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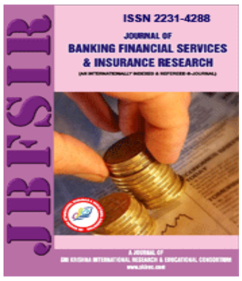

CORPORATE GOVERNANCE - LAYING GROUNDWORK FOR THE ECONOMIC GROWTH

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ABSTRACT

A financial system can only perform its function of channeling funds from savers to investors if it offers sufficient assurance to the providers of the funds that they will reap the rewards which have been promised to them. To the extent that this assurance is not provided by contracts alone, potential financiers will want to monitor and influence managerial decisions. This is why corporate governance is an essential part of any financial system. It is almost obvious that providers of equity have a genuine interest in the functioning of corporate governance. However, corporate governance encompasses more than investor protection. Similar considerations also apply to other stakeholders who invest their resources in a firm and whose expectations of later receiving an appropriate return on their investment also depend on decisions at the level of the individual firm which would be extremely difficult to anticipate and prescribe in a set of complete contingent contracts. Lenders, especially long-term lenders, are one such group of stakeholders who may also want to play a role in corporate governance; employees, especially those with high skill levels and firm-specific knowledge, are another.

INTRODUCTION

Corporate governance is entering a phase of global convergence, driven by the growing recognition that countries need to attract and protect all the Investors, both foreign and domestic. The equation is clear: global capital will generally flow at favorable rates to where it is best protected, but will not flow at all or will flow at higher-risk rates where protections are uncertain or nonexistent.

In many countries whose legal systems are rooted in British common law, the interests of shareholders are held to be paramount in most corporate decisions. However, this has not been the case throughout the rest of the world - at least not until now.

Countries that have traditionally fostered notions of partnerships between management, employees and other stakeholders, have other social priorities, or have mixed government - private ownership arrangements are now recognizing investor protection as an important.

In recent years, corporate governance has received increased attention because of high-profile scandals involving abuse of corporate power and, in some cases, alleged criminal activity by corporate officers. An integral part of an effective corporate governance regime includes provisions for civil or criminal prosecution of individuals who conduct unethical or illegal acts in the name of the enterprise.

MEANING

Corporate governance is a term that refers broadly to the rules, processes, or laws by which businesses are operated, regulated, and controlled. The term can refer to internal factors defined by the officers, stockholders or constitution of a corporation, as well as to external forces such as consumer groups, clients, and government regulations.

Well-defined and enforced corporate governance provides a structure that, at least in theory, works for the benefit of everyone concerned by ensuring that the enterprise adheres to accepted ethical standards and best practices as well as to formal laws. To that end, organizations have been formed at the regional, national, and global levels.

PARTIES TO CORPORATE GOVERNANCE

The most influential parties involved in corporate governance include government agencies and authorities, stock exchanges, management(including the board of directors and its chair, the Chief Executive Officer or the equivalent, other executives and line management, shareholders and auditors). Other influential stakeholders may include lenders, suppliers, employees, creditors, customers and the community at large.

The agency view of the corporation posts that the shareholder forgoes decision rights (control) and entrusts the manager to act in the shareholders' best (joint) interests. Partly as a result of this separation between the two investors and managers, corporate governance mechanisms include a system of controls intended to help align managers' incentives with those of shareholders. Agency concerns (risk) are necessarily lower for a controlling shareholder.

A board of directors is expected to play a key role in corporate governance. The board has the responsibility of endorsing the organization's strategy, developing directional policy, appointing, supervising and remunerating senior executives, and ensuring accountability of the organization to its investors and authorities.

All parties to corporate governance have an interest, whether direct or indirect, in the financial performance of the corporation. Directors, workers and management receive salaries, benefits and reputation, while investors expect to receive financial returns. For lenders, it is specified interest payments, while returns to equity investors arise from dividend distributions or capital gains on their stock. Customers are concerned with the certainty of the provision of goods and services of an appropriate quality; suppliers are concerned with compensation for their goods or services, and possible continued trading relationships. These parties provide value to the corporation in the form of financial, physical, human and other forms of capital. Many parties may also be concerned with corporate social performance.

A key factor in a party's decision to participate in or engage with a corporation is their confidence that the corporation will deliver the party's expected outcomes. When categories of parties (stakeholders) do not have sufficient confidence that a corporation is being controlled and directed in a manner consistent with their desired outcomes, they are less likely to engage with the corporation. When this becomes an endemic system feature, the loss of confidence and participation in markets may affect many other stakeholders, and increases the likelihood of political action.

