CHAPTER-1

CONCEPTUAL FRAMEWORK OF CORPORATE GOVERNANCE AND DIVIDEND POLICY
CONCEPTUAL FRAMEWORK OF CORPORATE GOVERNANCE AND DIVIDEND POLICY

- Meaning of Corporate Governance
- The Concept, Structure and Process
- Definition
- Key Points of Governance
- Code Of Corporate Governance
- Key Elements
- The Corporate Objective
- Responsibility Statement
- Trends In Corporate Governance
- Corporate Governance: A Suggestive Code
- Corporate Governance Policies
- Corporate Governance: An evolutionary Process
- Role Of SEBI In Corporate Governance
- Reports Presented By The Different Committees:
  - Cadbury Committee Report
  - CII Code on Corporate Governance
  - Recommendations of Kumar Mangalam Committee Report
  - Naresh Chandra Committee Report
  - Narayan Murthy Committee Report
  - OECD Principles
- Challenges Faced By Corporate Governance
- Meaning of Dividend
- Kinds of Dividend
- Meaning of Dividend Policy
- Objective of Dividend Policy
- Essentials of Sound Dividend Policy
- Types of Dividend Policy
Factors Affecting Dividend Policy
Dividend Policy Theories
Dividend Models
Dividend Payments Procedure
Dividend and a firm's life cycle
Conclusion
References
CORPORATE GOVERNANCE

In recent times high quantities of domestic and international capital are being availed by business, a prime benefit of Corporate Government is the improvement in the prospects for attracting long-term capital. The investors are afforded a wide range of choices by the worldwide development of corporate finance and control systems. Providers of finance today emphasize on good governance and credibility aspects of the corporation. Good practices in Corporate Governance must be evolved in order to attract international investors and encourage domestic investors.

THE CONCEPT, STRUCTURE AND PROCESS

Corporate as we are all aware, do not come into being from thin air, there has to be some substance, some meaning, and some objective for a corporate to come into existence. For a company of small means to grow up into a huge corporate is an achievement itself. But, to sustain the growth and carry out further expansion, related and unrelated segments such require acumen, which in normal circumstances would not be possible for one single person. A group comprising of persons specialized in their own fields such as finance, manufacturing, marketing, etc. most get together and form a board. This board must choose its leader, e.g. like in the army we have GOC, OC, and IC and so on the chain of command is well defined. This group works in unison to pull along the whole organization.

Its relevance to the group has many ramifications. Most of us must be shareholders in some company or the other or may be representing the operating management. The group is responsible vis-à-vis its accountability to its providers of capital, the investors or shareholders, for efficient utilization of assets. There must be total transparency and be institutionally sound.

DEFINITION

Corporate governance by definition; is the code of practice by which a firm’s management is held accountable to capital providers for the efficient an use of assets. It exhibits how its mission, its values and philosophy govern an organization.

✓ Governance refers to the system of directing and controlling an organization. A good governance system; Generates ideas through participation of all stakeholders. Harmonises different viewpoints while protecting interests of the minority stakeholders.
Governance assumes greater significance for publicly traded companies because of the separation of management from shareholders in general, leading to conflict of interest of the management and shareholders. Pre-requisites of good governance are education, technical skills, core competency and a system of effective communication, both internal and external.

The primary objective of the management of a publicly traded company is to enhance the value of the enterprise. As a good corporate citizen, an enterprise is expected to honour and protect the right of other stakeholders including the local community. Increased competitiveness is all the more reason for the Management of the Board to institute Corporate Governance on highly ethical grounds all across the organization.

KEY POINTS OF GOVERNANCE

The management--- which is represented by working directors is very distinct and separate from providers of capital and managers---representing the executive group from the line are responsible for the efficient use of assets in pursuit of the firms’ objective. Besides the judicious functioning of the management and the managers the firm has to perform. It must achieve or strive to achieve heightened economic performance in order to survive and sustain its long-term goals. For this the firm has to garner support, generate stable, long-term and low cost capital.

The Corporate Board is comprised of a board director who is at the helm of affairs organization. They must hold the managers down the line responsible for proper utilization of the shareholders’ funds/assets. Secondly they must corporate the concept of Corporate Governance. This is essential in that, that it affects a firm’s economic performance and its ability to attract quality investors. The help, improve the above function, corporate governance guidelines and code of practice are so designed.

CODE OF CORPORATE GOVERNANCE

The environment we operate in is dynamic, with law, regulations, practices, concepts and cultures in a constant state of evolution and flux. As a result, any code of framework built thereon must change with the times, wherever corporate governance framework has been built
on this code, such framework must be serviced time to ensure it mirrors appropriate reactions to changing realities.

A one time installation of a corporate governance system based on this code should not entitle any enterprise to claim, for all times to come, that it has a due process of corporate governance in place. For verifying whether this code, it is necessary for the enterprise to subject themselves at intervals of not less than 3 years to a review and revamping of the framework and procedures to the extent necessary.

**Regulations**

In India, SEBI introduced a code of corporate governance by way an amendment to the listing agreement with the stock exchange. This made the organizations follow regulations and listing rules bearing societal values. This disclosure could be legally mandated or it could be totally voluntary in nature.

**Indian Scene**

SEBI put into place the code of corporate governance under clause 49 in the listing agreement of SEBI. On the other hand, Call put down its Code of Corporate Governance for which a panel was constituted by the ICAI under the chairmanship of Vinod Jain. This gives us to understand that Corporate Governance is a well-understood phenomenon in India. But, is it practiced in its true sense. The answer id NO!! Very few organizations are transparent in the true sense and most camouflage their activities defeating the real essence of Corporate Governance.

**KEY ELEMENTS**

Key elements of the Guidelines and Code of Corporate Governance is very much clear in itself that the organization must have a Corporate Objective which would act as a guiding path to achieving the desired results—in being a responsible corporate citizen besides ensuring proper utilization of the investors’ money and other resources.

The individual and collective responsibilities of each member and the board as a whole must be spelt out. The composition of the board must comprise of members chosen without bias and only on their merit. The board committees must be well formed to meet the objectives so desired of such a committee. And finally the disclosure issues have to be decided upon so
that at no point of time present or future should anyone get a chance to raise a finger thereby bringing down the prestige and reputation of the organization and which would reflect the organization in bad light in the eyes of the shareholders and employees alike.

**THE CORPORATE OBJECTIVE**

The organization must prioritize the interests of other shareholders such as employees, suppliers, etc. as these are the ones who in turn would provide the strengthening effect from within. This is upheld by the view and belied of many organizations in many developing countries that their mission is to enhance the shareholder investment. On must take note that the Shareholder and Stakeholder interests in the success of the corporation are compatible in the long—run. The board assures responsibility for the stewardship of the organization and is definitely distinct from that of the management. This made clear by the fact that it is responsible in;

**RESPONSIBILITY STATEMENT**

(a) The report includes a responsibility statement such as;
(b) Putting in place an Internal Control system so as to ensure effective operations.
(c) Having an adequate Internal Audit function. Complying to generally accepted accounting principles and the reasons for deviations, if any.
(d) The board must prepare financial statements in compliance with statutory requirements and in a manner to provide a true and fair view of the state of affair of the enterprise.
(e) The board must not risk exposure in excess of what can be considered reasonable
(f) With reference to the size nature of the business of the enterprise and the enterprise must document risk management strategy.

It falls on the shoulders of the board to formulate, direct and execute organization strategy. Further it must determine what business the organization should be in and ensure that the management executes the strategy as to realize the objectives and targets set by the board.

Besides, the board has to ensure adequate financial and operational controls in order to monitor the activities of the executive management.
It is also the function of the board to provide adequate information to its investors. To be in business and run the business ethically demands a lot of transparency and clarity in its functioning. These factors would eventually have to exhibit the quality of Governance, which is further influenced by;

**Factors influencing Quality of Governance**

Quality of Governance Depends of the following Factors;

(a) *integrity of the Management*

A board of directors with a low level of integrity is tempted to misuse the trust, reposed by shareholders and other stakeholders, to take decisions that benefit a few at the cost of others.

(b) *Ability of the Board*

The collective ability, in terms of knowledge and skill, of the board of directors to effectively supervise the executive management determines the effectiveness of the board, a board, which dose not has members with right specializations, lacks this ability.

(c) *A adequacy of the process*

Board of directors cannot supervise the executive management if the process fails to provide sufficient and information to the board, necessary for reviewing plans and the performance of the enterprise. Similarly, the process should be such that it should not dampen the entrepreneurial spirit of the executive management.

(d) *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.

(e) *Quality of Corporate Repotting*

The quality of corporate reporting depends on the transparency and timeliness of corporate communication with shareholders. This helps the shareholders in making economic decisions and in correctly evaluating the management in its stewardship function.

(f) *Participation of Stakeholders in the Management*

The level of participation of stakeholders determines the number of new ideas being generated in optimum utilization of resources and for improving the administrative structure
and the process. Therefore, an enterprise should encourage and facilitate stakeholders’
participation.

(g) **The Board Responsibilities**

- Overseeing Strategic Development & Planning,
- Management Selection, Supervision and Upgrading,
- Maintenance of Good Member Relations,
- Protecting and Optimizing the Organizations’ Assets, and
- Fulfiling Fiduciary and Legal Requirements.

**Requirements**

Requirements when translated to operation level must comprise issues such as
Financial controls—just as corporations like Ranbaxy, ICI,J&J, etc, have them well defined
and hence their success.

They have various systems in place and they are well practiced. To ensure that the
above are being adhered to, a periodic review is conducted besides upgrading of systems. Its
right having systems in place but if an early warning system is not put in place all the systems
will come to naught.

**Chairman**

Hi is responsible for managing the board, chairing the meetings besides setting
schedules for board meetings. He is responsible for monitoring a director’s performance and
maintains communication with the directors between meetings and also controls the meeting
attendance. He also helps in appointing and also decides board information packages. He must
make it a point to attend committee meetings whenever possible.

In conjugation with the board he/she determines what contribution has to be made by
the board. He must place for the composition of the board and lay down guidelines for
successions. Whenever the need may arise, he has to ensure recruitment of new directors and
the “retirement” of those who are ineffective. He must draw plans for orienting new directors
and ongoing training for all members of the board.
He must bear upon himself the maintenance of an active collaboration with the management. He must ensure and guide the development of vision, mission and objectives, which would over the time act, as guiding stones to one and all in the organization.

He must act as a guiding figure and monitor besides helping shaping strategic planning. He must also evaluate the performance of the CEO and ensure accountability by the management.

In conjugation with the CEO he has to lend another discussion to his set of responsibilities—he has to perform Liaison Functions. He must represent the organization to the public and others like suppliers, employees, etc; He has to develop across board relationships both inside and outside, as he has to represent the organization with the government regulatory agencies. He may also represent the organization on the Board of other organization.

**Chairman’s Leadership Ability**

‘It is no understatement to say that the leadership ability and performance of the chairman is the most significant determinant of the success or failure of any Board ‘Inadequacy of the Chairman’s Leadership ability can be very disastrous;“Quality of leadership is undoubtedly the most critical of the key factors determining board success or failure, so much so that the problem of, and solution to, board under –performance can be traced almost always to a failure of leadership”

**Disclosures**

Law can mandate disclosures just as that had done by SEBI or it could be voluntary. In case law such as SEBI laying down the guidelines mandates it. Then the issues of interest would be the directors’ interests and the financial performance of the organization. Voluntary disclosures would entail disclosing to plans and strategies, environmental and energy—related initiatives and key changes in structure. Disclosures required under generally accepted accounting principles and other statutory provisions the enterprise should disclose information, which will be of value to shareholders. Disclosures should include;

(a) A brief resume of each director including the mature of his expertise and names of companies in which he holds the directorship and the membership of the Committees of the board.
(b) All elements of compensation package to all the directors including the terms of appointment.
(c) Remuneration of senior officers just below the level of directors.
(d) Movement in stock prices in capital markets where enterprise’s shares are listed.
(e) Loss/profit arisen out of enterprise’s transactions in future and options.
(f) Movement of key personnel during the period.
(g) Summary of financial results as per International Accounting Standards.

TRENDS IN CORPORATE GOVERNANCE

Today the corporations have to come across in a highly unambiguous manner as there is a;

1. Demand for greater transparency and accountability.
2. Written job descriptions detailing roles and responsibilities of Chairmen and Board Members.
3. Core competencies for Board Members are defined and those without skills or expertise not invited.
4. Development of performance criteria and annual evaluations of the Board.
5. Orientation for new members.
6. Ongoing training;
The corporation should periodically organize training/reorientation for directors to acquaint them with latest management techniques, technological development innovations in areas of enterprise and to augment their skills to enable them to discharge their duties to the best of their abilities
7. Succession planning.
8. Board that are more representative of the make—up of communities; gender balanced, representation of youth, and representation of minorities.
CORPORATE GOVERNANCE: A SUGGESTIVE CODE

In view of the recommendations of the committees and deliberations of various academic and legal luminaries, an attempt has been made in this paper to put forward a desirable code of corporate governance;

(1) **Board of Directors**

The board of directors of a company is the most important pillar on which the whole structure of corporate governance is to be built. The board provides leadership and strategic guidance, objective judgment, independent of management to the company and exercise control over the company, while remaining at all time accountable to the shareholders, in view of revelations and the critical importance of the director, certain important suggestions should be followed;

A survey 500 concerns ranging from hospitals to Fortune 500 companies reveals;

(1) 30% of the boards actively help in giving strategic direction to the company (active governance).
(2) 30% of the board work to revise and ratify management proposals (nominal governance).
(3) 40% of the board merely ratifies management proposals (phantom governance).

(a) **Composition of Board of Directors**

The composition of board of directors; important in as much as it determines the ability of the board to collectively provide the leadership and ensure that no one individual or group is able to dominate that board. To follow this principle, it is desirable that 50% of directors should be non executive if chairman and C.E.O. is the same person; otherwise 30% of the directors should be non-executive.

