# "CORPORATE GOVERNANCE MODELS IN PRACTICE"

**Smt. Shanti Suresh**

Adam Smith:

"It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest"

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## Factors Influencing Governance models

- Economic Patterns of the country.
- Forms of business organizations.
- Business context.
- Legal Environment of the country.
- Socio cultural environment.
- Financial Systems Prevalent.

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## Good Governance ensures:

- To Cradle the vision of the company.
- Address fundamental values.
- Force forward thinking
- Facilitate diversity and unity in board
- Balance over control and under control
- Enable pro activity
- Enable an outcome driven organizing system.
- Separate large issues from small ones .
- Use board time efficiently .

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## Anglo-Saxon Model.

- Countries where practiced are USA & UK
- Large companies with low concentration of shareholders.
- Large number of listed &traded companies
- Share holders spread their money over many companies.
- Many financial institutions are not allowed to hold share in listed co's on their own behalf ,but act as agents
- Also known as share holder Model

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## Continental European Model

- Countries where practiced :Germany, France, Italy, Netherlands.
- Large % of the total No of shares are publicly traded.
- Fewer listed companies.
- Equity Ownership concentrated in banks.
- Weak legal Protection systems.
- Employees,Private individuals and companies act directly .
- No agency system to manage their affairs.
- Also Known as stake holder model/insider model.

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## Japanese Model

- Based on cultural trends rather than statutory provisions
- Blend of capitalist competition and socialist relationships.
- Co's shares are held by banks ,major suppliers,and major customers& by large individual shareholders.
- Most of the directors and top executives rise from the ranks and many are former union leaders.

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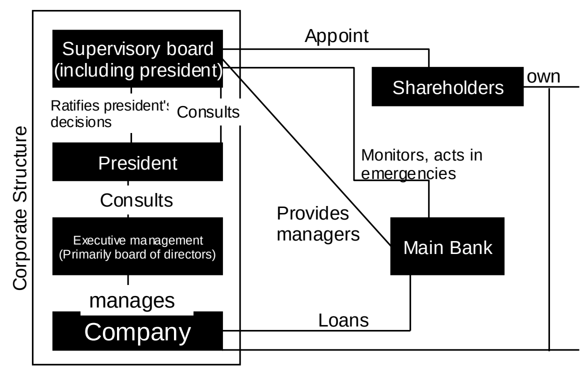
## Japanese Model




Japanese model of Corporate Governance

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## Indian Model

- Amalgam of the Anglo American and European Model.
- Corporate Sector is divided into Public, Private and banks.
- In Public enterprises state and central government forms the board
- Dominant role by the government.
- Large enterprises are run in the interest of the government than in the interest of maximization of shareholder wealth.

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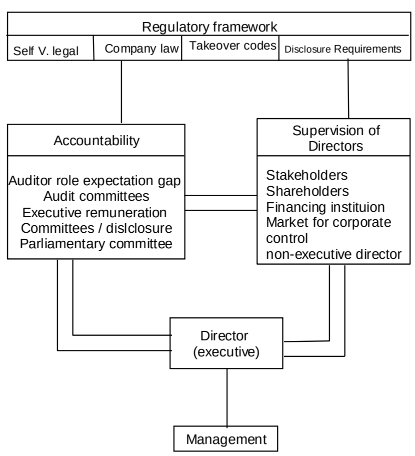
## Indian Model

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## Dynamic model

- Integrated Financial Markets
- Lead to International Competitiveness of the Economy.
- Prudent Risk taking and corporate performance
- Companies following Non Prescriptive and self regulated path.
- System based on sound principles rather than black letter of law, where regulators tread lightly but carry a big stick
- World Class Corporate Governance Standards.

