CHAPTER 1
INTRODUCTION TO CORPORATE GOVERNANCE

Corporate Governance is a system by which firms are managed. The stages of development of Corporate Governance and its systems synchronize with the evolution of the economy, corporate structure, ownership groups, political and legal developments of a country. Academicians, practitioners and researchers have evolved different theories and models describing different facets of governance and its practices across different countries of the world. In this process, metrics are also being developed to measure Corporate Governance and its processes. In India prior to the economic reforms of 1992, the development of Corporate Governance was slow but post liberalization rapid strides have been made in its development to converge with global practices.

This chapter covers these aspects and is organized as follows.

- Origin and development of Corporate Governance
- Definition of Corporate Governance
- Theories of Corporate Governance
- Models of Corporate Governance
- Development of regulatory framework
- Issues in Corporate Governance
- Corporate Governance indices and firm performance
- Development of Corporate Governance in India
- Indian model of Corporate Governance

1.1 Origin and development of Corporate Governance

The concept of governance is as old as human civilization and the word 'governance' has come into use from the time of Chaucer in the fourteenth century. It has only recently come to prominence in the business world because of conflicts of interest between the shareholders and the business managers of the firm. Economic aspects
necessitate the existence of firms because they either avoid or internalize some of the transaction costs using price mechanisms (Coase, 1937). Many activities become redundant in firms because of team working which improves the efficiency of the firm (Alchian & Demsetz, 1972). Benefits arising out of economies of scale and scope, monopoly gains and technology support the formation and growth of firms (Barzel, 1982; Williamson, 1981). Modern legal systems also foster the growth of the firms because they permit incorporation of firms as a separate legal entity, separate from the owners of the company.

In this process there is transfer of power from the owners to the managers of the firm resulting in the formation of two groups; the first being shareholders (principal) who are the legal owners; the second being managers (agents) who are appointed by the shareholders because managers have greater expertise to run the affairs of the firm. This eventually results in managers deriving discretionary powers to operate the firm. Over a period, managers develop the tendency to become de facto owners rather than the de jure owners pursing their own interests rather than that of shareholders. The shareholders also cannot directly observe all the actions of the managers, resulting in information asymmetries and moral hazard (Spence & Zeckhauser, 1971). Managers also have incentives to expropriate the firm's assets benefiting themselves thereby impacting shareholder's wealth (Jensen & Meckling, 1976; Fama & Jensen, 1983; Shleifer & Vishny, 1986).

The following quote of Adam Smith in ‘The Wealth of Nations’ (1776) encapsulates the managerial behaviors mentioned above:

“The directors of companies, being managers of other people's money than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in private co-partnerships frequently watch over their own”.

While the economic and legal aspects are essential for fostering the growth of the firms, it leads to agency conflicts and its associated costs (Berle & Means, 1932). Various academicians and practitioners of Corporate Governance have put forward different definitions emphasizing on the primary role of managers which is to enhance the wealth of the firm, thereby benefitting all the stakeholders of the firm.
1.2 Definitions of Corporate Governance

There is no universal definition of Corporate Governance. In this regard the objective of studying various definitions is to come to an understanding of what constitutes good governance, quantification of the attributes and its implications on firm performance. The divergence in these definitions can be attributed to two important factors: economic diversity and cultural diversity (Marisetty & Ved Puriswar, 2005).

In Anglo-Saxon countries, such as the U.S and the U.K, good Corporate Governance process means pursuing the interest of shareholders. In countries like Japan, Germany and France, Corporate Governance is concerned with the interests of a wider set of stakeholders, employees, customers and shareholders (Allen & Gale, 1999).

Following are some of the definitions which reflect these perspectives.

“Corporate Governance is holding the balance between economic and social goals. The governance framework is to encourage the efficient use of resources, its accountability and finally its stewardship. The aim is to align as nearly as possible the interests of individuals, corporations and society. The incentive to corporations is to achieve their corporate aims and to attract investment and the incentive for states is to strengthen their economics and discourage fraud and mismanagement (Sir Adrian Cadbury, 1992).

“Corporate Governance is the process by which corporations are made responsive to the rights and wishes of stakeholders” (Demb & Neubauer, 1992a).