(b) **Role of Non-executive Directors**

It is desirable that non-executive directors should play an important role in the management of the company, not merely interested in their perks and benefits. They should have complete knowledge about the working of the company, its accounting procedure and other relevant issues. They should bring an independent

Judgment to bear on board deliberation especially on issues of strategy, performance of conflicts and standards of conduct to encourage an active role of non-executive directors, they should be suitably compensated for their valuable services. They should get Rs.500 or sitting and 1% commission on profits. They be offered stock options in the company to link
performance with rewards. Along with incentives their performances should also be kept under watch. If a none—executive director fails to attend less than 50% meetings of Board of Directors they should not be considered for re—appointment.

(e) **Code of Conduct for Directors**

“Obviously not all well---governed companies do well in the market place. Nor do all badly governed companies always sink. But even the best performers risk stumbling, someday if they lack strong and independent board of directors” The members of board directors should devote sufficient time and care to the affairs of the company. There should minimum 4 meetings in a year with a maximum gap of 4 month. One person should not be a director in more than 10 companies at a time. Preferably the chairman of board of directors should be non-executive director. The directors should ensure balancing of interest of interest of different stakeholders, employees, customers, suppliers and local communities. There should be self introspection by the board. They should try to enforce the code of corporate governance in letter and spirit.

National Association of Corporate Directors (USA) has laid down 5 crucial elements, which affect the performance of a director;

- Personal characteristics.
- Core competence.
- Independence.
- Level of commitment.
- Team and company consideration.

Increasing pressures from society and shareholders is making mandatory for every board to follow this code religiously.

(d) It has been largely observed that the directors nominated by financial institutions are not very competent and they do not have much interest in the working of the company. In addition to this, they bring too much government interference with them; it is strongly recommended the financial institutions should have no direct role in managing the company. They would serve their cause better if they make more effective and pro—active use of their significant voting power at the General Body Meetings. If at all, they have to appoint nominee directors, these should be professionals, and not working or incompetent, retired employees of
the financial institution. In case of less than 5% shareholding by a financial institution, nominee director should not be appointed.

2. **Audit Committee**

“Shareholders require auditors to work with and not against management while remaining professionally objective, i.e. applying their Professional skills impartially and retaining a critical detachment and consciousness of their accountability to those who appoint them” (Cadbury Committee, 1991). There are few more reassuring to the investors and shareholders than accountability. The audit committee’s role flows directly from the board’s oversight function, it acts as a catalyst for effective financial reporting. It is strongly recommended that a qualified and independent audit committee should be set—up if the turnover of a company is 100 cores or paid up capital is Rs. 20 cores, whichever is less. The committee should have minimum 3 executive directors with adequate knowledge of accounts, finance, company law, etc. It should meet minimum 3 times in a year. The audit committee should interact with statutory auditors and internal auditors. The audit should help the board in meeting corporate accounting and reporting requirement, in exercising financial and accounting controls and supervision of financial and accounting controls and supervision of financial reporting process. The recent Enron debacle in USA has made the role of audit committee all the more important. If a company wants to ensure long—term goodwill, it will have to go for full transparency through audit committees otherwise public will start shifting their investments to public sector financial instruments.

3. **Disclosure of Financial and other Relevant Information**

Every company must ensure full disclosure about the following financial matters;

- Director’s remuneration and commissions, if any.
- Complete information about its divisions/ business segments, market conditions, future prospects.
- Funds rose from the public, utilization and balance.
- Foreign holding in share capital, loans, debentures raised in foreign exchange.
- Other Relevant disclosures;
✓ Report on relatives of directors having interest in the company.
✓ Register of interest of directors in any contract of the company.
✓ Directors’ shareholders in the company.
✓ Loans given to directors should not be more than 5 times of their annual remuneration and be given only for housing/educational/medical purposes.

This disclosure made for GDR issues should be followed completely in India as well.

4. Shareholders’ Rights

The shareholders are the owners of the company and as such they have every right to get complete relevant information about the company. It is strongly recommended that;

✓ All the shareholders must be treated at par and they should have same voting rights.
✓ In case of appointment/ reappointment of a director, they should be provided with;
  ▪ Brief resume of the director,
  ▪ Expertise in specific functional areas, and
  ▪ Names of companies in which the person holds directorship.
✓ Shareholders should be informed about material changes such as takeovers, sale of assets or divisions of the company and changes in capital structure.
✓ Shareholders should be provided information about economic value--added, market value--added, brand value, total shareholders and return, Human Assets Value during every year.
✓ The shareholders should be informed about the half--yearly performance of the company.
✓ Since only a fraction of shareholders can attend General Meetings, an opportunity to cast postal ballot should be provided to the shareholders on important issues.
✓ A grievance redressed committee should be formed under nonexecutive director to look into the complaints of shareholders regarding transfer of shares, none—receipt of balance sheet, nonreceipt of declared dividends, etc.

To ensure good corporate governance it should be made mandatory that a Compliance Certificate duly signed by the CEO and CFO should be insisted upon by all stock exchanges like London Stock Exchange.
CORPORATE GOVERNANCE POLICIES

The directors present below the Company’s policies on Corporate Governance.

A. Board Composition

1. Responsibilities of the CEO and the COO

The current policy of the Company to have an executive Chairman and Chief Executive Officer (CEO), and a Director and Chief Operating Officer (COO). There is a clear demarcation of responsibility and authority between the two. The CEO is responsible for corporate strategy, brand equity, planning, external contacts, acquisitions, and Board matters. The COO is responsible for all day-to-day operation-related issues and for the achievement of annual targets, customer satisfaction, sales, profitability, quality, productivity, and training and employee retention. The CEO, COO and the senior management make regular presentations to the Board on their responsibilities, performance and targets.

2. Size of the Board

The Board has seven Members, and periodically reviews the need for its expansion.

3. Executive and independent Directors

The Company’s board presently has three executive and four independent directors. In line with the policies of Corporate Governance prevailing in the country, the company will always maintain mix of independent and executive directors to reflect professionalism in the Company.

4. Board Membership Criteria

Board Member is required to possess the expertise, skills and experience required to manage and guide a growth Company. Expertise in strategy, technology, finance, quality and human resource is essential. They are not a relative of an executive of a director of an independent director. They are generally not expected to serve in any executive or independent position in any Company bin direct competition with pent media. Each Board Member expected to ensure that other existing and planned future commitments do not materially interfere with the Member’s responsibility as a director of pent media.

5. Membership Term

The Board regularly evaluates the contribution of its members, and recommends to shareholders their re-appointment as per statute. The current law in India mandates the retirement of one-third of the Board Members every year and qualifies the retiring Members
for re—appointment. The executive directors are appointed by the shareholders for a maximum period of five years term. However, the Membership term is limited by the retirement age for Members.

6. Retirement Policy

The Board has adopted a retirement policy for its Members. Under the policy, the maximum age of retirement of Executive Directors, including the CEO, is 60 years, which is the age of superannuation/retirement. The age for retirement from the Board is 70 years.

7. Board Compensation Review

The Compensation—Remuneration Committee determines and recommends to the Board, the compensation payable to the Members of the Board. The overall policy of the Committee is to institute such compensation and benefits for the employees, as well as for the Members of the management council, which reward performance as per set criteria. The Committee will review the compensation for all the management employees of the Company. The committee will formalize the compensation and benefits along with stock options adequate to motivate and retain senior officers of the Company. Independent directors are paid compensation by way of sitting fees for the Board Committee Meeting attended.

B. Board Meetings

1. Scheduling and Selection of Agenda Items for Board Meetings

Normally Board meeting are scheduled with proper notice in advance. Most of they are held at the Company’s Registered Office at United India Colony, Kodambakkam, and Chennai-24. The Company Secretary in consultation with the Chairman and CEO drafts the agenda for each meeting, along with explanatory notes, and distributes it in advance to the Board Members. Every Board Member is free to suggest the inclusion of items on the agenda. Normally, the Board meets once a quarter to review the quarterly results and other items on the agenda. The Board also meets on the occasion of the Annual Shareholders’ Meeting. On a need basis, additional meetings are held. A Committee of the Board meets as and when required for transacting business of a routine nature.

2. Availability of information to the members if the board
The board has complete access to information within the company. At the meetings of the Board, the Board welcomes the presence of managers who can provide additional insights into the items being discussed.

C. Board Committees

- **The Committees of the board**

  Currently, the board has three committees: the audit committee, the Share Transfer committee and the Remuneration/compensation committee. These committees are composed of majority of independent directors. The functions of this committee are described elsewhere in this report.

- **Assignment and terms of service of committee members**

  The Board decides, in consultation with the chairman and considering the views of individual Board Members, terms of service of various committees and the assignment of specific Board Members to various committees.

- **Frequency of Duration of committee meetings**

  The Chairman of the Board, in consultation with the Company Secretary of the Company and the Committee Chairman, determines the frequency and duration of the Committee meetings.

D. Management Review and Responsibility

1. **Formal evaluation of Officers**

   The Compensation Committee will review, evaluate and decide the annual compensation for officers of the Company from the level of General Managers and above. Further, the Compensation Committee decides the compensation and benefits for Board Members if any, as well as for the Members of the Management Council.

2. **Board Interaction with Clients, Employees, Institutional Investors, the Government and the Press**

   The Chairman and CEO manage all interaction with investors, the media, and the government. In this task, he seeks advice and help from the Director and COO as well as the CEO, where necessary. The Directors and COO manages all interaction with clients taking the advice and the help of the CEO, where necessary. Both the CEO and the COO handle employee communication.
Complains with Corporate Governance Codes

Corporate Governance has assumed great significance in India in the recent past. Even though the Companies Act, 1956 provides a framework for Corporate Governance, defined the powers, duties and responsibilities of the Board, and instituted a system of checks and balances with punishment for transgression of law, there was a need felt for a comprehensive code of Corporate Governance.

The Shri Kumar Mangalam Birla Committee on Corporate Governance appointed by the Securities Exchange Board of India (SEBI) submitted its report in November, 1999 and the report was accepted by SEBI in December, 1999. The recommendations of the Committee are mandatory for some companies effective fiscal year 2001, including your Company and compliance with the same is discussed below.

Compliance with the recommendations of the Shri Kumar Manglam Birla Committee on corporate Governance

The Company has complied with all the recommendations of the Committee.

(a) Company’s Philosophy on Corporate Governance

The Company is committed to good Corporate Governance. The Company provides detailed information on various issues concerning the Company’s business and financial performance. The Company respects the rights of its shareholders to information on the performance of the Company.

1.12 Corporate Governance: An evolutionary Process

The subject of corporate governance has assumed great importance at the present juncture of industrial history of the corporate world. Normally, in a developing economy and that too in earlier stages, the concept of corporate governance does not draw much attention, as the main emphasis is placed on the regulatory aspect of business and industry in consonance with the growth of the economy and the developmental processes set in motion. For instance, in case of India the initial process of the economic development concentrated mainly on such sectors of industry which constituted the core of the economy and were to be
used as the basal structure to give boost to various other processes in the field of economic growth and progress.

While the state control mechanism confined itself to demarcating the areas of development for the private and public sector enterprises and restricted its activity to the regulatory process like allocation of resources, grant of licenses and permits, installing the physical controls in the shape of import and export duties. Otherwise, the industry was left to manage its own affairs. This was so, as the resource inputs especially the financial resources had to be managed by the promoter from the family, friends, the moneylenders or other informal bodies. The public money was to be made available to various enterprises only through the financial institutions like banks. This way, the investors or the owners of the firms were the only people not directly affected by the use of resources and performance of an enterprise.

**ECONOMIC GROWTH**

With the growth of economy in India, and overall development in the advance countries, the general scenario and the pattern of interactions between the local economy and the various enterprises operating across the national boundaries necessitated a different type of approach for managing the economy and business in the various countries. Besides, the scope of activity of the international organization like UNO in the various social, economic, industrial, labor and managerial spheres led to specific formulation of strategies, polices procedures and operational mechanism for efficient management of the economy, on the lines advocated by its various organs.

As the process of industrial development and growth progressed further in the various countries, a dire need was felt for the mobilization of financial resources on a large scale for setting up of the various industries. Even the trading activity required enormous funds to finance and sustain their enhanced scale of activity. Services, which emerged as a vital activity to support the advanced economic systems also necessitated the acquisition of huge funds to finance their operations. The various consulting agencies and other engaged in similar occupations too created a demand for financial resources to support their activities.

**Board of Directors**

20
In the case of India, most of the public undertakings were mostly being administered by
the government with the help of bureaucrats in the ministry to oversee the working of PSUs. However, later with the extensive corporatization of business activity the government too
foermaised the institute of Board of Directors for the PUSs However, in the private sector as
most of the enterprises were owner managed, the promoter with the help of some active
members of the family or in some cases even friends constituted a sort of managing
committee which as per the provisions of company law was converted into the Board of
Directors.

The institution of Board of Directors has expanded considerably over a period of time
and most of the limited companies have to have a Board of Directors from the initial stage of
incorporation.

**Role of Board of Directors**

In the nominal circumstances the Board is expected to perform the functions which
ensure efficient management of an enterprise. The board plays the role of visionary and
oversee the working of a corporation in respect of implementation of the strategy evolved by
the CEO and other related agencies. It is assumed that the board will identify and nominate
the various directors on to the Board as per the criteria prescribed in this regard. The Board is
also expected to ensure the selection of competent CEO to manage the affairs of the
corporation. Accordingly the board is to lay down the requisite specifications in the context of
the job profile of the CEO. Appraisal of the performance of the CEO as also his retention and
removal and finding a substitute for succession or to develop the senior executive who could
step into the shoes of CEO are the other responsibilities of the board. It is also expected that
the board will have an effective audit committee, compensation committee and executive
committee of independent directors to ensure that the functioning of the Board is not
influenced by the CEO or other senior executives. Through the functions of a Board are akin
to fire fighting yet, in certain situations is has to assume an active role as has happened in the
case of US and Germany where, some of the corporations have been found guilty of
malapartices. Adequate level of compensation for the CEO and other top level executives is
the responsibility of the Board which has to ensure that performance is rewarded adequately
and suitably yet, greed is controlled to the extent possible.
Board of Directors is also expected to evaluate its own functioning from time to time. It is not only the impact of the resolutions passed by the Board but also ethical conduct of the activities of the Board members in this regard. The Board is also to ensure that the members do not have any direct interest in the working of the enterprise in terms of business contracts on any other professional or consultancy arrangements.