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Aristotelian approach to business is that a good corporation is one that is not only profitable but that provides a morally rewarding environment in which good people can develop not only their skills but, also their virtues

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# Corporate Governance

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## What a difference a few years can make!

| What's In? | What's Out? |
|---|---|
| ✓ Corporate Governance | × Corporate Greed |
| ✓ Investor Crisis of Confidence | × Investor Confidence |
| ✓ Value Investing (old economy) | × Dot.coms (new economy) |
| ✓ Enforcement Matters | × The Market Matters |
| ✓ "Perp Walks" | × Top ENRON Executives |
| ✓ Real Boards | × CEO-Friendly Boards |
| ✓ Arthur Levitt | × Harvey Pitt |
| ✓ The Big 4 | × The Big 5 |
| ✓ Auditing | × Consulting |
| ✓ Earnings Restatements | × Earnings Management |
| ✓ Accounting *Transparency* | × Accounting *Opaqueness* |
| ✓ Expensing Stock Options | × Excessive Stock Options |
| ✓ Government Regulation | × Auditor Self-Regulation |

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## *Principles of Corporate Governance (OECD, 1999)*

… a set of relationships between a company's management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently

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## OECD Principles

1. **Rights of Shareholders** - the corporate governance framework should protect shareholder rights
2. **Equitable Treatment of Shareholders** - 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
3. **Role of Stakeholders in Corporate Governance** - the corporate governance framework should recognize the rights of stakeholders as established by law and encourage active co-operation between corporation and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises

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## OECD Principles *(cont)*

1. **Disclosure and Transparency** - 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

2. **Responsibilities of the Board** - the corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders

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## What can be learned from ENRON?

**The Limits of Corporate Governance**

- **Failures are cyclical (market booms/busts)**
- **Aggressive risk-taking, opaque accounting**
- **Not curbed by organization controls**
- **Not curbed by directors**
- **Auditing is 3rd order effect**

**WHAT HAPPENDED AT ENRON?**

**Greedy Managers**
- Compensation cash versus stock

**Sketchy Accounting**
- Principles versus rules

**Ineffective Boards**
- Independent directors

**Research Analysts**
- Investment bank conflict of interest

**Auditor Independence**
- Fee dependence, consulting

**GRADING THE ACCOUNTING REFORMS**

**Audit Committees - Full Marks**
**Other Reforms - Fail**

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## Compensation Trend


The New York Times

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## What's Not Being Talked About

**Auditor Incentives**

- Partner versus firm incentives

**Auditing is Risky Business**

- Low failure rates - but big risks

**Litigation Exposure and Reform**

- The punishment must fit the crime

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## Classic Red Flags of Management Fraud

- Unduly aggressive earnings targets
- Management compensation based on aggressive earnings targets
- The inability to generate operating cash flows while at the same time reporting large earnings / earnings growth
- Financial statements based on significant estimates that involves subjective judgment
- Significant related-party transactions

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# GOVERNANCE

Self regulation, coordination, cooperation, principles, standards, procedures, protocols, ethics –

A way of life.

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## Many Shades of Governance

- Village local self governance
- District
- State
- National
- UN
- Corporate governance
- Cooperative movement
- Democratic movement

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## What is Corporate Governance?

| Many stakeholders | | The many issues |
|---|---|---|
| Government<br>Intergovernmental organizations.<br>International Organizations Private<br>Regulatory authorities<br>Sector and Business Civil Society, Citizens, Investors, taxpayers | Self regulation coordination corporation rule of law ethics security, regulatory & statutory requirements social issue | Corporate regulations<br>Corporate communications<br>corporate ethics |

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## Corporate Governance Definition

- Corporate governance is concerned with holding the balance between economic and social goals and between individual and community goals
- The concept is complex but principles are straightforward
- Transparency, accountability, fairness and responsibility- implemented through statutory and self regulation

- Sir Adrian Cadbury

Father of Corporate Governance

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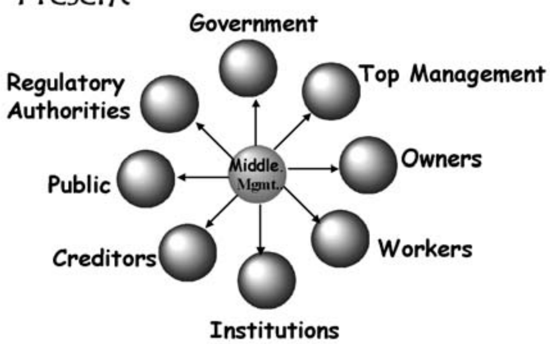
## Present