Shleifer and Vishny (1997) define Corporate Governance as, “The ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.”

The Financial Times Lexicon (2010) defines Corporate Governance as “How a company is managed, in terms of the institutional systems and protocols meant to ensure accountability and sound ethics. The concept encompasses a variety of issues, including disclosure of information to shareholders and board members, remuneration of senior executives, potential conflicts of interest among managers and directors, supervisory structures, etc”.

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Narayana Murthy committee’s report, 2003, states that Corporate Governance is beyond the realm of law. It stems from the culture and mindset of management, and cannot be regulated by legislation alone. It is about openness, integrity and accountability. Legislations can lay down a common framework, the ‘form’ to ensure standards. The ‘substance’ will ultimately determine the credibility and integrity of the process. The “substance” is inexorably linked to the mindset and ethical standards of management.

It can be seen from the above definitions that the core aspect of Corporate Governance is ethical conduct of managers in the pursuit of wealth maximization of the firm and its stakeholders. Over a period of time, these operational and relationship issues have drawn the attention of academicians who have put forth certain theories to explain them. The Corporate Governance framework stems from these theories. The broad set of theories developed by academicians have linkages to different disciplines such as finance, economics, accounting, law, management and organizational behavior etc (Stiles & Taylor, 1993). Some of the important theories are discussed in this part.

1.3 Theories of Corporate Governance

1) Agency theory: This theory is about the conflicts that arise between the Principal and the Agent because of differences in the goals resulting in additional costs to the firm thereby eroding the wealth of the firm and its shareholders. Study by Berle and Means (1932) has brought into focus the divergence in the profit maximizing and cost minimizing ideals of the firm’s behavior. This causes agency costs, since managers and owners, having conflicting objectives, try to control each other (Shankman, 1999). Owners’ expect managers/agents to operate the businesses with planned outcomes to enhance shareholders’ wealth, which the managers may not do (Ghatak, Healey & Jackson, 1998). This necessitates the implementation of governance structures in large business firms to safeguard the interests of shareholders (Jensen & Meckling, 1976). Fama and Jensen (1983) assume a two-tier form of firm control based on the premise that firms are actually groups of connected fiefs and each fief has its own specific interest and culture and views the purpose of the firm differently. As the number of shareholders (owners) and the complexity of operations increase,
managers are prone to pursue their own interests due to lack of monitoring (Mizruchi, 1983). Shleifer and Vishny (1986) argue that managers may act too cautiously in making investments thereby eroding shareholders’ wealth. This is also due to differences in the risk perceptions between the agent and owners (Arnold & Lange, 2004). The implicit effect of all these result in increase of agency costs.

In the banking firms a different set of agency conflicts arises owing to the interaction of three sets of interest groups; Managers, shareholders and creditors. Shareholders often have conflicts with managers because managers seek quick profits that increase their own wealth, power, reputation and rewards, while shareholders are more interested in a slow and steady growth over time (Mayur & Saravanan, 2008). Since banks operate under different statutes, the transaction and borrowing costs increase due to information asymmetry; increased monitoring and limiting managers’ powers (Hughes & Mester, 2008).

According to agency theorists, the purpose of studying the agency theory is to identify points of conflict among the key players and suggest the following mechanisms of Corporate Governance to reduce it:

a) Separate roles for CEO and Chairman: this avoids managerial opportunism and agency loss (Jensen & Meckling, 1976; Donaldson & Davies, 1991).

b) Provide financial incentives to managers: these include fixing executive compensation and levels of benefits linked to shareholders’ returns; Issue of stock options etc.

c) Inclusion of more independent directors on the board (Baysinger & Hoskinson, 1990).

d) Direct intervention by shareholders and the threat of firing the underperforming managers (shareholder activism)

e) An active market for corporate control: The threat of a hostile takeover disciplines managerial behavior and induces managers to attempt to maximize shareholder value.

