and Tyco covered up or misrepresented a variety of questionable transactions, resulting in huge losses to stakeholders and a crisis in investor confidence. Therefore, the Act imposed (among other things) new financial control and reporting requirements on publicly traded companies. Also, the Sarbanes Oxley Act called for the formation of a Public Company Accounting Oversight Board (PCAOB) to oversee the auditing of public companies. Further, the Act also specifies several requirements that include management's quarterly certification of the financial results and management's annual assertion those internal controls.

In India as well, ***Clause 49 of the Listing Agreement*** (which relates to corporate governance) was amended in the light of the recommendations of the NR Narayan Murthy Committee. The amendment was intended to enhance the corporate governance standards, primarily through increasing the responsibilities of the Board, consolidating the role of the Audit Committee and making management more accountable.

After having made the regulations, the government and various regulatory authorities need to ensure effective administration and enforcement of the same. As such, if the enforcement mechanisms are not effective, the regulations also themselves tend to become ineffective. This is because if the general environment is such that there is no fear of punishment, people are bound to be tempted to indulge in corrupt practices and moral hazards, which goes totally against corporate governance. Thus, enforcement can affect the overall credibility of a regulatory system. However, the regulatory authorities should also pay regard to the fact that greater enforcement is not always better, for taken too far it can dampen valuable risk-taking and restrict innovations.

Corporate Governance in Private Companies

Here one thing that we think needs to be brought to everyone's notice is the fact that most of the regulations made, such as SOX in US and Clause 49 of Listing Agreement in India, are ***applicable only to publicly-registered or listed companies*** and ***private companies are out of the ambit of these regulations***. However, today we see that private companies are also becoming big in size and impact. Very near examples would include joint ventures being organized as private companies within the insurance industry in India. Thus, failure of corporate governance within these private companies as well can very badly harm the general public at large. And also since new standards of corporate governance, while only required by law at public companies, are for forming "best practices" in many will governed private companies, we strongly feel that the applicability of such regulations, after suitable modifications, be extended to private companies as well.

Apart from the necessity as above, it is also in the self-interest of private companies to ensure good corporate governance. This is primarily because:

1. Usually, in most private companies, controls are *informal* or even if there are formal controls, they tend to be *detective rather than preventive*. This makes private companies unprotected against risks, which needs to be mitigated.
2. Good corporate governance increases creditworthiness of the company and thus, enables it to raise funds at cheaper cost. Good corporate governance is also a must for companies that are planning to seek stock exchange listing and raise money from markets by converting them into public company.
3. Finally, if the owners of a private company are considering the sale of all or part of the entity, or are seeking private equity financing, effective controls can increase prospective buyers' willingness to pay a premium for the acquisition. Controls enhancements can also help attract new business partners.

b. Risk Management and effective governance:

Somebody named "Murphy" once stated something called "law" which dictates that if something wrong can happen, it will. To protect the organisation from any such ill consequences and also to take advantage of favourable changes in the environment, risk management is used. And as the name suggests, risk management is a discipline that enables people and organizations to cope with uncertainty by taking steps to protect its vital assets and resources. Risk Management process provides a framework for identifying risks and deciding what to do about them. It should be noted that risk management doesn't mean that the risk will go away rather it is a proactive effort conducted in advance of an action or event in an effort to minimize the potential for harm or negative results.

In today's world, frauds are an undeniable fact of business life, affecting all types of businesses. New technologies such as the Internet, and the development of fully automated accounting systems, have increased the opportunities for fraud to be committed. Once suspected or discovered, investigating fraud is a specialist task requiring experience and technical skill and can be very costly. Thus, there is no doubt that fraud is best prevented, rather than dealt with after the fact. The most effective and appropriate response to the problem of fraud involves a combination of risk management techniques. These techniques, inter alia, include:

- Setting up inherent control based upon soft controls that occur continuously and consistently throughout the organisation. Such controls should be embedded in normal business practice and be designed in such a way that they are to a large extent self sustaining; and
- Setting up formal control processes of monitoring, reviewing and reporting (command-control style based upon a hierarchy).

