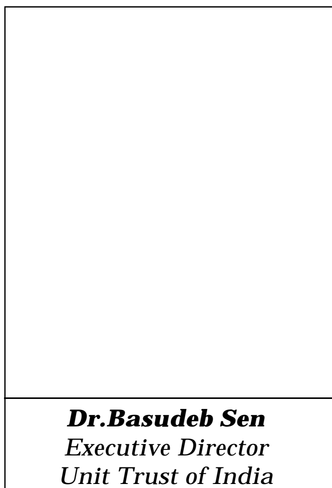
Corporate Governance : Principles to Practice



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All agree that Corporate Governance(CG) practices in India should improve to protect shareholders' wealth and enhance shareholder value. Shareholders demand improved CG as this would protect them from oppression, inefficiency, undue risk taking by management/dominant shareholder group (through the irrepresentatives). All company boards and managements agree almost unanimously on this issue, especially as individually most of them believe that what they practice follows the best CG, even though there is no survey to find how many companies have actually adopted the CG code issued by the Confederation of Indian Industries two years ago and to what extent. Others not connected with companies or directors or managers also agree. It gives a good feeling to know that efforts are being made to ensure that commercial firms are properly governed. Again mere observance of good CG is not enough.What is at the root of it is the synergy between good governance and good performance which alone ensures shareholder value.

Yet debate on CG continues. There does not seem to be any consensus on what it is that improved CG seeks to achieve. Debate on CG is increasingly becoming fashionable in the recent period, especially as multilateral fora like World Bank, ADB and OECD are giving importance to CG.

If only the shareholders are given primacy, there can hardly be any debate about CG. A simple way to test whether one gives primacy to shareholders or not is to check whether one agrees to the following 18 statements. Each 'No' answer is against shareholder primacy and hence against the interest of shareholder of a listed public limited joint stock company.

Statements

1. A company's existence arises only out of shareholders' interest and their willingness to put a part of their wealth at risk.
2. A company is owned by shareholders and none else.
3. A shareholder (as shareholder per se) cannot harm the company, but the company's performance and its boards, managements and employees'behaviour can harm the interests of the shareholder.
4. A company can make a profit for the benefit of the shareholders only after paying dues to all others including the creditors, managements, employees and the state.
5. When a company's operations turn unviable, or makes losses, it is the shareholder who suffers a loss in wealth.
6. While the Directors, managers and employees can leave a company at will, a shareholder cannot do so until the company is liquidated or someone else becomes a shareholder in his place or the company effects a share buy-back with the approval of shareholders.
7. A shareholder runs the risk of a loss if he wants to sell his shareholding to others especially when managers cause company's performance to deteriorate.
8. A shareholder remains the owner of the company as long as he/she owns (even) a single share - whether or not the person buys and sells shares in the secondary market frequently.
9. It is the shareholders (and not anyone else) who decides what businesses their company should be in (as members they agree by majority vote on the articles of association and charter).
10. All shareholders have a right to know, as frequently as possible, the company's actual performance and business plans as well as the risks(including those due to non- adherence/ non-compliance to laws and regulations) the company is exposed to and the adequacy of systems and procedures to control and mitigate risks to the shareholders' wealth. The Board or management can plead for lower degree of disclosures in shareholder interest, but it is upto the shareholders to agree or disagree.
11. It is only the shareholders' right and prerogative to decide who should be on the Board of Directors of the company and no one else has anything to do with this. Shareholders need to be convinced by Boards on the justification for having each member on the Board.
12. The criteria of fairness and credibility to all shareholders(small or big, new or old, short term or long term) should determine the composition of the Board . For the entire Board to win confidence of the shareholders, the Board must make adequate disclosures on the strength of the Board as a team.
13. The Board of Directors are representatives of all shareholders and are expected to act in a manner that they are fair to all shareholders and not

merely to one or two dominant shareholders.