Check List

In many countries including India the Board of Directors have complied detailed check lists in regard to the composition of the Board, constitution of the committees, expertise of the members of the Board, integrity of the members and other related issues, to ensure that, the Board functions effectively in the larger interest of the corporation and the various stakeholders. The check list also demarcates the specific areas of activity for the Board as a whole, Directors, CEO and the committees.

Social Responsibility

In the case of India, the various business houses have constituted trusts for handling certain activities in the field of education, health, community service and so on. They also participate in certain other social activities in the area of philanthropy. While the cynics may dub the trusts as a sort of tax evasion mechanism yet, the business houses especially with high standard of integrity and public image like Tatas, Birlas, Singhanias and Reliance do undertake these activities as a part of their obligation to the society. Even MNCs are engaged in these activities in different parts of the world though their basic pre-occupation is with the proper running of business and profit-making. But as the society enables them to sustain their business, they consider it as an imperative to win the goodwill of the hosts by acting as good citizens.

Birth of Stock Markets

With a view to generate funds from a vast segment of investors in the various countries, the institution of stock market came into being. In case of India, an informal system known as satta in the local parlance was practiced in the various trading centres of the country. Initially, this system did not invoke much response from the government or controlling powers. But as the economy advanced and the process of stock markets came into existence this particular institution formalized the various processes of generation, started organizing themselves in
the form of chambers, associations and federations. CII, FICCI and the various bodies at the state level like PHDCCI came to be organized and activated for day-to-day coordination and operation of activity of these enterprises.

In the case of government, in addition to the department of company affairs the various other controlling bodies like SEBI were created to effectuate control on the proper working of the stock exchanges with specific focus on proper utilization of the public money and avoidance of its misuse and misappropriation by the unscrupulous elements.

**Listing of Companies**

To ensure proper safeguard of the investing public, SEBI has drawn up a list of requirements which need to be met by the various companies listing purpose of proper guidance of the corporate and to create a standard identity for these norms. Virtually, rules and regulations with homogeneous requirements are the steps in this direction.

**Accounting Standards**

The various countries of the world have laid down certain standard accounting guidelines for the various corporations of ensure that the reports and returns are complied and filed with controlling authorities in a standard format. International Standard Accounting Board (ISAB) and Federation Accounting Board (FAB) are the standards created for this purpose at international and national level. However each country has the prerogative of evolving its own accounting standards. Besides, it has been made incumbent on the various functionaries like chartered accountants, stock market analysts, brokers and agents, legal experts and fund managers to follow norms of high conduct and ethical practices in the discharge of their functions. Through its still remains a contentious issue especially, in the case of chartered accountants as to whether they should prescribe their own norms for their conduct, or some outside agencies should control their mode of conduct. This is true of India as also of other countries.

In any case, the subject of corporate governance will continue to evolve in the context of ever changing social, economic and political conditions at a given juncture of time. The process of governance and control has to be established in consonance with the contemporary social and economic needs of the society. May be, the standards and the controls prescribed today need to be revoked of updated or reformulations tomorrow.
**Stock Market Related Agencies**

With the institutionalization and professionalization of the economy a number of agencies have been established to undertake activities relating to the stock market functions in the interest of the corporate, investors, the financial institutions, regulatory authorize client services and various other stake-holders. These agencies carry out activities regarding day-to-day working of the stock market in the shape of buying and selling of shares, transfer of shares, forecasting value of stocks, analyzing the past, present and future trends and guiding investors in regard to the safety of their funds. Some other agencies are handling the technical operations of the stock exchanges regarding computerization of transactions, generation of information and its dissemination and overall control of the operations. For instance, stock brokers, market analysts, financial analysts, fund managers, custodians, chartered accountants, company secretaries, legal experts and some other are engaged in these services for effective running of the stock markets and offering useful guidance to the various stock-holders. The role of these agencies becomes important especially when a number of corporate float the issue. The various related activities like compilation of balance sheet of the company with adequate discloser and transparency has to be ensured for the guidance of the public. Regulatory bodies like SEBI, exercise control through oversight and regulation of the various processes involved in the effective working of the stock exchange. Their main concern is that through proper transparency and disclosure certain malpractices in the shape of insider trading and restricted, etc. are avoided to protect the interest of the public. Chartered accountants are endeavoring to ensure that proper accounting standards are maintained by their client companies.

**ROLE OF SEBI IN CORPORATE GOVERNANCE**

The SEBI, as the custodian of investor interests, did not lag behind. On May, 1999, it constituted an 18-member committee, chaired by the young and forward-looking industrialist, Mr. Kumar Mangalam Birla (a chartered accountant himself) on corporate governance, mainly with a view to protecting the investors’ interests. The Committee made twenty-five recommendations, nineteen of them mandatory in the sense that these were enforceable. The listed companies were obliged to comply with these on account of the contractual obligation arising out of the listing agreement with stock Exchanges.
The mandatory recommendations of the Kumar Mangalm Committee include the Constitution of Audit Committee and Remuneration Committee in all listed companies, appointment of one or more independent Directors in them, recognition of the leadership role of the chairman of a company, enforcement of Accounting Standards, the obligation to make more disclosures in annual financial reports, effective use of the power and influence of institutional shareholders, and so on. The committee also recommended a few provisions, which are non-mandatory. Let us see these recommendations in brief.

- The board of a company should have an optimum combination of executive and non-executive Director with not less than 50 percent of the Board comprising the non-executive Directors.
- The Board of a company should set-up a qualified and an independent Audit Committee.
- The Audit Committee should have minimum three members, all being non-executive Directors, with the majority being independent, and with at least one Directors having financial and accounting knowledge.
- The chairman of the Audit Committee should be an independent Director.
- The board of directors is combination of executive directors and non-executive directors.
- The non-executive directors comprise of promoter director and independent directors. Independent directors are those, who, apart from receiving director's remuneration, do not have any material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries that in the judgment of the Board may affect their independence of judgment.
- The chairman of the Audit Committee should be present at Annual General Meeting to answer shareholder queries.
- The company Secretary should act as the secretary to the Audit Committee.
- The Audit Committee should meet at least thrice a year. The quorum should be either two members or one-third of the member of the Audit Committee.
- The Audit Committee should have powers to investigate and activity within its terms of reference, to seek information from and employee; to obtain outside legal or professional advice, and to secure attendance of outsides if necessary.
- The Audit Committee should discharge various roles such as, reviewing any change in accounting policies and practices; compliance with Accounting Standards; compliance with
Stick Exchange and legal requirements concerning financial statement; the adequacy of internal control systems; the company's financial and risk management policies, etc.

- The Board of Directors should decide the remuneration of the non-executive Directors.
- Full discloser should be made to the shareholders regarding the remuneration package of all the Directors.
- The Board meetings should be held at last four times a year.
- A Director should not be a member in more than ten committees or act as the chairman of more than five committees across all companies in which he is a Director. This is done to ensure that the members of the Board give due importance and commitment of the meetings of the Board and its committee.
- The management must make disclosures to the Board relating to all material, financial and commercial transactions, where they have personal interest.
- In case of the appointment of a new Director or re-appointing of a Director, the shareholders must be provided with a brief resume of the Director his expertise and the names of companies in which the person also holds Directorship and the membership of committees of the Board.
- A Board committee should be formed to look into the redressal of share of shareholders complaints like transfer of shares, non receipt of balance sheet, dividend, etc.
- There should be a separate section on Corporate Governance in the annual reports of the companies with a detailed compliance report.

Apart from these, the Kumar Mangalam Committee also made some recommendations that are non-mandatory in nature. Some of the non-mandatory recommendations are that:

- The Board should set-up Remuneration Committee to determine the company's policy in specify remuneration packages for executive directors.
- Half-yearly declaration of financial performance including summary of the significant events in the last six months should be sent to each shareholder.
- Non-executive chairman should be entitled to maintain a chairman's office at the company's expense. This will enable him to discharge the responsibilities effectively.

It will be interesting to that Kumar Mangalam Committee while drafting its recommendations was faced with the dilemma of statutory v/s voluntary compliance. The
desirable code of Corporate Governance which was drafted by CII and was voluntary in nature did not produce the expected improvement in Corporate Governance. It is in this context that the Kumar Mangalam Committee felt that under the Indian conditions a statutory rather than a voluntary code would be far more purposive and meaningful. This led the Committee to decide between mandatory and nonmandatory provisions. The Committee felt that some of the recommendations are absolutely essential for the framework of Corporate Governance and virtually form its code, while others could be considered as desirable. Besides, some of the recommendations needed change of statute, such as the Companies Act for their enforcement. Faced with this difficulty the committee settled for two classes of recommendations.

SEBI has given effect to the Kumar Mangalam Committee’s recommendations by a direction to all the Stock Exchanges to amend their listing agreement with various companies in accordance with the ‘mandatory’ part of the recommendations. With its list of recommendations, the SEBI clearly addresses the rights, responsibilities and obligations of the different groups of stakeholders in the company. Although these changes are being implemented, one needs to consider that in many cases the most important stakeholder of an Indian company is likely to be the owner/proprietor himself. The owner usually controls management and typically members of the family are involved in the day-to-day supervision of the company. Even though the Company may be listed on the stock exchange, shares are mostly held within the family. The Board of Directors may be comprised of family members and close friends of the family.

REPORTS PRESENTED BY THE DIFFERENT COMMITTEES:-

In India the norms of corporate governance were introduced by different committees which are as under:

1. Cadbury Committee Report
2. CII Code on Corporate Governance
3. Recommendations of Kumar Mangalam Committee Report
4. Naresh Chandra Committee Report
5. Narayan Murthy Committee Report
1. **Cadbury Committee Report:**

   A Committee was setup in the UK in May 1991 under the chairmanship of Sir Adrian Cadbury (Sir Adrian Cadbury, former Chairman Cadbury Schweppes) by the Financial reporting Council, the London Stock Exchange and accountancy profession for reviewing the aspect of corporate governance related with financial reporting and accountability. The objective of the Committee was to help raise the standard of corporate governance and the level of confidence in financial reporting and auditing by setting out clearly what it sees as the respective responsibilities of those involved and what it believed was expected of them. The committee had submitted a 19 point report and a Code of Best Practice in December 1992. The report laid stress upon role of board of directors, duties of board and its composition, role of non-executive directors, directors emoluments, accounting practices and principles, effectiveness of internal control system and need for auditors acting with due care.

   Though the code had no legal basis, all companies registered in the UK and listed on the London Stock Exchange were required to state in their annual reports from July 1993, the Extent to which they complied with the code and give reasons for areas of non-compliance.

**The Code of Best Practice:**

- **The Board of Directors:**

  The Board should meet regularly, retain full and effective control over the company and monitor the executive management.

  There should be a clearly accepted division of responsibilities at the head of a company, which will ensure a balance of power and authority, such that no one individual has unfettered power of decision. Where the chairman is also the chief executive, it is essential that there should be a strong independent element on the board, with recognized senior members.

  The board should include non-executive directors of sufficient caliber and number for their views to carry significant weight in the board’s decision.

  The board should have a formal schedule of matters specially reserved to it for decision, to ensure that the direction and control of the company is firmly in its hands.

  There should be an agreed procedure for directors in the furtherance of their duties to take independent professional advice if necessary, at the company’s expense.

  All Directors should have access to the advice and services of the company secretary, who is responsible to the board for ensuring that board procedure, are followed and that
applicable rules and regulations are compiled with. Any question of the removal of the company secretary should be a matter for the board as a whole.

- **Non-Executive Directors:**
  
  Non-executive Directors should bring an independent judgment to bear on issues of strategy, performance, resources, including key appointments and standards of conduct.

  The Majority should be independent of management and free from any business or other relationship, which could materially interface with exercise of their independent judgment, apart from their fees and shareholding. Their fees should reflect the time which they commit to the company.

  Non-executive directors should be appointed for specified terms and re-appointment should not be automatic.

  Non-executive directors should be selected through a formal process and both this process and their appointment should be a matter for the board as a whole.

- **Executive Directors:**

  Director’s service contracts should not exceed three years without shareholders’ approval.

  There should be full and clear disclosure of directors’ total emoluments and those of the chairman and highest paid director, including pension contributions and stock options. Separate figures should be given for salary and performance related elements and the basis on which performance is measured should be explained.

  Executive directors’ pay should be subject to the recommendation of a remuneration committee made up wholly or mainly of non-executive directors.

- **Reporting and Control:**

  It is the board’s duty to present a balanced and understandable assessment of the company’s position.

  The board should ensure that an objective and professional relationship is maintained with the auditors.

  The board should establish an audit committee of at least three non-executive directors with written terms of reference which deal clearly with its authority and duties.

  The directors should explain their responsibility for preparing and accounts next to a statement by the auditors their reporting responsibilities.
The directors should report on the effectiveness of the company’s system of internal control.

The directors should report that the business is going concern with supporting assumptions or qualifications as necessary.

2. **Confederation of Indian Industry (CII)**

   **Code on Corporate Governance:**

   DCA had set up (NGCG) National Foundation for Corporate Government in Partnership with CII, ICAI and ICSI.

   For enhancing Corporate Governance standard in Indian, NFCG will take some important initiative, including training for board members. The broad objective of the National Foundation include providing a platform to deliberate issues relating to good corporate leaders on the important on importance of good Corporate Governance, self regulation and directional responsibilities statutory, social and environmental.