2) Stewardship theory: Stewardship theory has a more social-oriented perspective on Corporate Governance. Although agency theory appears to be the dominant
paradigm underlying most governance research and prescriptions, researchers in psychology and sociology have suggested theoretical limits of agency theory because of its focus on only economic assumptions (Hirsch, Machael & Friedman, 1987). There are non-economic assumptions supporting stewardship theory (Doucouliagos, 1994). The dominant non-monetary motive, which directs managers to accomplish their job, is their desire to perform excellently because their reputations are at stake (Davis et al, 1997; Burkart, Gromb, & Panunzi, 1997). Drawing from Maslow’s hierarchy theory, self actualization motivates manager to successfully perform challenging tasks and gain recognition (McClelland, 1961). Based on this premise, stewardship theory favors boards having a majority of ‘specialist’ executive directors rather than a majority of ‘non-specialist’ independent directors who will supplement the organizational knowledge resources.

3) Resource dependence theory: This theory focuses on the resources the directors can provide to the firm for its effective operations and profitability. As per Pfeffer and Salancik (1978) boards have a critical role to play in achieving economic efficiency and since some directors may have access to some strategic resources required by the firm, they may be appointed to the board. Gales and Kesner (1994) suggest that directors may also bring in specialized skills and expertise which will help them to cope with uncertainty by connecting with external resources (Alchian, 1950). Williamson (1964) held that environmental linkages could reduce transaction costs associated with environmental interdependency. Scott and Davis (2007) extend this concept to alliances between organizations to share knowledge and resources to pursue joint activities for mutual benefit.

4) Stakeholder Theory: Stakeholder is a term originally introduced by the Stanford Research Institute (SRI) referring to “those groups without whose support the organization would cease to exist”. Stakeholders of a firm include suppliers, buyers, public policy decision makers, social groups and Government (Freeman, 1984). The conventional view that the success of the firm is dependent only on maximizing shareholders’ wealth has limitations due to negative externalities imposing external costs on the society. This theory states that the success of the firm is dependent on the relationship that a firm has with its stakeholders. The potential stakeholders may be divided into two groups: (1) the primary stakeholders - shareholders/investors,
creditors, customers, suppliers and employees; (2) secondary stakeholders - the government, trade associations, political groups and the community. Stakeholder theory states that, managers and entrepreneurs must take into account the legitimate interests of those groups and individuals who can affect or be affected by their activities (Donaldson & Preston, 1995). Watts and Zimmerman (1983) suggest that firms should carry out socially responsible activities to reduce the risk of governmental intrusions that may affect firm value. The underlying emphasis of this theory is that managers should have broad stakeholder orientations rather than narrow shareholder orientations.

5) Managerial Hegemony Theory: Managerial hegemony theory states that CEOs and Management dominate the boards of directors resulting in passive roles for NED and independent directors (Mallete & Fowler, 1992). This is because CEOs dominate the director selection process and therefore control the board (Mace, 1986). Vancil (1987) is also skeptical about the ability of outside directors to make independent judgments on firm performance due to the dominant role played by CEOs in selecting outside directors. Stiles and Taylor (1993) cited Sir Adrian Cadbury’s quote that up to 80% of outside appointments to the boards of large British companies were made on the old boys’ network. All these may negatively influence the board cohesiveness since Non executive and independent directors are involved in the decision-making process of the firm and, at the same time, act as monitors of management. This conflict of interest will impair the efficiency of the firm despite being dominated by outside directors.
Main theories influencing the development of Corporate Governance

1.4 Models of Corporate Governance

Depending upon the business practices, customs and culture, the process of Corporate Governance differs from country to country. Besides, the variety of capitalism in which countries are embedded with, explains the considerable variations in Corporate Governance models around the world. While there are different models, many of them can be clustered into the following broad groups and each model has its own distinct features.
The Japanese model (J-Form): Many firms of Japan are a part of intricate shareholding structures called keiretsus. A Japanese Keiretsu is a network of different businesses that hold interest in each other to form a type of security blanket. In a horizontal keiretsu firms are financed by a main bank with a system of cross-share holding and horizontal network of interlinked corporations (Ojo, 2009). While the central figure in a horizontal Keiretsu is a central bank, in a vertical Keiretsu it would be a big manufacturing company such as Toyota. Managers do not have a fiduciary responsibility only to shareholders but also to the stakeholders. In practice the managers are expected to pursue the interests of a wider set of stakeholders, including employees, customers and Shareholders who are considered part of it (Allen & Gale, 1999).