PROBLEM PAVING WAY FOR CORPORATE GOVERNANCE RATING:

Corporate governance is one of the major practical importance’s because it deals with the ways in which shareholders and banks assure that managers work for long-term interest of the company and for maximizing investor’s returns. The main issue that corporate governance tries to resolve is the agency problem, arising from the separation of ownership and control and the uncertainty financiers have that their funds will be invested in attractive projects. The agency problem is also an essential element called contractual view of firm. Ideally a contract can be signed between the manager and investor, how the manager should perform his duties and how the profits should be allocated for the growth of the company. But it is complicated to happen in real life.

A better solution to this agency problem could be a long term inventive contract that aligns managerial interests with those of investors. Incentive contracts can include share ownership, stock options or even a risk of dismissal.

Holmstrom had argued that the optimal incentive contract is determined by the manager’s risk aversion and the relevance o his decisions. There is another problem in incentive contracts when they give the opportunity to the managers for self-dealing that is to negotiate with them to terms of the contract.

Whereas the Yermack says that the managers receive stock option grants shortly before good news announcements and delay them after bad news announcements.

Another important issue of corporate governance is that of financier’s control rights and their legal protection. The most important rights for the shareholders are voting on corporate issues. The role of legal protection is that the investors are ensured that they will get their returns back. Concentration of ownership will also create a problem in a concern’s development. Like transparency of the internal control functions.

Corporate governance refers to the mechanisms that limit agency costs by checking managerial discretion and aligning manager and owner interests. In common usage corporate governance extends to a wide array of devices – internal and external technical and legal, contractual m incentive and other – that shape the relationship between the owners and mangers and define their response to the agency problem that exists between them.

According to Hermalin and Weisbach, if a firm’s performance is related to governance, then the relationship is a “disequilibrium phenomenon”, and firms can increase value by altering their corporate governance regimes. However, if the firm's performance is unrelated to governance, then the relationship is an "equilibrium phenomenon" and managers cannot enhance the value by changing their approach to governance.

SHAREHOLDER THEORY VS STAKEHOLDER THEORY

- The shareholder theory gives a narrow view of corporate governance in the sense that it overemphasizes shareholders though they are not the only ones who make investments in a company. A company is the outcome of a bundle of people who make specific investments in their capacity as customers, employees, creditors, suppliers and distributors apart from shareholders. A corporate will be success only if it takes into account all the parties involved for its growth.

- There is an overemphasized and practically presumption of strong managers Vs weak shareholders conflict which has paved the way for all the corporate governance theories of resolving monitoring and diverse interest problems. The argument is favour of this is that widely dispersed ownership in companies is not the general norm but more like an exception, and it would be erroneous to think that corporate governance is just meant for large public listed companies only. Even small companies also the part of the growth of the economy which also contribute its share for the development of the economy. In certain concerns the shareholders will have the full power of controlling rather than the managers. Not only has the conflict between the manager and shareholders evened the dominance between the majority shareholders, the minority shareholders rights might also suffer.

CORPORATE GOVERNANCE VS COMPETITION

Competition among competitor would provide positive incentives for companies to take care that it has the best governance structure in place. The companies which are uncompetitive because of their poor cost structure would be wiped away from the economy. This would mean that no external regulatory intervention would be necessary. Things like markets for corporate control, stock opinions and soon are some of the recent developments. A good corporate governance mechanism is a combination of many things which include competition in the product, labour market, capital and etc. All together will provide a healthy and systematic approach for the corporate governance.

POPULARLY ESPOUSED PRINCIPLES OF CORPORATE GOVERNANCE

- **RIGHTS AND EQUITABLE TREATMENT OF SHAREHOLDERS**: Organizations should respect the rights of shareholders and help shareholders to exercise those rights. They can help shareholders exercise their rights by effectively communicating information that is understandable and accessible and encouraging shareholders to participate in general meetings.

- **INTERESTS OF OTHER STAKEHOLDERS**: Organizations should recognize that they have legal and other obligations to all legitimate stakeholders.

- **ROLE AND RESPONSIBILITIES OF THE BOARD**: The board needs a range of skills and understanding to be able to deal with various business issues and have the ability to review and challenge management performance. It needs to be of sufficient size and have an appropriate level of commitment to fulfill its responsibilities and duties. There are issues about the appropriate mix of executive and non-executive directors.

- **INTEGRITY AND ETHICAL BEHAVIOR**: Ethical and responsible decision making is not only important for public relations, but it is also a necessary element in risk management and avoiding lawsuits. Organizations should develop a code of conduct for their directors and executives that promotes ethical and responsible decision making. It is important to understand, though, that reliance by a company on the integrity and ethics of individuals is bound to eventual failure. Because of this, many organizations establish Compliance and Ethics Programs to minimize the risk that the firm steps outside of ethical and legal boundaries.