   The major recommendations of CII to foster good corporate governance in India are:-

   - The Board should meet a minimum of six times a year, preferably at an interval of two months, and each meeting should have an agenda item that require at least half a day’s discussion.

   - Any listed companies with a turnover of Rs.100 crore and above should have professionally competent and acclaimed non-executive directors, who should constitute :-
     1. At least 30 percent of the Board of the Chairman of the company is a non-executive director.
     2. At least 50 percent of the Board if the Chairman and managing director is the same person.

   - No single person should hold directorship in more than 10 companies. This ceiling excludes directorship in subsidiaries (where the group has over 50 percent equity stake) or associate companies (where the group has 25 percent but not more that 50 percent equity stake.)

   - The non-executive directors should participate actively in board meeting pay a commission over and above the sitting fees for the use of the professional inputs. The percent commission of 1 percent of net profits (if managing director) is sufficient and considers offering stock options to reward performance.
While reappointing members of the Board, companies should give the attendance record of the concerned directors. If a director has not been present (absent with or without leave) for 50 percent or more meetings, that this should be explicitly started in the resolution that is put to vote. As a general practice a non-executive director who has not attended even one half of the meetings should not be reappointed.

Key information must be furnished to the board to avoid informational asymmetry and it must contain information about annual operating plans, budgets and quarterly result of the company as a while and its divisions, internal audit reports, show cause notice or other important notices and details of defaults of payments due by he company. Details of joint ventures, collaborations, transactions that involve substantial payments towards goodwill, brand equity, etc. should be provided. Any issue which involves possible public or product liability claims of a substantial nature should be discussed. Details of recruitment and remuneration of senior officers just below board level must also be placed before the board.

3. Recommendations of Kumarmangalam Committee Repost:-

The Recommendations should make applicable to listed companies, their directors, management, employees and professionals associated with such companies and other body corporate.

- The board of directors of a company should have an optimum combination of executive and non-executive directors. In case the company has a non-executive chairman, at least one third of the board should consist of independent directors.
- A non-executive chairman should be entitled to maintain a chairman’s office at the company’s expense and also allowed reimbursement of expenses incurred in performance of his duties, so as to enable him to discharge his responsibility effectively.
- A qualifies and independent audit committee should be set up by the board of the company as per the composition and frequency suggested. Powers and functions of audit committee have also been prescribed.
- The board should set up remuneration committee to determine on their behalf and on behalf of shareholders with agreed terms of reference, the company’s policy on specific
remuneration package for executive directors including pension rights and any compensation payment.

- Board meetings should be held at least four times in a year, with a maximum time gap of four months between any two meetings.
- A director should not be a member in more than 10 committees or act as a chairman on more than five committees, across all companies in which he is director.
- Companies should be required to give consolidated accounts in respect of all their subsidiaries. Companies should be required to give segment wise reports, where a company has multiple lines of business.
- A management discussion and analysis report should form part of the annual report to the shareholders covering industry structure, opportunities and threats, segment wise or product wise performance, outlook, risks and concerns, internal control system, financial and operational performance and material developments in human resources/industrial relations.
- Disclosure must be made by the management to the board relating to all material financial and commercial transactions, where they have personal interest that may have a potential conflict with the interest of the company at large.
- For appointment of new directors, shareholders must be provided with a brief resume of the candidate, nature of his expertise and his other directorships.
- Information like quarterly results, presentation to analysis etc., may be put on its website or on its regional stock exchanges’ websites. A half–year financial performance report should be sent to all shareholders.
- A board committee under the chairmanship of a non-executive director should be formed to specifically look in to shareholders’ committees.
- The power of share transfer should be delegated to an officer or a committee or to the registrars and transfer agents. Shares should be transferred once in a fortnight.
- These recommendations may be implemented through the listing agreements.
- The company should arrange to obtain a certificate from his auditors regarding compliance of corporate governance provisions. This certificate should be sent to stock exchange and all shareholders.

4. Naresh Chandra Committee Report:
Separately, Naresh Chandra Committee appointed by the Department of Company affairs made recommendations, inter alia, on the issues of corporate governance:

- The auditors-company relationship, disqualification for audit assignments because of direct financial interest in audit client, loans and guarantees and business relationship between the company and the audit form.
- List of prohibited non audited services prescribed.
- Independence standard for consulting other entities that are affiliated for audited firms.
- Compulsory audit partner rotation.
- Disclosure of contingent liabilities by auditors.
- Setting up of independent override boards for supervising the work of auditors.
- Setting up an independent quality review board of auditors.
- Independent director defined. A part from following the criterion of family pecuniary business relationship, one should also not be director for more than three terms of three years and prescribed that not less than 50 percent of the board of directors should comprise independent directors.
- Minimum boards size prescribed.
- Provisions regarding the Audit Committee and its powers.
- SEBI not to exercise legislation. Special legislation exists.
- Improving facilities in the DCA offices.
- Setting up of a serious fraud office in the Department of Company Affairs.

Many of these recommendation aroused the ire of the corporate world for Example, limiting the term of directors for nine years has been contested. These recommendations have been questioned on the ground of creating space for micromanagement by DCA and SEBI. One gets the impression that the corporate world in India and its spokesmen are at best interested in paying lip service to the concept of corporate governance. While they do not want to give up their privileges, they also do not want to appear as bad guys. Many of these recommendations were contained in the companies (Amendment) Bill 2003 was not approved by the Cabinet.

One of the problems of the Indian system is the growing clout of the large corporate. No doubt, many of them are ethical. They are also creators of wealth. It is also a fact that without the
promoters, there would be no impulse for enterprise. The cost of corporate governance and regulation too should not be disproportionate to its advantages. On the other hand, many of the large corporate with increased business profits and association with powers that be do not sincerely believe in corporate governance and try to subvert this concept by means fair and foul. The inadequate competition law too has helped them acquire more power than what is good for the system. The battle of corporate governance has ultimately to be fought against them.

5. Narayana Murthney Committee Report:-

Recognizing that process of reforms is an on-going one, the SEBI appointed Narayana Murthy Committee on corporate Governance. Accordingly the committee reviewed the progress and made further recommendations. The covering letter of the chairman of the committee who gave the report to SEBI sums aptly the rationale of the corporate governance:

Corporation pool capital from a large investor base both in the domestic and in the international capital markets in management, when an investor invests money in a corporation, he expect the board and the management to act as trustees and ensure the safety of the capital and also earn a rate of return that is higher than the cost of capital. In this regard, investor expects management to act in their best interest at all times and adopt good corporate governance practices.

Corporate governance is the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinct between personal and corporate funds in the management of a company.

The Narayana Murthney Committee noted the following level of compliance of the corporate governance code as reported by 1026 companies of BSE and 595 companies of NSE:

• The compliance level in respect of requirements relating to board of directors. Audit Committee, shareholders Grievance committed and shareholders is very high.

34
Many companies are yet to comply with the requirements relating to remuneration and report on corporate governance.

Few companies have submitted that the provisions relating to managements and board procedures are not applicable.

The Narayana Murthy Committee also obtained SEBI’s observations on the compliance of the corporate governance code. The views of the SEBI as reported by the committee are worth repeating:

SEBI observe that the compliance with the requirements in clause 49 of the listing agreement is, by and large, satisfactory, however, an analysis of the financial statements of companies and the report on corporate governance discloses that their quality is not uniform. This is observed on the corporate governance report itself (which is often perfunctory in nature), and the business transacted and the duration of audit committee meetings. Variation in the quality of annual reports, including disclosures, raises the question whether compliance is in form or in substance; and emphasizes the need to ensure that the laws, rules and regulation do not reduce corporate governance to a mere ritual. This question has come under close scrutiny in recent times.

SEBI has analyzed a few recently published annual reports of companies to assess the quality of corporate governance. These reports could be classified into the following categories:

- Reports where there is no mention about the compliance with corporate governance requirements.
- Reports that state that the company is fully compliant with clause 49 of the listing agreement and provide explanation for non-compliance.
- Reports that mention areas on non-compliance with clause 49 of the listing agreement and provide explanation for non-compliance.
- Reports that mention areas on non-compliance with clause 49 of listing agreement but provide no explanation for auditor’s qualification or for reason for non-compliance.
SEBI also observed that there was a considerable variance in the extent and quality of disclosures made by companies in their annual reports.

6. The Organization for Economic Co-operation (OECD) Principles :-

As the globalization expanded to make the world more interdependent, the need for internationality accepted norms of corporate governance became more apparent and found expression in private sector, public sector and the Government thinking. The focal point of official efforts has been the OECD Principles of Corporate Governance, endorsed by OECD ministers in May 1999 and thereafter revised in 2004. The principles are based essentially on the existing legal and regulatory arrangements as well the best prevailing practices followed by market participants in the OECD countries. Support for this OECD initiative was reaffirmed on several occasions by various intergovernmental groups and international organisation as part of efforts to construct a sound architecture for corporate governance particularly after 1997 crisis.

The OECD revised its principles of Corporate Governance in the year 2004 to respond to corporate governance developments including corporate scandals that further focused the minds of governments on improving corporate governance practices. The revised OECD principles reflect a global consensus on critical importance of good corporate governance in contributing to economic viability and stability of economics.

The OECD has laid down certain principles, which can be globally adopted. These are:

- The Right of Shareholders :-
  Basic rights cover a wide ambit of rights from the first step of registration as an owner, transfer of shares, providing relevant and timely information on a regular basis.
- Equitable Treatment of Shareholders :-
  This is vital in many cases for controlling shareholders, boards and managements; use their over the corporation and over information to the detriment of non-controlling and foreign investors.
• The Role of Stakeholders :-

The Corporate Governance framework should recognize the legal rights of stakeholders and encourage active co-operation in creating wealth jobs and the sustainability of financially sound enterprises.

• Disclosure and Transparency :-

It is an essential element effective corporate governance system Timely and accurate information should be disclosed on all matters regarding the financial situation, performance, ownership and governance of the company. An independent audit and an audit committee are essential.

• The Role Board :-

Accountability of the board to the company and its shareholders is a basic tenet of sound corporate governance. It is the duty of the board to act fairly respect to all groups of shareholders and to assure compliance with applicable laws.

9. CORPORATE GOVERNANCE AT INTERNATIONAL LEVEL :-

The ability and incentive for institutional to transcend the rules and limitations of their domicile economies is evident from the creation of international associations dedicated to sharing information and developing global policies on investment and shareholder rights and responsibilities. The most prominent is the international Corporate Governance Network (ICGN), established in 1995, and now including membership overseeing over $10 trillion in assets. Its four primary purposes are:-

• To provide an investor- led network for the exchange of views and information about corporate governance issues internationally;
• To examine corporate governance principles and practices;
• To develop and encourage adherence to corporate governance standard and guidelines; and
• To generally promote good corporate governance.
The Global Corporate Governance Forum:-

Corporate governance is increasingly recognized as an important element of sustainable private sector development. The forum contributes to the efforts of the international community to promote the private sector as an engine of growth, reduce the vulnerability of developing and transition economies to financial crises, and provide incentives for corporations to invest and perform efficiently, in a socially responsible manner. It fosters cooperation with various corporate governance programs and plays a coordinating role among donors, founders, and other relevant institutions. The forum seeks to address the corporate governance weaknesses of middle-income and low-income countries in the context of broader national or regional economic reform programs.

The forum has an extensive work program to support corporate governance reform in developing countries. The focus of the work program is based on four core pillars as defined in its charter.

The work program of the forum is executed, managed, and implemented by the secretariat, which is the executive arm of the forum. The Secretariat is also responsible for disbursing funding in accordance with the procedure and criteria agreed by the Steering Committee of Donors and Founders.

1. Corporate Governance in GERMANY:-

In 2002, Germany adopted a new corporate governance code to respond to criticism of its previous system, and issued an amended version in 2006, with a commitment to an annual review. Highlights include:

- One share, one vote, with management obligated to “facilitate” the casting of proxy votes.
- Use of technology like the internet to make annual shareholder meetings accessible.
- “good Corporate governance required an open discussion between the Management Board and Supervisory Board as well as among the members within the Management
Board and the Supervisory Board. The comprehensive observance of Confidentiality is of paramount importance for this.”

- “In the event of a takeover offer, the Management Board and Supervisory Board of the target company must submit a statement of their reasoned position so that the shareholders can make an informed decision on the offer.”
- Annual report of compliance with governance principles by the company.
- Disclosure of compensation and conflicts of interests.
- “All members of the Supervisory Board are bound by the enterprise’s best interests. No member of the Supervisory Board may pursue personal interests in his/her decisions or use business opportunities intended for the enterprise for himself/herself.

2. Corporate Governance in CHINA:

As with the former Soviet and Eastern Bloc countries, China is evolving from a state-owned enterprise (SOE) system, with companies controlled by a committee of the communist part, the trade union, and employees’ representatives, to something more along the lines of a public corporation, directed by shareholders and directors. But the Chinese government continues to maintain block holdings in many “public” companies that guarantee it still has control. Signals are mixed and inconsistent and so are results.

The Chinese government recognized the limitations and disadvantages of state control of businesses, using the term “scientific management” as an alternative to the problems of “Random decision – making, relaxed management, undisciplined job performances, and low – level managerial abilities” in SOEs. Business enterprises need effective mechanisms of incentive and restraint and the implementation of checks and balances inside the corporate governance structure. The corporate law of 1994 was designed to promote and provide incentives for these new structures. But some government agencies still insist on approval of corporate decision – making, effectively short circuiting structural efforts to assure some independence. And the law gives shareholders rights in matters left to directors in other countries, like approving the budget and profit distributions. This may be a reflection of the governments’ interest in maintaining control or it may be a reflection of the cultural priority of share decision – making. In either event, it does not qualify as “scientific management.”
The Chinese Securities Regulatory Commission has adopted a Code of Corporate Governance (2002) and guidelines for independence of directors (2001). But their legal foundation is uncertain and is at this writing being challenged. Enforcement is weak and there are not enough qualified directors to serve on boards. Spencer Stuart’s 2007 corporate Governance Lexicon cites an economic study by Qiao Lie and concludes, “Shareholder protection is poor; insider trading rife, and listed companies tend not to take the maximization of shareholder value as their prime directive.”