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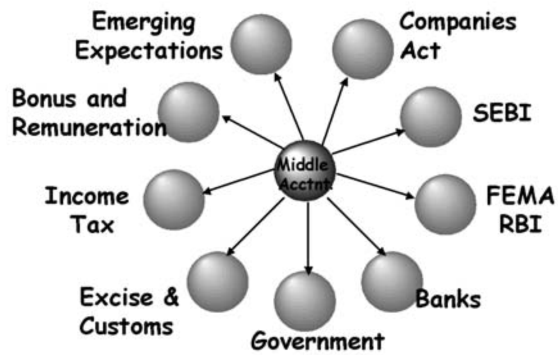
## Changes in statutes

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## The Issues

- The nature of corporate governance
- Internal & external governance mechanisms
- The agency relationship: Owners & managers
- International examples: Germany & Japan
- Governance & ethical behavior
- Securities law reform: Sarbanes-Oxley Act
- Corporate sustainability

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## Corporate Governance

- Corporate governance is
  - A relationship among stakeholders used to determine and control the strategic direction and performance of organizations
  - Concerned with identifying ways to ensure that strategic decisions are made effectively
  - Used in corporations to establish order between the firm's owners and its top-level managers

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## Corporate Governance Mechanisms

**Internal Governance Mechanisms**

- Ownership concentration
  - Relative amounts of stock owned by individual shareholders and institutional investors
- Board of directors
  - Individuals responsible for representing the firm's owners by monitoring top-level managers' strategic decisions

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## Corporate Governance Mechanisms

**Internal Governance Mechanisms**

- Executive compensation
  - Use of salary, bonuses, and long-term incentives to align managers' interests with shareholders' interests

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## Corporate Governance Mechanisms

**External Governance Mechanisms**

- Market for corporate control
  - The purchase of a firm that is underperforming relative to industry rivals in order to improve its strategic competitiveness

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## Separation of Ownership & Managerial Control

- Basis of the modern corporation
  - Shareholders purchase stock, becoming residual claimants
  - Shareholders reduce risk by holding diversified portfolios
  - Professional managers are contracted to provide decision-making

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## Separation of Ownership & Managerial Control

- Modern public corporation form leads to efficient specialization of tasks
  - Risk-bearing by shareholders
  - Strategy development and decision-making by managers

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## Corporate Governance & Ethical Behavior

Capital Market Stakeholders

- **It is important to serve the interests of the firm's multiple stakeholder groups!**
- In the U.S., shareholders (in the capital market stakeholder group) are viewed as the most important stakeholder group served by the board of directors. Hence, the focus of governance mechanisms is on the control of managerial decisions to ensure that shareholders' interests will be served

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## Corporate Governance & Ethical Behavior

Capital Market Stakeholders

Product Market Stakeholders

- **It is important to serve the interests of the firm's multiple stakeholder groups!**
- Product market stakeholders (customers, suppliers and host communities) & organizational stakeholders (managerial and non-managerial employees) are also important stakeholder groups. In the U.S., there is a growing focus on serving the interests of these stakeholders.

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## Corporate Governance & Ethical Behavior

Capital Market Stakeholders

Product Market Stakeholders

Organizational Stakeholders

- **It is important to serve the interests of the firm's multiple stakeholder groups!**
- Although subject to debate, some believe that ethically responsible companies should design and use governance mechanisms to serve all stakeholders' interests. The importance of maintaining ethical behavior through governance mechanisms is seen in the example of Enron and Arthur Andersen.