- **DISCLOSURE AND TRANSPARENCY**: Organizations should clarify and make publicly known the roles and responsibilities of board and management to provide shareholders with a level of accountability. They should also implement procedures to independently verify and safeguard the integrity of the company's financial reporting. Disclosure of material matters concerning the organization should be timely and balanced to ensure that all investors have access to clear, factual information.

MECHANISMS AND CONTROLS

Corporate governance mechanisms and controls are designed to reduce the inefficiencies that arise from moral hazard and adverse selection. For example, to monitor managers' behavior, an independent third party (the external auditor) attests the accuracy of information provided by management to investors. An ideal control system should regulate both motivation and ability.

Internal corporate governance controls

Internal corporate governance controls monitor activities and then take corrective action to accomplish organisational goals. Examples include:

- **MONITORING BY THE BOARD OF DIRECTORS**: The board of directors, with its legal authority to hire, fire and compensate top management, safeguards invested capital. Regular board meetings allow potential problems to be identified, discussed and avoided. Whilst non-executive directors are thought to be more independent, they may not always result in more effective corporate governance and may not increase performance. Different board structures are optimal for different firms. Moreover, the ability of the board to monitor the firm's executives is a function of its access to information. Executive directors possess superior knowledge of the decision-making process and therefore evaluate top management on the basis of the quality of its decisions that lead to financial performance outcomes, ex ante. It could be argued, therefore, that executive directors look beyond the financial criteria.

- **INTERNAL CONTROL PROCEDURES AND INTERNAL AUDITORS**: Internal control procedures are policies implemented by an entity's board of directors, audit committee, management, and other personnel to provide reasonable assurance of the entity achieving its objectives related to reliable financial reporting, operating efficiency, and compliance with laws and regulations. Internal auditors are personnel within an organization who test the design and implementation of the entity's internal control procedures and the reliability of its financial reporting

- **BALANCE OF POWER**: The simplest balance of power is very common; require that the President be a different person from the Treasurer. This application of separation of power is further developed in companies where separate divisions check and balance each other's actions. One group may propose company-wide administrative changes, another group review and can veto the changes, and a third group check that the interests of people (customers, shareholders, employees) outside the three groups are being met.

- **REMUNERATION**: Performance-based remuneration is designed to relate some proportion of salary to individual performance. It may be in the form of cash or non-cash payments such as shares and share options, superannuation or other benefits. Such incentive schemes, however, are reactive in the sense that they provide no mechanism for preventing mistakes or opportunistic behavior, and can elicit myopic behavior.

EXTERNAL CORPORATE GOVERNANCE CONTROLS

External corporate governance controls encompass the controls external stakeholders exercise over the organization. Examples include:

- competition
- debt covenants
- demand for and assessment of performance information (especially financial statements)
- government regulations
- managerial labour market
- media pressure
- takeovers

SYSTEMIC PROBLEMS OF CORPORATE GOVERNANCE

- Demand for information: In order to influence the directors, the shareholders must combine with others to form a voting group which can pose a real threat of carrying resolutions or appointing directors at a general meeting.

- Monitoring costs: A barrier to shareholders using good information is the cost of processing it, especially to a small shareholder. The traditional answer to this problem is the efficient market hypothesis (in finance, the efficient market hypothesis (EMH) asserts that financial markets are efficient), which suggests that the small shareholder will free ride on the judgments of larger professional investors.

- Supply of accounting information: Financial accounts form a crucial link in enabling providers of finance to monitor directors. Imperfections in the financial reporting process will cause imperfections in the effectiveness of corporate governance. This should, ideally, be corrected by the working of the external auditing process.

BUSINESS ENVIRONMENT'S IMPACT ON CORPORATE GOVERNANCE

SLOWER (OR NO) ECONOMIC GROWTH: Some predict that, even after the ultimate "end" of our financial crisis, domestic economic growth is likely to remain at relatively low levels for an extended duration, or that we may experience a prolonged "no growth" period. This will result in an increasingly challenging business environment that, instead of promoting the much desired boardroom focus on long-term value creation, may actually accelerate investors' emphasis on short-term, activist investing, much like as was evidenced over the pre-crisis years by the rise of day-traders, hedge funds and similar speculative invest As many historical investment options become more challenged in a slow or no growth economy, these circumstances may result in increased pressure on boards of directors from institutional shareholders to produce higher short-term returns. Generating increased near-term returns in a slow or no growth economic environment may involve further intensified boardroom efforts to reduce labor and/or supply chain costs and pursue short-term revenue and earnings enhancement goals and objectives.

In some cases, these circumstances may lead boards to implement specific governance policies and practices to boost their near-term share price by, for example, removing takeover defenses such as poison pills, classified boards and supermajority vote requirements, and pursuing more business combinations that can result in achieving additional financial and business synergies. Hedge fund and other short-term investors also may act as "governance arbitrageurs," seeking corporate governance reform from companies in which they invest in order to drive near-term share price increases to improve their portfolio performance.