German Model: In the German model of Corporate Governance even though the shareholders own the corporation, they do not directly control the governance mechanism. In fact in Germany the legal system is quite explicit that firms do not have a sole duty to pursue the interests of shareholders because of the system of codetermination. In large corporations employees have an equal number of seats on the supervisory board of the company which is ultimately responsible for the strategic decisions of the company (Hopt & Leyens, 2004). Half of the supervisory board is elected by the labor unions which ensure that the workers participation in the governance mechanism is ensured. Another feature is that there is a heavy presence of banks in the equity structure of German firms.

Chaebols of South Korea: Chaebol refers to a South Korean form of business conglomerate. They are powerful global multinationals owning numerous international enterprises. The traditional structure of Korean chaebol can be explained by two of their features; their absolutely closed concentration of ownership within the family of the founder, and their highly diversified business structure. The founding family possesses bulk of the stocks and holds the decision making right as top management. Chaebols suffer from a number of problems such as entrenchment, agency conflicts, tunneling, etc (Kim & Nam 2004).
Anglo-American Model: The traditional Berle-Means (1932) model of Corporate Governance is characterized by a separation of ownership and management. It is considered as a liberal model which is common in Anglo-American countries, which tends to give priority to the interests of shareholders. The CEO has broad powers to manage the corporation on a daily basis, but needs to get board approval for certain major actions, such as hiring his/her immediate subordinates, raising money, acquiring another company, major capital expansions, or other expensive projects. Other duties of the board may include policy setting, decision making, monitoring management's performance, or corporate control (Clarke & Dela Rama, 2009).

1.5 Development of Corporate Governance Regulatory mechanisms

The regulations related to Corporate Governance have been significantly influenced by the regulations of UK, USA and Europe. Following are some of the important enactments which form the core element of governance systems, not only in India, but across the world.

The Cadbury Report, 1992

There were a series of governance failures in UK around the years 1990-92; Bankruptcy of Maxwell's; Insolvency of BCCI; Polly Peck and others. These events led to the formation of a committee chaired by Sir Adrian Cadbury whose aims were to suggest improvements and restore investor confidence in the British Corporate Governance system. The committee made recommendations on the arrangement of company boards and accounting systems to mitigate Corporate Governance risks and failures. The report's recommendations have been adopted in varying degrees by the European Union, the United States, the World Bank, and other common wealth countries.

The Asian financial crisis (AFC)

In late 90’s, East Asian economies came to limelight due to the quick boom and burst phenomenon disrupting the economies of not only Asian countries but many countries of the world. The East Asian financial crisis (AFC) was primarily attributed to poor governance and it undoubtedly established the importance of having effective
Corporate Governance structures for corporations particularly PLCs (Kim, 2005). Subsequently, World Bank brought in a series of Corporate Governance reforms, primarily in countries to which it lends, to avoid such crisis.

**Sarbanes Oxley Act, 2002 (Referred to as SOX ACT, 2002)**

Enron’s scandal has been one of the serious lapses in the Corporate Governance history. Since many world markets were inter-connected it had wider and serious ramifications resulting in loss of billions of dollars, affecting many countries. Enron’s Governance fiasco led to the enactment of the Sarbanes Oxley Act, 2002. This has been one of the most sweeping reforms in the past 70 years of the Corporate Governance history (Byrnes et al., 2003). Because of global importance of US financial markets, many countries of the world reviewed their Governance regulations on the basis of this Act. Foreign Firms which are listed in US and Subsidiaries of US firms have to comply with its stringent internal control and financial reporting requirements of this Act (Baker, et al., 2007; O’Brien, 2006).

**Parmalat Scandal of Italy, 2004**

It is dubbed as Europe’s Enron. Parmalat was Italy’s largest food company. Primarily there was disappearance of more than $10 billion in declared assets which came into limelight during the auditor rotation. Subsequent to this scandal there were regulatory amendments, particularly in the area of Auditing and Audit committees.

**1.6 Issues in Corporate Governances**

**Ethical issues:** Corporate Governance encompasses commitment to values and ethical conduct of businesses to maximize shareholder’s wealth, while ensuring fairness to all stakeholders and retain investors’ trust. Ethical dilemmas arise from conflicting interests of the parties involved and managers should make decisions based on a set of principles influenced by the values, context and culture of the organization. What constitutes good Corporate Governance will evolve with the changing circumstances of a company and must be tailored to meet these circumstances.