14. The Board of Directors is expected to act on behalf of the shareholders(and nobody else) to supervise, monitor and evaluate performance of the company, as also of the board itself .
15. Directors singly or jointly represent and are accountable to the shareholders(and nobody else).
16. Shareholders have the right to decide the compensation the company would pay to Directors on the Board depending on the performance of the company.
17. Managers run the business of a company as agents of the shareholder who are the principals; managers are not shareholders' representatives.
18. It is only the shareholder who has a right to terminate a contract with the manager or a director, but a manager or a director cannot choose the shareholder or the directors on the board as per the manager's/director's preference.

If the primacy of the shareholder as reflected by the above statements is accepted, a proper CG process should automatically fall in place to serve the needs of the shareholders, subject, of course to compliance with all state imposed regulations and laws.The extent to which these statements are not reflected in the way a company conducts its business, its CG practices cannot completely serve shareholder interest.

An alternative theory which suggests that a company should respond to the interests of different stakeholders, does not accept the supremacy of shareholders. This view naturally appears to suit all but is clearly against the shareholders.This view is generally propounded by the State(to gain, political or revenue or bureaucratic power mileage), or by the employees (interested in lifetime security of jobs) or by managers themselves so that they can put different stakeholders to fight while they enjoy complete freedom. History of Corporations gives evidence of how by turning shareholders' corporation into stakeholders' corporation led to inefficiency, fraud, corruption and destruction of shareholder value and national wealth.

The pseudo- socialistic stakeholder theory represents a clear misconception of the foundation on which the concept of a joint stock company rests. A company is a legal entity and is subject to all laws of the land as a citizen. It has therefore to discharge the obligations to all other stakeholders by paying taxes, paying dues to creditors, complying with environmental and safety regulations as well as adhering to labour laws, contract regulation laws, consumer protection laws and all other laws. It is only after all other dues are paid, are shareholders entitled to make profits. It is therefore the primacy of shareholder value and supremacy of shareholders which is the key to economic efficiency, social justice and creation of national wealth If this principle is accepted, managements (or shareholders in management control) ,can be expected to respect all shareholders. On the other hand, if this principle is not accepted, the concept of a joint stock company gets convoluted, the principles of corporate democracy vitiated and focus on shareholder value lost. In such a situation, no CG process is of any economic significance. Economic liberalisation may imply less control and intervention of State on Corporate freedom, but it also means more control by shareholders over companies – not merely at shareholders' annual general meetings, but all the time. Corporations need to recognise that their existence depends on shareholders. A joint stock company is <u>of</u> the shareholders, it is to be controlled <u>by</u> the shareholders and it is to be managed <u>for</u> the shareholders. Corporate Governance process has to reflect this maxim.

The generally agreed principle of CG, that a listed joint stock corporation is to be managed only in the interest of protecting and enhancing shareholder value subject, of course to meeting all laws and regulations of the land, may appear to be a simple principle. It is not easy to put it into practice. It is even more difficult to ensure that the practice does not over time diverge from the principle.There are many reasons why divergence tends to take place, even if such divergence was not intended or planned. Business environment changes over time. As corporations/managers/boards respond to these changes, they change their organisation structures, the way they reward/punish/motivate themselves and employees, the way they compete with the rivals, the way they try to influence the state in economic policy making and the way they develop relationships with their creditors and customers. All such business responses may divert the attention of the board, the managers and the employees away from the supremacy of the shareholders.When one makes the organisation more client oriented (customer is the king), it is possible that the empowered front-end employee pleases customers at the expense of the shareholder. At times, the management or the board may borrow agressively from a banker agreeing to conditionalities that expose the shareholders wealth at a risk greater than what the shareholders would have agreed to. While celebrating commendable performance, boards and managements may spend on sponsorships or donations at the cost of shareholders (and no one else).