The hugely publicized effort in China to modernize has obscured that the bottom line is about ensuring the party maintains its monopoly on political power. There continues to be a rash of trials for “corruption” as there continues to be seemingly limitless commitment to expansion in whatever combination with foreigners seems to suit the moment. And yet “The party remains a nimble beast. A few year ago, it noticed the explosive growth of the private sectors. So the part began inviting entrepreneurs to officially join its ranks and establishing cells inside private companies to ensure they did none incubate an alternative political force.”

Chinese enterprise exists on perhaps the highest level of productivity in the world. The extent of citizens’ capacity effectively to assert the integrity of “property” rights against the government must be considered uncertain. What about the sustainability of a system of government that combines political authoritaritharianism and economic liberalization? Ms. Ying Fang says: “Economic reforms will naturally affect the political system and in the long run democracy will emerge but that will take time as the legal framework is in its infancy… China has made a transition from communism to pragmatic socialism. Make no mistake. Private businessmen understand the need to provide returns to shareholders. But they are also supportive of the modernized ideology that most believe offers the best way for China to develop the economy to make it strong enough to take on the world. It is about Patriotism.” She adds: “Ad Den Xiasoping Said: ‘It does not matter if the cat is black or white, as long as it can catch mice.”

3. Corporate Governance in JAPAN:-

Corporate governance in Japan used to be characterized by cross shareholding among banks and client companies or companies that formed conglomerates. The cross – holding companies and banks exerted influence on the management of a certain company as client or
creditor in addition to or rather than as a shareholder. The interests of other stakeholders such as employees and clients also tended to come before the power held by shareholders. “Thus, given the context of cross shareholding, decisions made by the executive board were considered to reflect the will of employees, clients, or regulatory agencies rather than that of shareholders. Against this background, the composition of shareholders in Japan began to change due to various factors such as bursting of the bubble economy, the consequent downslide of the status of banks, the growth tendency to seek more efficient fund management, increasing foreign investment in Japan because of the internationalization of the capital market, and the expanding influence of institutional investors.”

Yoshiaki Murakami comes from a wealthy Osaka family and has a traditional background as a regulator in the Japanese bureaucracy. He became persuaded that Japanese companies were poorly governed and that values were lost and careers diluted because of the entrenchment of inefficiency. He organized funds, with some foreign backing, and began a program of trying to bring corporate governance in Japan up to global levels. His now–defunct MAC fund called for higher dividends and equity repurchases, using the proxy power associated with large equity holdings and making hostile bids.

Early in 2006, Murakami was arrested for making use of “insider information” in the management of his funds. He pled not guilty, but his fund was liquidated. The question arises as to whether Murakami is really being prosecuted for challenging the Japanese establishment. But the fate of his fund has not deterred activist investor Warren G. Lichtenstein's Steel Partners Japan Strategic Fund, which is stepping up efforts to challenge vulnerable Japanese firms by inducing them to boost stock prices under the threat of acquisition.

Financial Times journalist John Plender wrote on March 15, 2007: “Whatever the outcome in the courts, it is already clear that Japan’s tradition to a more shareholder-friendly form of corporate governance will be a very governance is part of the solution is Japan’s chronic tendency to over invest and generate poor returns on capital by global standards.”

4. Corporate Governance in SOUTH AFRICA:

Corporate activity will only achieve the goal of sustainable wealth maximization if doing so is compatible with long – term policy goals like a healthy environment and a strong economy. One outstanding effort to make this explicit is the King report.

Governance in any context reflects the value system of the society in which it operates. Accordingly it would be pertinent to observe and to take account of the African world view and culture in the context of governance of companies in South Africa. Some aspects of which are set out as follows:

- Spiritual Collectiveness is prized over individualism. This determines the communal nature of life; where household live as an interdependent neighborhood.
- An inclination towards consensus rather than dissension helps to explain the loyalty of Africans to their leadership.
- Humility and helpfulness to others is more important than criticism of them.
- In the main, African culture is non-discriminatory and does not promote prejudice. This explains the readiness with which Africans embrace reconciliation at political and business levels.
- Co-existence with other people is highly valued. The essence of ubuntu (humanity) that cuts across Africa is based on the premise that you can be respected only because of your cordial co-existence with others.
- There is an inherent trust and belief in fairness of all human beings. This manifests itself in the predisposition towards universal brother hood, even shared by African Americans.
- High standards of morality are based on historical precedent. These are bolstered by the close kinship observed through totem or clan names and the extended family system.
- A hierarchical political ideology is based on an inclusive system of consultation at various levels. The tradition of consultation as practiced by the chiefs since time immemorial should form the basis of modern labor relations and people management practices.
- Perpetual optimism is due to strong belief in the existence of an omniscient, omnipotent and omnipresent superior being in the form of the creator of mankind.

5. Corporate Governance in PAKISTAN;

Corporate entities in Pakistan are primarily regulated under the Companies Ordinance 1984, the Banking Companies Ordinance 1962, and Securities and Exchange Commission of Pakistan Act, 1997, Insurance Ordinance 2000 and the various rules and regulations made there under.
The introduction of the Code of Corporate Governance in Pakistan in March 20002 (Code) by Securities and Exchange Commission of Pakistan (SECP) was a major step in corporate governance reforms in Pakistan to establish a formwork for good governance of companies listed on Pakistan’s stock exchanges. This was soon followed by two reports issued by SECP in April 2003 on Harmonizing the Code of Corporate Governance with the other laws/regulation in Pakistan and in September 2003 on Impact Assessment of the Code. In keeping with recommended practice, World Bank carried out a Review of Observance of Standards & Codes (ROSC) in 2005. A pioneering effort was then made with Mr. Zaffar A. Khan in his personal capacity carried out a survey on The Effectiveness of Boards in Pakistan in 2006 and this wa supplemented by the Karachi Stock Exchange Survey on Corporate Governance in the same year and with International Finance Corporation (IFC) funding a further survey of Corporate Governance Practices in Pakistan which was issued in November 2007.

The Code as it exists today is a compilation of “best practices” which was developed partly as “principal based” and partly as “code based” to provide a direction to companies listed on Pakistan’s stock exchanges with the objective of safeguarding the interests of stakeholders and promoting market confidence.

- Implementation of Pakistan Code:

The Code is a comprehensive document, setting out the rules and guidelines to provide a better governance structure and is applicable to all listed companies through its implementation in the Listing Rules & Regulation. Additionally, the State Bank of Pakistan which is the apex regulator bank in Pakistan has implemented Corporate Governance Guidelines as part of its prudential regulations governing banking companies. These guidelines follow a stricter observance of governance practices than in the Code itself. Subsequently, SECP which regulates Non-Banking Finance Companies has issued separate instructions requiring such companies to observe the Code.

It was noted that the Code required revision in the light of best governance practices globally to fill any gaps or loopholes that might be present and go unaddressed consequent to the voluntary nature of observance of most of the principles set out in the Code. More so as the
shareholding structure of listed companies was largely controlled by single majority groups be these family, multinationals or public sector, with limited dispersal or broad-basing of shareholdings. The saving grace has been the cumulative system of voting for election of directors that was introduced at the time of the Companies Ordinance 1984.

- Increase of awareness:

  Pakistan Institute of Corporate Governance (PICG) was set up in 2004 as a public-private partnership with SECP playing a pivotal role in conjoining SBP and seventeen other associations that were all concerned with corporate governance. PICG is today a hybrid Institute of Governance and Institute of Directors. As the Institute of Governance, it increases awareness and champion the cause of good governance practices and, as the Institute of Directors, it develops professionalism and encourages engagement of corporate bodies and individuals in the role of effective oversight. This business model is unique in the IFC MENA Region and has been recognized as a success story for other countries in the Region to emulate.

  PICG is indeed a leading provider of knowledge about best practices in corporate governance to all key stakeholders affected by corporate governance by improving the quality of corporate governance in Pakistan.

- Regulatory buy-in for review:

  SECP requested IFC in November 2006 to conduct a review of the Code. SECP would provide clearance, direction and co-ordination in the process. However, IFC recommended that PICG should undertake the task since it was better equipped and already in process of promoting good governance practices in Pakistan. The matter was taken up in the PICG board on which SECP and SBP were both represented. Additionally, the elected Chairman of the PICH Board was the then Chairman of SECP.
Project Identification and Approval:-

The first and foremost task was to identify a Chairman most appropriate for heading the taskforce that was to be constituted for reviewing the Code. The Board of Directors of PICG proposed Mr. Ebrahim Sidat was one of the key charged with developing the Code in 2002. The other taskforce members were engaged in consultation with the Chairman.

Project task force:-

An eleven member taskforce was set up in December 2007 to review the Code. The Taskforce included a representative of SBP, the banking regulator, two professional independent directors on boards of companies, two representatives from industry, the country representative of Centre for International Private Enterprise, USA (CIPE), a senior professional accountant in public practice and the managing directors of the three stock exchanges in the country.

After developing the terms of reference, initial meeting included engaging a consultant to develop position paper providing a gap analysis in the light of available surveys and reports to highlight the points for deliberation by the taskforce members.

The taskforce proceeded to meet on 23 occasions and covered in its deliberations:-

- The definition, number and the process of election of Independent Directors
- Separation of the Chairman and the CEO positions
- Need and time period for the orientation courses for directors
- Fit and proper criteria for corporate directors and disclosure of this information
- Non-executive director’s remuneration
- The tow-tier implementation of corporate governance regime
- The critical role of Succession planning
- Board evaluation
- Whistle-blowing function in enterprises
- Ethics policy
- Statement of Compliance with the Code of Corporate Governance
• Audit Committee; appointment and removal of auditors
• Need for, and method of limiting the liability of independent directors
• Need for a standard disclosure policy
• Related party transactions
• Applicability to public interest entities & other non-listed companies

10) MODELS OF CORPORATE GOVERNANCE:-

There is considerable debate about what actually constitutes corporate governance. Its key elements, however, concern the enhancement of corporate performance through supervision or monitoring of management performance and ensuring accountability of management to shareholders and stakeholders as set out above. Four structural attributes of the modern corporate have been highlighted (Saba, 1977):
• Separate identity
• Limited liability
• Centralized management
• Transferability of shares

The weakness of absence of one or more of these pillars significantly impairs any corporation’s efficiency. The central feature of the corporation of 1960s was its authoritarian power structure, with the superior-subordinate pair relationship as the fundamental building block. Ultimate authority for all decisions lies at the top and this authority is delegated or withheld by the superior at each level. Most of the state-owned enterprises suffer from these types of structures.

It would be worthwhile to examine different models of corporate governance that exist in the developed world to see whether they have any lessons to offer to us and whether any model is worth emulation with such modifications as would suit our body politic. In the context of the discussion outlined earlier, there is a broad convergence on the laws and forms of corporate organization and a few models like the Anglo-American, German and the Japanese are the ones selected for description for this purpose.
- Model-1: Anglo-American Model of corporate governance has a corporate structure where the board of directors elected by the shareholders (owners) act as supervisors. Shareholders generally exercise their control over a private corporation through the board of directors. The board has three functions: representation, direction and oversight. In this model, it appoints and supervises the managers who manage the day-to-day affairs of the corporation.

**Diagram 1.1**

While the legal system provides the structural framework, the stakeholders in the company will be employees, suppliers and creditors. But the creditors exercise their lien over the assets of the company. The board oversees the implementation through a well-designed information system. The board of directors, being responsible to their appointers—the shareholders commits to them certain returns within the broad counters of the market framework.

It will ensure an efficient organization for production. Exchange and performance monitoring. However, there is no agreement on the cost effectiveness or efficiency of the model (macey 1998) make a very optimistic assessment of the U.S. corporate governance system,
Jensen (1993) finds it deeply flawed. It will not be costless for the market to provide a greater supply of institutional investor monitoring.

**Mode-II:** In the case of the *German Model* of corporate governance, although the shareholders own the company, they do not dictate the governance mechanism. Fifty percent of the members of the supervisory board are elected by the shareholders while the other fifty percent are appointed by the labour unions. This system implies that employees and labor are not just the stakeholders but they enjoy a share in governance. They are equally responsible for the policy that has to be implemented by them for the profit of the organization.

The supervisory board appoints and monitors the management board. There is a reporting relationship between both the boards although the management board independently conducts the day-to-day operations of the company. One represented on the management board. Therefore, the governance mechanisms have imbibed workers’ participation. German banks can own corporate stock unlike the U.S. banks. Although the German Universal Banks as group cast 54 to 64 percent of the votes in 1992 without absolute majority there is no evidence that they had acted as effective institutional monitors on behalf of the shareholders.
• Model-III: In the Japanese Model, the financing institution has a crucial role in the governance structure. The shareholders and the bank together appoint the board of directors. Unlike in the other models, the president is also appointed by the shareholders and the bank. The relationship of the board to the president is hierarchical in nature. The president consults the board. Even, otherwise, the board generally ratifies the president’s decisions.

Although shareholders own the company, the financing bank has a crucial role. The executive management, which steps into the shoes of the board of directors, performs the management function. In fact, the financing bank provides even the managerial personnel and motors the management function. It also has powers to supersede the board when it become expedient or in a state of emergency.

All the three models have found methods for combining economic and control rights into large blocks, in order to overcome the ineffectiveness of fragmented voting power. In Germany, it takes the form of large investors, with their voting clout sometimes augmented by proxy control. In Japan, it takes the form of coordinated networks, acting through institutions like the president’s council and the main bank. Both these arrangements are relatively stable, whereas in the U.S. the aggregation is ad-hoc; voting power is assembled for the occasion, through a proxy contest or tender offer of a leveraged buyout. While techniques differ, they appear to be addressing a common need in effective governance system (Scott, 1998).
Diagram 1.3

- Model-IV: The Indian Model is an amalgam of the Anglo-American and German models (Chart 7-4). The Indian corporate can be typified into three distinct patterns:-
  - Private Company
  - Public Enterprise
  - Banks.