**Accountability issues:** Transparency in decision-making leads to accountability because responsibilities could be fixed easily for actions taken or not taken. The
accountability for safeguarding the interests of the stakeholders and the investors in the organization is paramount and rests with the management.

**Efficiency issues:** Efficiency issues are concerned with the efficient performance of the management to ensure fair returns to the shareholders. This means achievement of economic efficiency comprising of allocative and productive efficiencies.

1.7 Development of Corporate Governance Indices

It is well known that Good Corporate Governance practices reduce the agency costs. However many of the Corporate Governance processes are subjective. Hence an objective assessment of Corporate Governance practices helps in better understanding and monitoring of the same. Metrics in the form of an index facilitates better assessment of the CG practices of a firm.

A Corporate Governance index, in its simplest form, is a tool summarizing in a measurable form, the various Corporate Governance factors which influence the performance of a firm. The idea and concept of Corporate Governance index (CGI) has been adopted by researchers, commercial agencies and others to measure the level of governance in listed companies. It is an indicator to benchmark the Corporate Governance quotients of companies, and through it the capital markets of countries. S&P has devised a Corporate Governance evaluation and scoring methodology; similarly the FTSE Group in UK; ICRA/CARE in India and so on.

Both S&P's Corporate Governance score and FTSE/ISS's CGI are primarily tools for institution investors to measure the Corporate Governance practices of listed companies and to manage risks associated with poor Corporate Governance when
investing in global equities. They are each derived from a set of objective criteria under which a company's Corporate Governance practices are evaluated. These criteria are based on universally accepted Corporate Governance principles of fairness, transparency, accountability, and responsibility.

Among other things, such criteria examine the structure and transparency of a company's ownership, the structure, independence, and effectiveness of its board, the company's shareholder rights and stakeholder relations, shareholders meetings and voting procedures, the transparency, content and timeliness of disclosure, the audit process and internal control, and the compensation policy of its senior executives and directors. In recent times corporate social responsibility of a company is also considered as an important criterion. Some researchers use the data provided by the institutions or build their own index based on the above principles.

CGI measures the non-financial quality of companies. Together with the usual financial data and information, CGI would enable investors to have a comprehensive analysis of the risk profiles of companies in their portfolio. After all, corporate scandals in the last few years have shown that poor governance is a high risk factor for investors. As a qualitative score, the CGI will be a competitive differentiator for companies within the same market, as well as among different markets. With a CGI, there will be a ready distinction among companies of different quality in the market and at the same time, CGI will also distinguish the quality of one market from those of others in the region.

Thus the importance of CG Index, as a metric, is gaining more acceptances because of its comprehensiveness, wider applicability and a strong belief that these indices positively correlate with the financial performance.
Firm performance

Researchers have different perspectives of the terms firm performance, financial performance and firm values and these terms are being interchangeably used.

Researcher Huselid (1995) has used Tobin’s Q as market based financial performance measure and also considers the same as a measure of value added by the management. In their studies on Board independence and managerial entrenchment, Surroca and Tribo (2007) have considered Tobin’s Q as a financial performance measure. Tobin’s Q has been considered as a proxy for firm values by many researchers in developed and emerging markets (Gompers et al., 2003; Balasubramanian et al., 2010 to name a few). Similarly MVBV is also considered as a proxy for Firm Value by Mohanty (2003). Brown and Caylor (2006) and other researchers besides using Tobin’s Q, have also used ROA (Return on assets) and ROE (Return on equity) as operating performance measures. Gupta et al., (2010) have considered reduction in the cost of equity as a proxy for improvement in firm values.
Hence while the terms used by the researchers could vary, the common aim of all of them is improvement in financial performance resulting in increase of the wealth of the firm.

1.8 Corporate Governance in India

The macro perspective of Corporate Governance in developed countries is finance and economics while in the developing countries, particularly in India, it is financial and economic development (Chakrabarti, 2005). The Corporate Governance history in India can be distinctly bifurcated, based on the initiation of economic reforms in the year 1992, into two distinct historical time periods: pre-1992 era and post-1992 era.