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## Developing Issues

- Both legislative action and business community pressure are driving significant governance changes
  - **Securities law reform**: The Sarbanes-Oxley Act of 2002 to Mandate accountability and corporate responsibility
  - **Corporate Sustainability Movement**: To create long-term shareholder value through an integrated strategic model

Sarbanes-Oxley Act Full Text: http://vscpa.com/Advocacy/SOtext.htm
Dow Jones Sustainability Indexes: http://www.sustainability-index.com

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## Securities Law Reform: The Sarbanes-Oxley Act of 2002

- **Enhance corporate disclosure and SEC oversight**
  - CEO & CFO certification of financial reports
  - Real-time disclosure of material events
  - Material correction of auditor adjustments
  - Off-balance sheet transactions
  - Pro forma financial information changes
  - Internal controls assessment
  - Frequent SEC review

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## Securities Law Reform: The Sarbanes-Oxley Act of 2002 (Cont.)

- **Strengthen corporate governance**
  - New audit committee independence standards
  - Audit committee financial expert
  - Whistleblower job protection mandated

Cont.

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## Securities Law Reform: The Sarbanes-Oxley Act of 2002 (Cont.)

- **Expand insider accountability & disclosure**
  - Disgorgement of certain compensation & profits if restated because of misconduct
  - 2-day deadline for reporting insider trading
  - Loans to insiders prohibited
  - Insider trades restricted during pension blackouts
  - Code of ethics disclosure for senior financial officers

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## Securities Law Reform: The Sarbanes-Oxley Act of 2002 (Cont.)

- **Heighten auditor independence**
  - Non-audit services restricted
  - Report to audit committee required
  - Rotation of audit partner (5 years)
  - Auditor conflicts of interest limited
  - Prohibition of corporate influence on audit process

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## Securities Law Reform: The Sarbanes-Oxley Act of 2002 (Cont.)

- **Increased auditor oversight**
  - Independent auditor oversight board to regulate auditors and audits (SEC oversight)
- **Broader sanctions for wrongdoing**
  - Criminal sanctions increased
  - Civil sanctions increased
- **Other issues**
  - Analyst conflicts of interests addressed
  - Attorney responsibilities addressed

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## The Corporate Sustainability Movement


- **Corporate sustainability**: A business approach designed to create long-term value for shareholders. Accomplished by integrating economic, environmental, and social success factors in the firm's strategies and operations.

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## Standards of corporate governance

- Reliability and predicatbility
- Openness and transparency
- Accountability
- Efficiency and effectiveness
- Integrity

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## Standards of corporate governance

These standards should be reflected in 3 areas:

- Organisational structures and processes
- Reporting to stakeholders and in the control system
– (including, stewardship of resources, efficiency and effectiveness, demonstrating that the control system works at policy and operational levels)
- Standards of behaviour (how leadership is exercised and the culture of the organisation)

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## THE COMPANIES ACT 1956

- **Schedule VI – Balance sheet & P&L A/c**
- **MAOCARO – 1988**
- **Additional information part II, schedule VI**
- **Cost accounting records, rules & cost audit (sections 209 & 233B)**
- **Statements in prospectus sections 60A & 61**

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## THE COMPANIES ACT : RECENT CHANGES

- **Directors responsibility statement (DRS) section 217 (2AA)**
- **Audit committee (section 292A)**
- **SEBI regulations (section 55A)**
- **Accounting standards section 211 (3A to 3C)**

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## Recent Amendments Directors responsibility Statement (section 217(2AA))

- applicable accounting standards followed
- going concern concept
- rational selection and consistent application of accounting policies
- judgements and estimates are done in a reasonable and prudent manner
- asset safeguarding and prevention and detection of fraud

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## SEBI

- Section 55A and Listing Agreements provide powers to SEBI regarding
- prospectus
- public issue of companies
- investor protection
- redressal of grievances

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## Accounting Standards Section 211 (3A to 3C)

- AS-17 Segment Reporting
- AS-18 Related Party Disclosures
- AS-20 Earning Per Share
- AS-21 Consolidated Financial Statements
- AS-22 Accounting for Taxes on Income

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## Other Statutes FEMA/RBI

- Rules and guidelines include form ODI requiring furnishing of five years projections for setting up a WOS or Branch abroad or for FDI into India.
- Yearly reporting with analysis of variances from projections based on actual performance.