The pattern of private companies is mostly that of closely held or dominated by a founder, his family, and associates. The role of external equity finance is small; the business is financed by retained earnings and heavily by debty (Tata group, Reliance group, Birla group etc.)
In respect of public enterprises, the board is formed by the central/state government and even where divestiture has taken place, hold of the government continues to be dominant. Here, the issues concerning protection of stakeholders generally take a back seat. Large corporations are, therefore, often run more in the interest of the government than in the interest of efficiency and maximization of aggregate shareholder wealth.

The appropriation of corporate opportunities, excessive compensation, and consumption and managerial perks do not merit much discussion of the board as they are decided externally a government policy. Participation of workers is recognized trade union – sometimes both of the workers and officers separately where two separate unions exist – whose voice does not represent the concerns of the organization.
Governance model of the sub-sectors like insurance, banking, non-banking finance companies etc, in the Indian context are kept out of the purview of discussion in this paper in view of the complexity of laws, rules, and regulations that bind those structures.

In coordination with the Confederation of Indian Industry (CII), Federation of Chambers of Commerce and Industries (FICCI), and other apex industry organizations, the Department of Company Affairs is in the process of evolving a draft corporate governance code.

Structural changes in corporate governance call for a paradigm shift in the constitution of board. Admittedly the processes are only the means to an end bringing into fore the thoroughness, openness and objectivity in the reviews of system should be very crucial to proper governance.

CHALLENGES FACED BY CORPORATE GOVERNANCE

Challenges faced by Corporate which are detrimental to the effective implementation and following of Corporate Governance are; Ineffective Leadership of the Chairman; One might be tempted to say why? I would say—can a ship reach the shore without the able guidance of its captain? On the same grounds, lack of competence by the board members is often the cause of an organization’s misfortunes with each pulling the sails in the direction he pleases. The ship stalls mid—water and eventually flounders and goes under. This is followed up by a lack of trust amongst Member of the Board and the staff down the line as they (Members of the Board) show a lack of interest and time to address important issues. The functions, roles, responsibilities are not defined and this leads to lack of clarity between role of Management and the Board. All the above leads to a state of perceptual change showing that there is less predictability in decision—making which is needed for quick decisions while on the other hand there awaits more complex issues to be dealt with. The problems cited above show that there is no sustained commitment to vision, mission and values across the organization. All this would eventually lead to poor Management Information System a case where too much or too little would arise. And above all a stupid mentality would develop such as “Accession to the throne” mentality leading to harsh undercurrents, which can dislodge even an edifice.
All said and done the challenges do not end just there. Further the Corporate Governance is faced with a challenging task of recruitment of Members of the Board. This is all the more important as even one misfit can spoil the show just as one rotten apple can spread the rot to a basket full of apples. So selection of the right Member of the Board is of prime importance for proper Corporate Governance to be in place. It has to put in place a succession plan so that the right candidate is to fill the slot as the older one moves out, just as Lord Tennyson said the old order changed giving way to new. So with present day scenario—we have to be ready to move in and move out to sustain the ever—dynamic process of change.

The size and cost of the boards should not such be that weight above becomes so huge that let alone the organization, they would not be able to sustain themselves and the organization would collapse like a house of cards. (This would be much clear from the Ranbaxy case). A good corporate governance system must ensure that the enterprise does not fall short in fulfilling this obligation, hence good governance, in the context of a publicly traded company, implies.

(a) Optimal utilization of resources for enhancing the value of the enterprise by effectively monitoring executive performance and supporting entrepreneurship spirit.

(b) Ethical corporate behavior in honoring and protecting the rights of all stakeholders.

(c) Corporate governance is the structure and process of;

(d) Monitoring executive performance.

(e) Ensuring accountability of management to shareholders,

(f) Motivating management towards creating value for shareholders,

(g) Protecting interests of other stakeholders including the local community.

Adding value Addition through Good Governance which;

✓ Provides stability and growth to the enterprise.
✓ Is demonstrated by adoption of good corporate practices, builds confidence.
✓ Reduces perceived risks, consequently reducing cost of capital.
✓ In the knowledge driven economy excellence in soft skills such as management, will be the ultimate tool for the corporate to leverage a competitive advantage in the financial market
✓ Good corporate practices promote stability and long—term sustenance of all.
✓ A good corporate citizen becomes a role model and enjoys a position of pride.

✓ Potential stakeholders aspire to enter into relationships with an enterprise whose governance credentials are exemplary.

Another important challenge that faces the Corporate Governance is having effective communication with its own members and the public, i.e. the shareholders;

(a) The enterprise should maintain an interactive communication web site having for two—way communication with shareholders. The web site must include key information regarding the enterprise and must be updated regularly.

(b) The enterprise should publish quarterly financial reports.

(c) The enterprise should display in its web site the comments of the chairman of the board/CEOs on important reports relating to the enterprise published in important newspapers/journals/electronic media.

(d) The enterprise on its web site the number of suggestions received from shareholders in last three months.

(e) The enterprise must display on its web site the names, e-mail addresses, etc. of key personnel to facilitate communication.

(f) The enterprise must display on its web site the number of grievances received and redressed in last three months and the number of unsettled grievances.

(g) The enterprise shall display at its web site a brief resume of its directors.

(h) The enterprises must send to each household of shareholders the half yearly financial results including the summary of events in

In order to remain competitive the organization must ensure implementation of never technologies. This is the surest way of cutting costs besides proper utilization of money of the shareholders.
Theory of Dividend policy

(a) **INTRODUCTION:**

A major decision of the financial management is the dividend decision and the firm has to choose between two things.

(b) **Distributing profits to the shareholders and**

(c) **Ploughing them back into the business.**

The profits of a company that remain after meeting all the expenses, provision for taxation and depreciation and transferring a reasonable amount to reserve funds is called 'divisible profits' or 'surplus'. A portion of this surplus is distributed among the shareholders of the company as dividend and the balance is retained or ploughed back in the business for meeting future needs of funds. How this surplus should be bifurcated between dividends and retained earnings, depends upon the rational decision of the directors. Payment of dividend is desirable, because the shareholders invest in the capital of the company with a view to earn higher return and to maximize their wealth. On the contrary, retained earnings are the sources of internal finance for financing future development and expansion programmes of the company. If a large portion of the surplus is distributed as dividend among the shareholders then the management has to depend upon external sources like debentures or new issue of shares for financing future expansion and working capital needs. Thus, both growth and dividends are desirable. But they are in conflict, a higher dividend amounts to less provision of funds for growth and retention of large earnings leaves a little amount of funds for dividends to which shareholders may react strongly. Therefore the finance manager has to formulate a guidable dividend policy in such a way as to strike a compromise between dividend payments and retention.

**MEANING OF DIVIDEND:**

Etymologically the word 'Dividend' is derived from the Latin word 'Dividendum' which means 'that which is to be divided'. This distribution is made out of the profits remained after deducting all expenses, providing for taxation and transferring a reasonable amount to reserves from the total income of the company such distribution of profit is made as a fixed percentage of paid up capital or fixed amount per share. Thus, a dividend is that portion of profits and surplus funds of company which has actually been set aside by a valid act of the company for distribution among its shareholders on record at a fixed date in proportion to their...
holding to be paid on demand or at a fixed time. In other words, a dividend of a defined as divisible profits which are distributed amongst the members of a company in proportion to their shares in a manner as is prescribed by law.²

✓ Sufficient profits in the company
✓ Recommendation of the Board of Directors.
✓ An acceptance of the shareholders in the annual general meeting.

❖ Definition:

- **Institute of Chartered Accountant of India.**
  "A dividend is a distribution to shareholders out of profits or reserve available for this purpose."³

- **Dr. S.N. Maheshwari:**
  "The Dividend may be defined as the return that a share holder gets from the company out of its profits, on his share holdings."⁴

- **Khan & Jain**
  "Dividend refers to that portion of a firm net earning which are paid out to the share holders."⁵
KINDS OF DIVIDEND:
Dividend may be to different kinds.

The figure 1.5 given below shows the common classification of dividends.⁶

Diagram 1.5
A brief description of each of these dividends is made here.

1. **Preference dividend:**
   Preference dividend is paid on preference shares. It is paid at the fixed rate which is mentioned at the time of issue of preference share. This dividend is paid before the payment of equity dividend. The decision to pay or not pay preference dividend is taken by the board.
of directors. But, the board of directors has no freedom of choice to reduce the rate of preference dividend.

2 **Equity Dividend:**

Equity dividend is paid on equity shares at the rate recommended by the board of directors and approved by the shareholders in annual general meeting. The board of directors have freedom of choice with regard to payment or non-payment of dividend, the rate of dividend and the medium of dividend i.e. cash dividend or non – cash dividend. Because of the maximum managerial freedom available in the case of equity dividend, most of the discussions on dividend policy relates to equity dividend.

3 **Interim Dividend:**

Interim dividend is a dividend which is declared between two annual general meetings. If the profits are good in a firm the board of director may from time to time pay interim dividend to its share holders. However, the director have to consider many important aspects such as cash resources, orders in hand any seasonal element in business otherwise it may capital be considered out of capital.

4 **Cash Dividend:**

The usual practice is to pay dividend in cash payment of dividend in cash results in outflow of funds from the firm. The firm should, therefore, have adequate cash resources at its disposal or provide for such resources so that its liquidity position is not adversely affected on account of distribution of dividend in cash for such resources. Generally, shareholders are interested in cash dividend and according to sec.205 (3) of the companies ACT also dividend is payable in cash only.

5 **Stock Dividend or Bonus Shares:**

Sometime, a Company cannot pay dividend in cash due to shortage of liquid funds in spite of large amount of reserve and surplus. under such circumstance, the company issues new shares are known as 'stock dividend' or 'bonus shares', Thus, stock dividend or bonus shares represent a distribution of share in lieu of or in addition to cash dividend to the existing shareholders as per the guidelines issued by the central government. The issue of bonus shares is the conversion of profits into capital; therefore, it is also called 'capitalization' of profits. This capitalization of profits may take two forms.
Making the partly up shares fully paid up without asking for cash from the shareholders, or
Issuing or allotting fully paid up shares to the existing shareholders in a define proportion free of cost.

The issue of bonus shares results in an increase in number of shares and hence increases the paid up capital of the company without involving any monetary transaction. Such shares are issued to all the existing shareholders in proportion to their holdings of share capital of the company. Thus, bonus shares do not alter the proportional ownership of the company as far as the existing shareholders are concerned. In other words, the owner's equity or net worth remains unaltered.

6  **Scrip or Bond Dividend:**

Scrip dividend is the dividend paid by a company to its shareholders in the form of scrip's i.e. shares and debentures of another companies or a promissory note. This form of dividend is used by a company when it faces a Temporary financial crisis in spite of high earnings Scrip and bond dividend differ only in respect of time period. In case of scrip dividend, the time period is short term whereas in bond dividends are not in practice in India after the companies Amendments Act, 1960.

**MEANING OF DIVIDEND POLICY:**

Dividend policy is a flexible and comprehensive term. In narrow sense, dividend policy means the policy followed by the board of directors concerning quantum of profits to be distributed as dividend. In broader sense, dividend policy refers the determination of the principal's rules and procedure for the planning of distribution dividend after deciding the rate of dividend. The oxford Dictionary defines a policy as "the plan of action accepted by a person or organization." A company's dividend policy can be defined as the plan of action adopted by its directors whenever the dividend decision is to be made."

Thus deciding a dividing policy is the most significant decision among three important decisions (investment, financing and dividend) of the financial management as the dividend policy determines the division of earnings, generally remains in business, are of much use for financing the replacement of assets and expansion programmes of the company. On the one
hand, dividend entails cash outflow and consequently reduction in current assets. Distribution of dividend at high rate results in reduction in current assets. Distribution of dividend at high rate results in reduction of ploughing back of profits and slackness in the rate of development. On the other hand merge distribution of dividend causes dissatisfaction among the shareholders. Therefore it is imperative for the directors to follow an unambiguous and balanced dividend policy.⁷

Definition:

- **R.P. Rustagi, Fundamentals of Financial Management**

  "Dividend policy is basically concerned with deciding whether to pay dividend in cash now or to pay increased dividends at a later stage or distribution of profits in the form of bonus shares.

- **Dr. S.N. Maheshwari**

  "The term dividend policy refers to the policy concerning quantum of profits to be distributed as dividend."

**OBJECTIVES OF DIVIDEND POLICY⁸:**

The firm's dividend policy represents a plan of action to be followed whenever the dividend decision must be made. The dividend policy must be formulated with two basic objectives in mind: maximizing the wealth of the firm's owners and providing for sufficient financing. These objectives are not mutually exclusive, rather, they are interrelated.

1. **Wealth Maximization:**

   The firm's dividend policy should be one that supports the general objective of maximizing the wealth of the firm's owner's over the long run. It must be designed not merely to maximize the share price in the coming year, but to maximize wealth in the long run, since the firm is assumed to have an infinite life. Of course, theoretically we expect that shareholders and prospective investors will recognize the long run effects of a dividend policy on their ownership and that this recognition will be reflected in the level of future returns they forecast.
Providing for sufficient financing:

Making provision for sufficient financing can be considered a secondary objective of dividend policy. Without sufficient financing to implement acceptable projects, the wealth maximization process cannot be carried out. The firm must forecast its future funds needs and, taking into account the eternal availability of funds and, taking into account the eternal availability of funds and certain market consideration, determine both the amount of retained earnings financial needs and the amount of retained earnings available after the minimum dividends have been paid. The important point to remember here is that amount of retained earnings financing available must be forecast on an after dividend basis, since the market can be expected to react adversely to the nonpayment of cash dividends.