Apart from chances of frauds, there are many other risks as well such as risk arising from unforeseen changes in economic factors, risks from natural disasters, currency risks, political risks etc. To mitigate each of these risks, risk management advocates various techniques, which are often used in practice to counter those risks.

Thus, various risk management techniques are often used to ensure that there are no undesirable activities or processes or practices or actions existing within the organisation. All these techniques together form the bedrock for sound corporate governance in any organisation. So it will not be an overstatement to say that risk management is one of the most potent weapons (with the management of any enterprise) in the ongoing fight to protect shareholders and the investing public. Though regulations are also an important tool in the hand of the Governments to ensure good corporate governance, but governance framework without an underlying value system encourages only compliance rather than commitment. As a result unless a management is committed to strictly observe the principles of propriety and risk management, the atmosphere becomes too tempting to observe good corporate governance compliance but actually bad corporate governance.

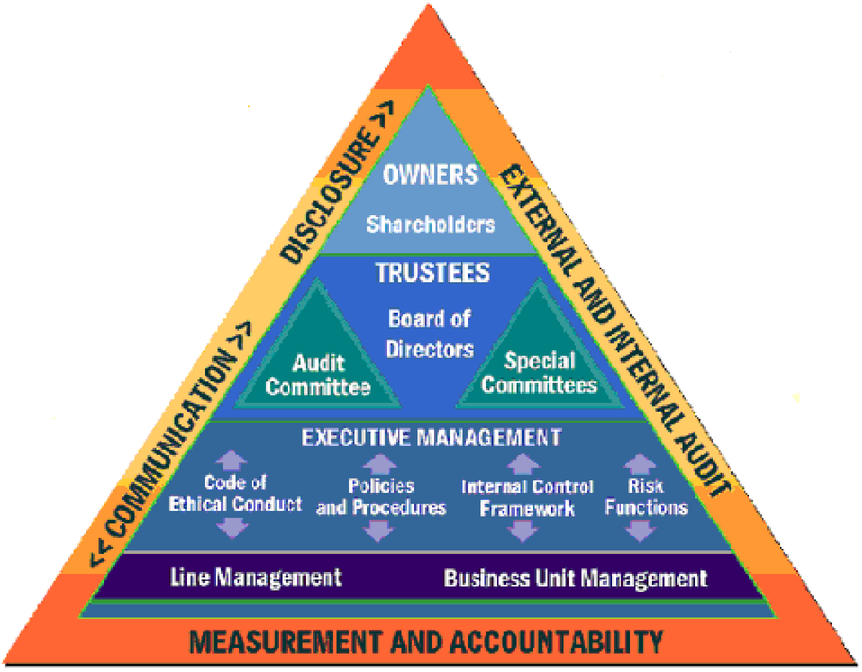
In the box below, we suggest a generic model for effective corporate governance.

An effective Governance model

We discuss the Governance Model, a simple, extensible framework that places the key elements of governance in context. Using this Governance model, all stakeholders in a business can better understand, plan, and execute activities in response to challenges and risks arising in business.

It should be noted that each of the elements is an essential component of good governance, but none is sufficient alone. Effective corporate governance relies on the interrelation of all the checks and balances within an organization.

The foundation of the model is the corporate structure that includes the owners of the business (i.e. Shareholders), trustees (i.e. Board of Directors), Executive and Line Management. The owners appoint a number of trustees to oversee their interests in the business. The trustees in turn appoint the Executive Management to run the business. The diagram below explains the structure and the means adopted by different stakeholders to control the subordinates.