The tendency of divergence from the principles of C.G. is normal and common. In the market place, business organisations change, strategies, structures, systems and processes, cultures, priorities etc keep changing –sometimes radically, sometimes incrementally. In the process, the consistency of organisational function to the CG principle is seldom checked. A corporation is essentially a collection of

interactive people-boards, managements and employees with their own minds, values, perceptions, preferences, emotions, greed and fear. When some C.E.O. or board or a manager or an empowered front-office employee starts feeling that he/she is the owner of the company, you never know. As it happens in many religious activities, the God is forgotten by many. There is a poem by Tagore which reminds one of the situation when the chariot festival takes place and the idol of the god is moved from the temple to a chariot and is taken out in procession along the road. The chariot thinks itself as the god being worshipped. So does the idol and the road. And, the almighty god smiles. In a joint stock company one can think that the idol is (a)the Board, the chariot is (b)the management and the employees and the road is (c) the environment (the policy makers, regulators, consumers and competition). If (a) or (b) or (c) think that they are the supreme bosses of the corporation, the shareholders of that corporation will have no choice but to weep.

In India , over the planning era, the importance of the joint stock company as the primary form of the business organisation declined. In the current liberalisation regime, it is necessary to rediscover the concept of such a company and the role of the board in such a company.The board is not the management. True, the Board represents the company as a legal entity-but this is not a business management role. The main role of the board is to appoint managements, agree with them the business strategy, business performance targets, the resource availability and the compensation, evaluate the performance of the management and recommend profit appropriation and other major decisions for shareholders approval.But in many cases boards tend to combine in them, the role of management along with management (executive directors) or shareholder managers and therefore have difficulty in practising the principles of C.G.

Thus, the mere acceptance of the 18 statements on primacy of shareholders may not ensure that the CG process in practice is necessarily attuned to the primacy of shareholders. It may be necessary for shareholders to be vigilant and active in trying to force Boards and managements to practice rather than merely profess CG. This may warrant frequent interactions with the Boards and managements to ensure that their rights, privileges and prerogatives are protected.It is necessary that boards are independent, that they represent all shareholders , that managers do not take an undue share of corporate income, and that all actions are centered around the shareholder. Such shareholder activism, vigilance and exercise of control over Corporate Boards and managements cannot be substituted by laws and regulations. If necessary, shareholders need to call managements and Boards to explain their performance and behaviour even between shareholders'meetings and test if the Boards and managements believe in shareholder supremacy or not.

There is a need to emphasise from time to time the fundamental relationship between a corporation and its shareholders. It is necessary to be vigilant on the possible sources of CG practices diverging from the basic principles. There are four major sources of such divergence:

a) Inter-se shareholder relationships,
b) Shareholder-board relationships,
c) Board-management relationships, and
d) Internal management control systems

Divergence takes place when there is oppression of some shareholders by other shareholders or when Board ignores shareholder interest or management ignores shareholder interest/Board's interest or when internal control systems or employee attitude is not attuned to shareholder interest. Shareholder oppression can take place because some shareholders are inactive or non-vigilant while some other shareholders have management control objectives. It has been observed that shareholders interest is not fairly served when either a few shareholders or the management or both dominate corporate boards. Shareholder interest also takes a back seat if the boards do not adequately disclose material information to shareholders or are themselves incompetent or ineffective. Lastly shareholder interest may be compromised by incompetent/ fraudulent managements in the absence of shareholder vigilance on boards, control systems and employee attitude.

Practising the principles of CG warrants vigilance over these sources of divergence. Regular review is required to assess the adequacy of shareholder representation on corporate boards, efficiency of board processes (constitution and functioning of board sub- committees), adequacy of information dissemination to shareholders and fruitful interaction between board and the shareholders. Establishment of effective and enforceable accountability standards for management's decision making processes is important. Equally important is the test of how far the employees are attuned to CG 'Best practices'. Revamp of existing people processes or study of the impact of empowerment/executive compensation structures may help reduce the probability of shareholders interest being ignored by managements.

Failure to adopt proper CG principles and ensuring that CG practices are in conformity with such principles, makes it difficult to use with advantage the best form of business organisation so far evolved for modern economies. India needs to rediscover the concept of a listed joint stock company.

** (Dr Basudeb Sen is currently an Executive Director at UTI. The views expressed are his own and not necessarily of his employer.)*