ESSENTIALS OF A SOUND DIVIDEND POLICY:

Sound dividend policy is a long-term policy that aims in maximization of shareholders wealth. While determining such a policy investment opportunities of the firm, its present economic status and investors preference. Should be given due weight age. Sound dividend policy remains stable during prosperous and lean years. Dividend is paid in cash and stock dividend is paid only when the amount of reserve exceeds too much. Generally a sound dividend policy contains the following elements:

1. **Distribution of Dividend in cash:**
   A dividend policy is good only when dividends are paid in cash. Dividend paid in property, scrip or bond is not considered good. Indian companies Act also prohibit distribution of dividend other than in cash except issue of bonus shares by capitalizing the profits.

2. **Initial Lower Dividend:**
   In the beginning, a company should declare dividend at low rate so that a substantial part of the profits is available as a source of internal financing. It will strengthen the financial position of the company. Initially lower dividend is also helpful in development and expansion of the company. Therefore, the rate of dividend should be increased gradually as the company prospers.

3. **Gradual Increase in Dividend:**
With the increase in price level, the income of the company also increases. The shareholders expect similar increase in their income. Therefore, the rate of dividend should be increased gradually so that there may not be any discontent among the shareholders. If there are super profits in any particular year, then extra dividend or interim dividend can be declared.

4 Stability:

Stability of dividend means that there should not be too much fluctuations in the rate of dividend. During stability, the rate of dividend is increased gradually and slowly. Payment of dividend at very high rate in a year and no dividend in next year results in high speculation in share of a company. Therefore, payment of stable and regular dividend is considered better than heavy fluctuations.

5 Dividend out of Earned Profits:

Dividend should be declared out of earned profits. If there is any loss in the profit and loss account, it should be written off and then dividend should be declared out of remaining profits. Moreover, all governmental restrictions on dividend should be compliance.

TYPES OF DIVIDEND POLICY:

The dividend policy should be determined by taking into consideration the aforesaid factors. But, if a clear-cut dividend policy is developed, it is in the interest of both the shareholders and the company. A financial manager can recommend any one of the following dividend policies:

1 Stable Dividend Policy:

Stability of dividend means similarity or no change in dividend payments over the years. In other words, when a company pays divided at a fixed rate and follows it for future years to come regardless of fluctuations in the level of earnings, it is said to be a stable dividend policy. Thus, stability of dividends refers to regular payment of dividend at a fixed rate. Stable dividend policy increases credibility of the management in the market and shareholders also prefer such stock giving minimum return at regular interval leads to increase in market price of shares. Those companies whose earnings are stable follow this policy. The stability of dividend is described in two different ways viz.
1. Constant dividend per share
2. Constant pay-out ratio
3. Constant Dividend per Share:

Under this policy, the firm pays a fixed amount per share as dividend to its share holders. However, the earning may fluctuate from year to year and so the firm has to be careful in setting the dividend amount at a reasonable level. The dividend per share is not increased or decreased for a temporary increase or decrease in earnings but only for maintainable increase of decrease. It is shown in the following figure.

![Diagram 1.6](image)

The dividend policy is quite popular and investors also favor this type of policy as it will enable them to plan their investment. Moreover, steady regular and constant dividend per share the firm.

a. Constant Pay-Out Ratio:

In this policy, a fixed percentage of net earnings are paid as dividend every year that is constant payout ratio. For example, a company adopts a 60% payout that is 6% of net earnings of the company will be paid as dividend and 40% of net earnings will be transferred to reserves. No dividend is paid in the of loss. Companies generally, prefer this policy because
it reflects the ability of the company to pay dividends. But it is not preferred by shareholders as the return fluctuates with the amount of earnings.

Diagram 1.7

2  **Policy of Regular Plus Extra Dividend:**

A firm may adopt a policy of paying a steady dividend together with paying some extra whenever supported by the earnings of the firms. The extra may be paid in the form of cash, or bonus shares, depending upon the firm’s liquidity position. The tem extra is used to tell the shareholders that this is extra and may not be maintained in future.

From the view point of the management a constant dividend per share together with an extra dividend when supported by higher earnings will be more flexible will be more flexible. However, the policy of extra dividend if adopted on a regular basis, the firm may run the risk of having share holders treating this extra component as really a part of regular annual dividend. Therefore, it is desirable to preserve the true meaning of the extra dividend.

3  **Policy of Regular Bonus Dividend:**

Under this policy, the company pays dividend in the form of its shares instead of cash. Such shares are designated as 'Bonus Shares' which is often used to capitalize company's
retained earnings. It does not at all effect the liquidity position of the company but increases the shareholding of the owners. This policy can be justified in the following circumstances:

➢ When the company needs cash generated by its earnings to cover its modernization and expansion schemes.

➢ When the company is deficient in cash despite high earnings.

    This policy should be followed temporarily. If it is followed for a long time, the earnings per share would decline and the value of shares would decline and the value of shares in the market would adversely be affected. Besides, this policy is not favored by those shareholders who have strong preference for cash dividend.

4  Policy to Pay Irregular Dividend:

    Under the policy of irregular dividend, the amount of dividend to be paid by the company of shareholders fluctuates with the changing level of earnings. The larger the earnings, the higher are the dividend and vice-versa. This policy is adopted due to (I) uncertainty of earnings; (ii) inefficient operations of business; (iii) shortage of cash and (iv) fear of adverse effect of regular dividend policy of the financial position of the company.

    Generally, this policy is adopted when companies have fluctuating investment opportunities. A large part of the profits should be retained in the year in which the company has profitable investment proposals whose execution may result in sufficient profits. On the contrary, if in any year the company has limited or no investment opportunities, the management may distribute larger share of earnings as dividend.

5  Policy of No Immediate Dividend:

➢ When directors of the company decide to declare no dividend despite large earnings, then it is known as policy of no immediate dividend. This policy is usually pursued in the following circumstances:

➢ When a company is new which requires a huge amount of funds for development purposes?

➢ When company's access to capital market is difficult for raising additional funds or availability for additional capital is costlier.

➢ When shareholders have strong preference for long-term capital gains in lieu of cash dividend.

    After the expiry of no dividend period the company should either pursue the policy of paying stock dividend from its reserves or company's shares should be split into shares of
small amount so as to keep dividend per share low and larger amount of dividend to shareholders. Such an action is necessary to keep share prices at reasonable level.
### Table 1.1 LEGAL FRAMWORK OF DIVIDEND

<table>
<thead>
<tr>
<th>Section</th>
<th>Legal Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>205 (1) &amp; (2) Depreciation should be charged before payment of dividend.</td>
<td>A company can pay dividend out of current profit and profit earned in any earlier financial years after charging depreciation as per the requirement of the companies Act. Depreciation is provided as the rates given in schedule XIV to the companies Act. This schedule gives minimum depreciation rate. But a company can charge higher depreciation rate. But a company can charge higher depreciation. For this purpose it has to charge at least 95% of the original cost of the asset over its useful life.</td>
</tr>
</tbody>
</table>
| 205 (2A) Compulsory transfer to Reserve before payment of dividend. | As per the companies (Transfer of profits to Reserve) Rules, 1975 a company has to transfer the following % of current profits.  
- Dividend proposed exceeds 10% but not 12.5% of the paid of capital 2.5%  
- Dividend proposed exceeds 12.5% but not 15% of the paid of capital 5.0%  
- Dividend proposed exceeds 15% but not 20% of the paid of capital 7.5%  
- Dividend proposed exceeds 20% of the paid of capital 10.0% |
| Can a company transfer higher % to reserves? | Voluntary transfer of higher % of profit to reserves is |
allowed, when the company declared dividend:

It has to maintain average rate of dividend declared by it over the last three years.

In case bonus shares are issued and its paid up capital has been increased a company has to maintain average of dividend declared over the last three years.

However, in case the net profit after tax of the company is lower by 20% or more in a year as compared to the average net profits after tax of the two preceding financial year, it is not required to maintain average rate or amount of dividend as stated above. If the company does not declare dividend, then amount proposed to be transferred from reserves should be lower than the average amount of dividend declared by in over last three immediately preceding financial year.

<table>
<thead>
<tr>
<th>205 (2B) compliance with the requirements of section 80A</th>
<th>Dividend on equity shares cannot be paid unless the company redeems irredeemable preference shares. Presently, it is not permissible to issue irredeemable preference shares.</th>
</tr>
</thead>
<tbody>
<tr>
<td>205 (3)</td>
<td>Dividend should be paid in cash only. However, a company can capitalize profit by way of issue of bonus shares.</td>
</tr>
<tr>
<td>205 A(1)</td>
<td>Dividend is declared by the shareholders in the annual general meeting on the basis of the dividend proposed by the board of direction. Dividend should be paid within 30* days from the date of declaration. In case a company cannot pay such dividend, it is to be transferred to a special account called &quot;unpaid Dividend Account... Company Ltd./(Pvt.) Ltd.</td>
</tr>
</tbody>
</table>

---

68
In case company wants to pay dividend out of reserves because of inadequacy of profit in any year, it should follow the companies (Declaration of dividend out of reserves) rules, 1975. The guidelines are:

1. The rate of dividend cannot exceed the average rate of dividend declared in the immediately preceding five years, or 10% of the paid up capital, whichever is less.

   i. Total amount to be drawn from accumulated profit earned in the previous year. The profit so drawn should be utilized first to set off any loss incurred during the financial year before payment of dividend.

   ii. The balance of reserves after such transfer shall not fall below 15% of its paid share capital.

Free reserves do not mean capital reserve & revaluation reserves.

Any money transferred to the unpaid dividend account and remains unpaid or unclaimed for a period of seven years should be transferred to Investor Education and Protection Fund established under section 205 C of the companies Act.

Dividend is to be paid to the registered shareholders or to their order or to their bankers.

Penalty for failure to distribute dividends within forty two days where a dividend has been declared by a company but has not been paid, or the warrant in respect thereof, has not been posted, within forty two days from the date of the declaration, to any shareholders entitled to the payment of the dividend, every direction of the company shall, if he is knowingly a party to the default,
be punishable with "simple imprisonment for a term which may extend to seven days and shall also be liable to fine". Provided that no offence shall be deemed to have been committed within the meaning of the foregoing provision in the act.\(^{(21)}\)

*substituted for 42 days by the companies (Amendment) Act, 2000

1. **FACTORS AFFECTING DIVIDEND POLICY:**

   It is a generally accepted principle that that director of a company has sole right to declare dividend and determine its amount out of company's earnings. But, in addition to legal restrictions, they have to consider many factors while deciding the dividend policy. A rational distribution of earnings has been very beautifully described in a legal case. Accordingly, the net earnings that should be distributed among the shareholders depends largely upon the company's needs for accumulated reserves to strengthen its credit, increase its working capital, carrying contemplated projects of expansion or provide contingencies against future hazards. In the light of this statement, the different factors which determine the dividend policy of a company are explained below\(^{11}\).

   i. **Stability of Earnings:**

      The nature of business has an important bearing on the dividend policy. Industrial units having stability of earnings may formulate a more consistent dividend policy than those having an uneven flow of incomes because they can predict easily their savings and earnings usually, enterprises dealing in necessities suffer less from oscillating earnings than those dealing in luxuries of fancy goods.

   ii. **Age of Corporation:**

      Age of the corporation count much in deciding the dividend policy. A newly established company may require much of its earnings for expansion and plant improvement
and may adopt a rigid dividend policy while, on the other hand, and older company can formulate a clear cut and more consistent policy regarding dividend.

iii. Liquidity of Funds:

Availability of cash and sound financial position is also an important factor in dividend decisions. A dividend represents a cash outflow, the greater the funds and the liquidity of the firm the better the ability to pay dividend. The liquidity of a firm depends very much on the investment and financial decisions of the firm which in turn determines the rate of expansion and the manner of financing. If cash position is weak, stock dividend will be distributed and if cash position is good, company can distribute the cash dividend.

iv. Extend of share Distribution:

Nature of ownership also affects the dividend decisions. A closely held company is likely to get the assent of the shareholders for the suspension of dividend or for following a conservative dividend policy. On the other hand, a company having a good number of shareholders widely distributed and forming low or medium income group would face great difficulty in securing such assent because they will emphasise to distribute higher dividend.

v. Needs for Additional Capital:

Companies retain a part of their profits for strengthening their financial position. The income may be conserved for meeting the increased requirements of working capital or of future expansion. Small companies usually find difficulties in raising finance for their needs of increased working capital for expansion programmes. They having no other alternative, use their ploughed back profits. Thus, such companies distribute dividend at low rates and retain a big part of profits.

vi. Trade Cycles:

Business cycles also exercise influence upon dividend policy. Dividend policy is adjusted according to the business oscillations. During the boom, prudent management creates food reserves for contingencies which follow the inflationary period. Higher rates of dividends can be used as a tool for marketing the securities in an otherwise depressed market.
The financial solvency can be proved and maintained by the companies in dull years if the adequate reserves have been built up.

vii. Government policies:

The earnings capacity of the enterprise is widely affected by the change in fiscal, industrial labour, control and other government policies. Sometimes government restricts the distribution of dividend beyond a certain percentage in a particular industry or in all spheres of business activity as was done in emergency. The dividend policy has to be modified or formulated accordingly in those enterprises.

viii. Taxation Policy:

High taxation reduces the earnings of the companies and consequently the rate of dividend is lowered down. Sometimes government levies dividend – tax of distribution of dividend beyond a certain limit. It also affects the Capital formation. North India, dividends beyond 10% of paid up capital are subject to dividend tax at 7.5%.

ix. Legal Requirements:

In deciding on the dividend, the directors take the legal requirements too into consideration. In order to protect the interests of creditors an outsider, the companies Act 1956 prescribes certain guidelines in respect of the distribution and payment of dividend. Moreover, a company is required to provide for depreciation on its fixed and tangible assets before declaring dividends on shares. It proposed that dividend should not be distributed out of capita, in any case. Likewise, contractual obligation should also be fulfilled, for example, payment of dividend on preference shares in priority over ordinary dividend.

x. Past Dividend Rates:

While formulating the dividend policy, the directors must keep in mind the dividend paid in past year. The current rate should be around the average past rate. If it has been abnormally increased the shares will be subjected to speculation. In a new concern, the company should consider the dividend policy of the rival organization.

xi. Ability to Borrow:

Well established and large firms have better access to the capital market than the new companies and may borrow funds from the external sources if there arises any needs. Such companies may have a better dividend pay-out ratio. Whereas smaller firms have to depend
on their internal sources and therefore they will have to build up good reserves by reducing the dividend payout ratio for meeting any obligation requiring heavy funds.

xii. Policy of Control:

Policy of control is another determining factor is so far as dividends are concerned. If the directors want to have control on company, they would not like to add new shareholders and therefore, declare a dividend at low rate. Because by adding new shareholders they fear dilution of control and diversion of policies and programmes of the existing management. so they prefer to meet the needs through retained earnings. If the director do not bother about the control of affair as they will follow a liberal dividend policy. Thus control is an influencing factor in framing the dividend policy.

xiii. Repayments of Loan

A company having loan indebtedness are vowed to a high rate of retention earnings, unless one other arrangements are made for the redemption of debt on maturity. It will naturally lower down the rate of restrictions on the dividend distribution still such time their loan is outstanding. Formal loan contracts generally provide a certain standard of liquidity and solvency to be maintained. Management is bound to hour such restrictions and to limit the rate of dividend payout.

xiv. Time for Payment of Dividend:

When should the dividend be paid is another consideration. Payment of dividend means outflow of cash. It is, therefore, desirable to distribute dividend at a time when is least needed by the company because there are peak times as well as lean periods of expenditure. Wise management should plan the payment of dividend in such a manner that there is no cash outflow at a time when the undertaking is already in need of urgent finances.

xv. Regularity and Stability in Dividend Payment:

Dividends should be paid regularly because each investor is interested in the regular payment of dividend. The management should, inspire of regular payment of dividend, consider that the rate of dividend should be all the most constant. For this purpose sometimes companies maintain dividend equalization fund.
b. **DIVIDEND POLICY THEORIES:**

Over the time various theories of dividend policy have emerged, some of the main theories are as follows.

![Dividend Theories Diagram](image)

i. **Relevance Theory:**

+ Relating to this theory there are following two models.

i) **Dividend Gordon's Model:**

It is based on the following important assumptions:
a) Retained earnings represent the only source of financing  
b) Rate of return is constant.  
c) Growth rate of the firm is the product of retention ratio and its rate of return.  
d) Cost of capital remains constant and is greater than growth rate.  
e) The company has perpetual life.  
f) Tax does not exist.

Argument:

"Gordon argues that the investor does have a preference for current dividend and there is a direct relationship between the dividend policy and the market value of the share".  
R.P.RUSTANGI

He believes that the investors are basically risk averse and they evaluate the future dividend/capital gains as risky. Dividend is more predictable than capital gains and also management can control dividend but can't dictate the market price of the share. In short an investor values current dividend more highly than an expected future capital gains.

ii) Walter's Model:

This is also best on relevance theory of dividend policy. It is based on following assumptions:

a) All investment proposal of the firm are to be financed through retained earnings only.  
b) The firm has an infinite life.  
c) All earnings are either distributed as dividends or invested internally immediately.  
d) With additional investment, undertaken, the firms basic risk does not change.  
e) There is no change in the key variables such as EPS & DPS. It considers that the investment decision and dividend decision of a firm are interrelated. According to him the market value of a share is the present value of the expected stream of dividend and capital gains.

ii. Irrelevance Theory:

Modigliani and Miller have argued that a firm's dividend policy has no effect on its value of assets. I.e. if the rate of dividend declared by a company is less its retained earnings
will increase and so also the net worth and vice-versa. This theory is based on a number of assumptions. The following are the most important.

1. There are no personal or corporate income taxes.
2. There is no stock floatation of transaction costs.
3. Dividend policy has no effect on the firm's cost of equity.
4. The firms capital invest policy is independent of its dividend policy.
5. Investors and managers have the same set of information regarding future opportunities.

➢ **Clientele effect:**

This effect states that a firm will attract stockholders whose preferences with respect to the payment pattern and stability of dividend match with the firms payment pattern. So, the clientele of the firm get what they expect, and the value of the firm's shares is unaffected by the dividend policy.

➢ **Argument for Irrelevance:**

They argue that the value of the firm is determined by its basic earning power and its risk class. Therefore the firms value more depend on its asset investment policy and not much on how earnings are split between dividend & retained earnings.

**DIVIDEND MODELS:**

There are three dividend models of which two are of dividend relevance and the one is for dividend irrelevance.\(^{13}\)

**Walter models:**

Prof. James E. Walter argued that in the long run the share prices reflect only the present value of expected dividends. Retentions influence stock price only through their effect on future dividends. Walter has formulated this and used the dividend to optimize the wealth of and equity shareholder. His formula in determination of expected market price of a share is given below:
\[ r (E - D) \]
\[ D + \frac{\text{----------------------}}{\text{Ke}} \]
\[ P = \frac{\text{------------------------}}{\text{Ke}} \]

Here,

\[ P \quad = \quad \text{Market price of equity share} \]
\[ D \quad = \quad \text{Dividend per share paid by the firm} \]
\[ r \quad = \quad \text{rate of return on investment of the firm} \]
\[ \text{Ke} \quad = \quad \text{cost of equity capital} \]
\[ E \quad = \quad \text{EPS of the firm} \]

**Assumptions**

Walter model is based on the following assumptions:

- All financing is done through retained earnings and external sources of funds like debt of new equity capital are not used. Retained earnings represent the only source of funds.
- With additional investment undertaken, the firm's business risk does not change. It implies that firm's IRR and its cost of capital are constant.
- The return on investment remains constant.
- The firm has an infinite life and is going concern.
- All earnings are either distributed as dividends or invested internally immediately.
- There is no change in the key variables such as EPS and DPS.
Gordon Growth Model:

The dividends of most companies are expected to grow and evaluation of value shares based on dividend growth is often used in valuation of shares. Dividend valuation model assumes a constant level of growth in dividends in perpetuity. The Gordon Growth Model is a theoretical model used to value ordinary equity shares. The model incorporated the retention of earnings and growth of dividends and hence it is also called as dividend Growth valuation model. The main proposition of the model is that the value of a share reflects the value of the future dividends accruing to that share. Hence, the dividend payments and its growth are relevant in valuation of shares. The model holds that shares market price is equal to the sum of shares discounted future dividend payments.

\[
P_0 = \frac{E_1 \cdot (1 - b)}{K - b_r}
\]

Here

- \(P_0\) = Price per share at the end of year.
- \(E_1\) = EPs at the end of year 1.
- \(1 - b\) = Fraction of earnings the firm distributes by way of Dividend
- \(K\) = Rate of return required by share holders.
- \(b\) = Retention ratio
- \(b_r\) = Growth are of earnings and dividends.

**Assumption:**

Gordon Growth Model using dividend capitalization is based on the following assumptions:

- The firm is an all-equity firm and has no debt.
- External financing is not used in the firm. Retained earnings represent the only source of financing.
The internal rate of return is the firm's cost of capital 'K'. It remains constant and is taken as the appropriate discount rate.

Future annual growth rate dividend is expected to be constant.

Growth rate of the firm is the product of retention ratio and its rate of return.

Cost of capital is always greater than the growth rate.

The company has perpetual life and the stream of earnings is perpetual.

Corporate taxes do no exits.

The mode provided by Walter and Gordon Growth model lead to the following implications:

- If $r > k$ price per share increase as dividend payout ratio decrease.
- If $r < k$ price per share increase as dividend payout ratio increase.
- If $r = k$ price per share remains unchanged with change in dividend payout ratio.

<table>
<thead>
<tr>
<th>TYPE OF FIRM</th>
<th>OPTIMUM PAYOUT RATIO</th>
</tr>
</thead>
<tbody>
<tr>
<td>GROWTH FIRM</td>
<td>NIL</td>
</tr>
<tr>
<td>NORMA</td>
<td>IRRELEVANT</td>
</tr>
<tr>
<td>DECLINING FIRM</td>
<td>100%</td>
</tr>
</tbody>
</table>

Modigliani and Miller's model:

They have argued that firm's dividend policy has no effect on its value of assets. According to them the value of the firm is determined by its basic earnings power and its risk class.

Modigliani and Miller's model has given the following formula:

\[
P_0 = \frac{P_1 + D_1}{1 + K_e}
\]

Here,

$P_0 =$ Prevailing market price of a share.
Ke = cost of equity capital
D1 = Dividend to be received at the end of period one.
P1 = Market price of a share at the end of period one.

.Iterator:

Modigliani and Miller's built their argument on a number of assumptions, the most important of which were:

- There are no personal or corporate income taxes.
- There are no stock floatation costs, transaction costs a brokerage fees.
- Dividend policy has no effect on the firm's cost of equity.
- The firm’s capital investment policy is independent of its dividend policy.
- Investors and managers have equal and cost less access to information regarding future opportunities.
- All investors can lend or borrow at the same rate of interest.
- No buyer or seller of securities can influence prices.
- Dividend decisions are not used to convey information.
- Perfect capital market exists with free flow of information.
- No tax differential between distributed and undistributed profits as also between dividends and capital gains.
- Investment opportunities and future net income of all companies are known with certainly to all market participants.

DIVIDEND PAYMENTS PROCEDURE:

A public company's board of directors determines the amount of the firm's dividend. The board sets the amount per share that will be paid and decides when the payment will occur. The date on which the board authorizes the dividends is the declaration date. After the board declares the dividend, the firm is legally obligated to make the payment.

The firm will pay the dividend to all shareholders of record on a specific date, set by the board, called the record date. Because it takes three business days for shares to be registered, only shareholders who purchase the stock at least three days prior to the record date receive the dividend. As a result, the date two business days prior to the record date is known as Ex-dividend date; anyone who purchases the stock on or after the ex-dividend date will not
receive the dividend. Finally, on the payable date (or distribution date), which is generally about a month after the record date, the firm mails dividend checks to the registered shareholders.

**FIGURE 1.9**
**IMPORTANT DATES FOR MICROSOFT'S SPECIAL DIVIDEND**

<table>
<thead>
<tr>
<th></th>
<th>Declaration Date</th>
<th>Ex-Dividend Date</th>
<th>Record Date</th>
<th>Ex-Dividend Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board declares</td>
<td>July 20, 2004</td>
<td>November 15, 2004</td>
<td>November 17, 2004</td>
<td>December 2, 2004</td>
</tr>
<tr>
<td>special dividend of</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$ 3.00/ share</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**DIVIDEND AND FIRM'S LIFE CYCLE:**

The payout policy of firms undergoes systematic changes over their life cycle. New firm or firms that are in the growth stage pay very low or no dividends as during this initial growth period firms retain funds to finance investment. Mature firms that are no longer in a growth phase of their life cycle pay high and increasing dividends. Thus, dividend payout keeps increasing as firms grow more mature and finally a stage arises where a firm's cash flow exceeds its capital needs, and during this liquidation stage, excess cash is distributed generously in the form of cash dividends to the shareholders.
FIGURE 1.10

<table>
<thead>
<tr>
<th>STAGE OF GROWTH</th>
<th>Stage I</th>
<th>Stage II</th>
<th>Stage III</th>
<th>Stage IV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction</td>
<td>Rapid Growth</td>
<td>Maturity</td>
<td>Decline</td>
<td></td>
</tr>
</tbody>
</table>

| DIVIDEND POLICY | No Dividend | Low Dividend payout policy | Growing or increasing pay out policy | Generous Dividend Payout |

**CONCLUSION:**

The usual practice in a company is to apportion a part of the profit for dividend payment and to retain the other payment and to retain the other part of for investment in profitable channels. Determination of the ratio between dividend payment and retention of earnings is very important. There are different views in this respect M.M. hypothesis suggests that dividends payment or no dividend payment has the same impact on the value of a firm. The share holders are therefore indifferent towards dividend. However in imperfect market conditions, where taxes and transaction cost exist, shareholders prefer cash dividend. Residual theory prefers retention of earnings; however smoothened residual theory suggests that retention should be preferred only after constant dividend payment. Walter believes that retention dividend ratio influences shareholder wealth. It raised share prices only when return from investment is greater than the capitalization rate. Gordon and Ezra soloman are in favor of dividend payment as it has a positive impact on share price. There are certain factors that influence dividend payments, such as shareholders expectation, financial requirements, legal and other constraints etc.

Dividend should be stable. It is normally paid in cash forms. Sometimes, however it is also in form of shares that are known as bonus shares.
REFERENCES

10. CII- Code for Corporate governance, April 1998.
11. Clifford C. Nelson, President of American Assembly once noted, “Corporate Governance
16. Dr. Parmjit Kaur & Dr. Suveera Gill (2008), ‘The Effects of Ownership Structure on Corporate Governance and Performance: An Empirical Assessment in India,
34. Kumar Mangalam Birla Committee Report by SEBI May 1999.
36. Lal C. Chugh Et Al (2010), ‘Corporate Governance and Firm Performance: Evidence from India, the journal of Financial and Accountancy,
49. OECD Principles of Corporate Governance, April 1998.
56. Rejie George Pallathitta (2005), ‘Corporate Governance And Firm Performance: An Analysis Of Ownership Structure, Profit Redistribution And Diversification Strategies Of Firms In India’
58. S.C Gupta and Mr. M.K Sehgal, the Changing Horizons of Corporate Governance.
61. Sir Adrian (2002), Corporate Governance and Chairmanship: A Personal View Oxford University Press, Oxford,