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## Income Tax Act

- Section 209 to 211 - Payment of Advance tax on the basis of estimates of income
- Section 92 to 92F Transfer pricing involving determination of arms length price
- McDowells judgement - Commercial expediency vis-a-vis tax advantage
- Fringe Benefit Tax
- Service Tax
- Annual Return of Information

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## Expectations

- external transparency
- greater accountability
- more information

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## Emerging Areas

- Social Accounting
- Environmental Reporting
- Inflation adjustments and net present value
- Economic Value Added statements
- Human Resource Accounting
- Business, Know-how and Brand Valuation

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## Corporate Governance

Thus is a nutshell, we can say corporate governance is a systematic and company specific process by which companies are directed and controlled, to enhance their wealth generation capacity in a transparent and legal manner, which meets shareholders aspirations and societal expectations. Corporate Governance is not merely about enacting regulation.

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## Corporate Governance

It is about establishing a climate of trust and confidence. It extends beyond corporate laws. Its fundamental objective is not merely the fulfillment of the requirement of law but n ensuring commitment of the Board in managing the company in a transparent manner for enhancing long term shareholder value.

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## Corporate Governance

Corporate Governance is much wider than mere transparency and disclosures and compliance. It calls for a paradigm shift in the role of Board and corporate directors. They need to be 'evolutionary' and revolutionary, constantly, moving the companies towards higher level of creativity.

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## Essential Ingredients of Corporate Governance

(i) Checks and Balances on Operations

Independent committees should be there to oversee the functioning of banks. Audit committees should play a specific and a well-defined role. Audit Committee, external and internal accounting systems, which are impendent of decision making on credit and borrowings, should be there for checks and balances operations.

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## Essential Ingredients of Corporate Governance

(i) Clear division of responsibility within the bank

Responsibility, both at the vertical and horizontal level should be clearly defined so that responsibility is taken by those who make the decisions.

(i) Transparency and disclosure

Once a decision is taken, it should be open to public so that nothing remains hidden for long.

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## Benefits of Good Corporate Governance

Good Corporate Governance practices create value and lead to

- Stability and growth of company
- Higher investor confidence
- Reduction in risks and cost of capital
- Leveraging of competitive advantage in financial market.
- Sustenance of long term shareholder relationship

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## Benefits of Good Corporate Governance

Other Benefits

It makes the company an icon and enjoy a position of pride.

It unlocks at he intellectual power of the Board

It bridges asymmetry in Information

It makes depositors and creditors feel more secure

Supervisory burden on scarce resources is reduced.

Potential stakeholders aspire to enter into relationship with the company

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## Benefits of Good Corporate Governance

It Promotes

Corporate fairness,

Transparency

Accountability

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## The Paradox of Corporate Governance

It increases efficiency, but there is no way to quantify its influence.

It enhances shareholder value, though there is no statistical evidence to prove it.

It enhances creation of wealth, but can not be related with financial performance of the firm.

It is vital for boards, but it is difficult to define best practices.

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## NEXT DECADE

The Challenges of Next Decade will be even greater due to

•E - commerce

•Globalization

•Instant Information

•Delivering Shareholder value through integrated performance management (IPM)

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## A Vision for the Future

- Widespread reporting of social and environmental performance
- Increased integration of corporate reports to give an integrated performance report
- Web reporting, probably increasingly taking place in real time
- A requirement for attestation of non-financial information
- A non-financial reporting standard

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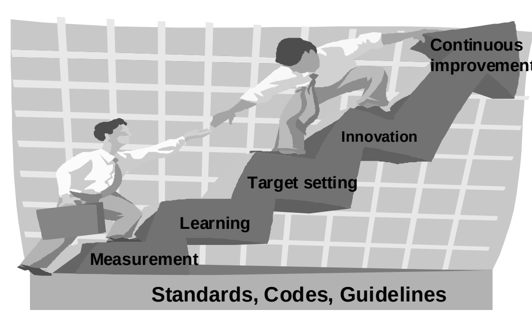
New economy reporting: Rear-view mirror and crystal ball




➢ Added value perspective

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