Elements of Effective Governance model

1. **The corporate structure**

The well-defined corporate structure with clearly defined responsibilities and controls are a must for ensuring good governance in any organisation. The major components of corporate structure, along with the function that each of those components they must perform are:

a. *Trustees (Board of Directors):*

Their activities include, inter alia, reviewing the execution of strategies, appraising the executive management, ensuring transparency in reporting and establishing an effective audit process. Since these activities are very crucial for the organisation as a whole, The Board of a company should: -

- Have the right proportion of independent Directors;
- With appropriate qualification and experience

Further, Board of directors should delegate oversight of key areas of responsibility such as audit, compensation etc to specific committees who are directly reportable to the board. Each of these committees should have a specific charter defining its responsibilities, scope and powers.

b. *Executive and Line Management:*

Executive management employs its experience, expertise and skills to develop and execute strategies to achieve the organizational goals. To develop and execute strategies effectively, the executive management should define the "rules of the game" according to which the line management, business unit management and the employees should operate the business. These rules should, inter alia, include:

- A *Code* of Ethical Conduct that outlines what the company considers is right and wrong. It provides a critical foundation for effective internal controls and may apply not just within the organization but also across its trading and value stream, including suppliers and customers.
- A comprehensive set of Policies and Procedures that are documented, accessible, understood, and enforced by all employees, and which institutionalize right and wrong into business processes and activities.
- An Internal Controls Framework that ensures that there are controls in place to mitigate significant business risks.

2. Internal and External Auditors

A good corporate governance structure must be based on a system of checks and balances. While management strives to achieve the right balance between growth and protection of value, auditors provide an objective check that the rules are being followed.

Thus, there must be a progressive internal audit function wherein the Internal auditors seek to understand and document business processes, identify risks and controls, and validate that the controls are effective in mitigating risk.

Also, it must be ensured that external or statutory audit is carried out in an independent and sacrosanct manner.

3. Disclosure and Communications

Effective communication underpins the relationship of trust among the shareholders, board and management. It forms the glue that holds the complex corporate governance framework together. Thus, it must be ensured that a transparent, accurate, and timely communication of information takes place in the organisation. There should be well designed and well enforced policies that ensure that 'grapevine' mechanism does not lead to any leakage of confidential information. Also, there should be checks to ensure that there is no loss or distortion of information while communication.

4. **Measurement and Accountability**

In order to translate the vision into reality, companies should operationalise the strategic objectives into more measurable Key Performance Indicators (KPIs). Defined KPIs for each level in the organisation helps employees clearly understand their respective roles and responsibilities.

Also, the appraisal of employees should be based on performance against these KPIs. The board and its committees should receive periodic reports from management on the performance of the company against the pre-defined KPIs. They should also review this performance in light of the benchmarks and the performance of industry peers.

c. ***Moral Values:***

Lastly, but most importantly, corporate governance is the net result of the individual sense of values and the values held in society. Key elements of good corporate governance principles include honesty, trust and integrity, openness, performance orientation, responsibility and accountability and mutual respect. Thus, the level of corporate governance in any country is largely affected by the moral values of the people including those working in various organisations and those assuming the regulatory roles. This is also because even the best of the regulations and risk management practices will fail if people are recklessly determined on committing frauds. Thus, in long run, to ensure good corporate governance, the society as a whole has to be revamped and strong moral and ethical values have to be engrained in the minds and hearts of the upcoming generations.

Conclusion

At last, it would be appropriate to say that firstly, there is no unique structure of “corporate governance and secondly, corporate governance goes far beyond regulation. The quantity, quality and frequency of financial and managerial disclosure, the extent to which the board of directors exercise their fiduciary responsibilities towards shareholders, the quality of information that management share with their boards and the commitment to run transparent companies cannot be legislated at any level of detail. Instead, these evolve due to the catalytic role played by the more progressive elements within the corporate sector and, thus, enhance corporate transparency and responsibility.

Thus, as the new business practices continue to evolve, governance initiatives will continue to be designed to ensure the ethical, legal and responsible behavior in times of success and crisis. While businesses exist to serve their stakeholders, they also exist to serve their greater society and civilization. The adoption of governance best practices increases the likelihood that leadership will provide the desired corporate performance while confidently tracking the right course into the future.

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