As a result, in the "new normal" business environment, boards may struggle to remain focused on delivering long-term value to shareholders in the face of increasing pressure from hedge funds and other activist, short-term portfolio managers who will be starving to generate positive investment returns for their long-beleaguered investors in a slow or no growth economic environment.

HIGHER TAXATION: As tax rates increase, the expected tax consequences of strategic and business decisions will become a more significant consideration to boards of directors and could begin to offset the underlying fundamental financial or business motivations to engage in specified transactions. Similarly, corporate governance practices may also be more impacted by the tax impacts of board decision making. In light of the increasing importance of taxes and the interaction of tax and corporate governance, the idea of "tax governance" is receiving renewed attention.

In the "new normal" business environment, boards may be called upon to revisit the question of how to structure their governance processes to take into account and mitigate against the negative effects of the increased tax consequences from otherwise seemingly beneficial strategic and business decisions

Additionally, as tax rates on dividends and capital gains increase in the era of “new normal,” many boards may be less motivated to return corporate cash resources to shareholders through increased dividends or corporate stock repurchase programs, opting instead to reduce debt or increase capital expenditures. Similarly, tax-free acquisition transactions may take increasing precedence over cash buyouts. These impacts will likely change many boards’ long-held perspectives on how best to deliver tangible investment returns to shareholders

INCREASED REGULATION: The re-regulation will likely not be limited to the financial services industry, but will be extended into all private industry business sectors. The resulting continued blurring of the line between the public and private sectors will mean that a company’s relationship with, and connections to, its regulators and legislators will become increasingly important to a private enterprise’s financial success. Boards will need to focus on how to best manage these relationships and connections in the context of applicable ethical and legal requirements.

ENHANCED FOCUS ON ENVIRONMENTAL SUSTAINABILITY: The development, implementation and reporting of environmentally sustainable business practices has become a hot button issue in recent years for corporate governance reform activists, and a large number of shareholder proposals relating to the topic have been submitted to publicly traded companies. This trend is likely to continue and accelerate in the “new normal” business environment. A recent rule interpretation by the Securities Exchange Commission, moreover, may result in a rise in the number of environmental, climate change and other social policy-related shareholder proposals submitted in 2010

Because environmental sustainability issues may involve considerations other than maximizing shareholder value in a narrow sense (e.g., protection of natural resources or the values of society generally), boards may be increasingly called upon to strike a delicate balance between, or otherwise reconcile, environmental sustainability considerations and their related non-shareholder constituency proponents against boards’ overarching fiduciary duty to their shareholders.

SUSTAINED HIGHER UNEMPLOYMENT LEVELS: Some forecasters, including some policymakers at the Federal Reserve, predict higher sustained levels of private sector unemployment in the “new normal” business environment than has been the case over the last 15 years. If these predictions prove to be accurate, companies may be able to attract and retain key personnel more easily, but demand for new employees, products and services may be relatively low compared to historical levels. In their oversight role, boards may need to ensure that employee and executive compensation and benefit arrangements reflect these realities. Similarly, as a result of these “new normal” labor market circumstances, boards may be able to act much more aggressively when pursuing plant/facility locations and related government subsidies and employee concessions.

GLOBALIZATION: Globalization has resulted in increased competition and expanded international operations for many U.S. companies and these effects will likely continue in the “new normal” era. In fact, the rapidly accelerating development of China, India and Russia, with Africa next on the horizon, will likely drive our global economic growth, as well as many companies’ financial prospects, in the “new normal” business environment. Accordingly, boards will need to continue to address these factors; especially adapting corporate governance practices to take into account the ethical business practices of, and companies' relationships with, foreign governments.

WEAKENING DOLLAR, INFLATION AND RISING COMMODITY PRICES: If, as is predicted by some observers, the dollar continues to weaken, inflation remains a long-term possibility and commodity prices rise, the risks posed to companies by these forces will increase in magnitude. Boards will need to devote increased attention to managing the impacts of such factors on their companies' core business and making strategic and business decisions that specifically take these trends into account.

CONCLUSION

A combined treatment of corporate finance and corporate governance is herein proposed. Debt and equity are treated not mainly as alternative financial instruments, but rather as alternative governance structures. Debt governance works mainly out of rules, while equity governance allows much greater discretion. A project-financing approach is adopted. I argue that whether a project should be financed by debt or by equity depends principally on the characteristics of the assets. Transaction-cost reasoning supports the use of debt (rules) to finance redeployable assets, while non-redeployable assets are financed by equity (discretion). Experiences with leasing and leveraged buyouts are used to illustrate the argument. The article also compares and contrasts the transaction-cost approach with the agency approach to the study of economic organisation.

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