1.8.1 Pre 1992 era

During the colonial period the managing agency model was prevalent in India where the investor protection was virtually absent. Subsequent laws, such as the Companies Act, 1956 were intended to strengthen the rights of investors, but all these were only on paper and its implementation was abysmally poor.

From the beginning of independence till late 1960s, the private corporate sector was dominated by 20 family groups (business houses) who had their beginnings as traders in the pre-independence era and who took a pioneering interest in the industrialization of the country in the post-independence era too. These family groups developed strong political connections and took full advantage of the licensing system (commonly referred as Licence Raj). Notwithstanding the diverse shareholdings pattern, companies were managed by the same family group with all senior management positions being occupied by the family (Vaghul, 1997).

Concentrated ownership of shares, pyramiding and tunneling of funds among group companies were the features of Indian corporates. Earnings management among family business groups was common. Due to the prevalence of weak form of market efficiency, and information asymmetry, even poorly governed firms could manage to raise enough equity. Entrenched companies had little fear of being taken over. Thus, Corporate Governance in India was in a dismal condition in the Pre 1992 era.
1.8.2 Post 1992 era

This was an era of economic and financial reforms—a strategic move towards market economy. The real opening up of the economy started with the issuance of new Industrial Policy on June 24, 1991. The main thrust of the new policy was on relaxations in industrial licensing and foreign investments. Industrial de-licensing resulted in a spurt of private sector investment and corporate restructuring. Increased transparency and speed in capital markets facilitated reasonably efficient price discovery mechanism—a move towards efficient markets. This has enabled spread of Indian investor base. Current account convertibility and relaxation in repatriation has attracted FII’s. Indian economy is on the move towards capital account convertibility.

Spurt in cross-border capital flows and the economic growth of India

Building on liberalization policies dating back to the early 1990s, India has differentiated itself as a dynamic recipient and source of global capital. India’s prospects are brighter now than ever to be a leading magnet for cross-border capital investments in the years ahead. The positive impact of transparency in Corporate Governance on FDI is well documented and hence over a period of time there have been a series of Corporate Governance reforms aiming towards global convergence.

1.9 Current Indian model of Corporate Governance

It is a hybrid model based on Anglo-American and German models. Unlike the dual class system prevalent in US, single class is the dominant model prevailing in India. This model can be best described by grouping businesses in India in the following way.

- Highly dispersed shareholding and professional management (L&T, ICICI Bank, Infosys).
- The founder, his family, and associates closely hold the company and exercise maximum control over the activities of the company (Tata group-Birla group, Reliance group, Wipro etc).
- Public sector with government ownership and professional management (SBI, ONGC, BHEL, etc).
- Multinational corporations (ABB, HUL, Siemens, etc).
INDIAN MODEL OF CORPORATE GOVERNANCE

It is a hybrid model based on Anglo-American and German models.
Development of Corporate Governance regulatory framework in India

The chronology listed below briefly indicates the evolution of the Corporate Governance norms in India.

1. CII Code on Corporate Governance (1998): The Confederation of Indian Industry (CII) "India's premier business association," unveiled India’s first comprehensive code on Corporate Governance in 1998. This Code was well received by Corporate India and many of its recommendations became part of subsequent regulations. However, since the Code's adoption was voluntary, few firms adopted it.

2. Kumar Mangalam Birla Committee on Corporate Governance (SEBI, May, 1999): SEBI appointed the Birla Committee to develop a code of Corporate Governance. In 2000, SEBI accepted the recommendations of the Birla Committee and introduced Clause 49 into the Listing Agreement of Stock Exchanges. Clause 49 outlined Corporate Governance requirements of exchange-traded companies.


4. Report of the Advisory group on Corporate Governance Standing Committee on Inter-official Financial Standards and Codes (RBI-March, 2001)

5. Recommendations of the Naresh Chandra Committee Report on Corporate Audit and Governance (2002), The Department of Corporate Affairs (DCA)


The regulatory framework of Corporate Governance systems in India are primarily influenced by the legal systems of UK and US. The development of Governance index is generally based on the compliance of the regulations both mandatory and voluntary. The economic consequences of Corporate Governance practices are reflected in firms’ financial performances. The related literature survey deals with these mechanisms, index and financial performance.