

CORPORATE GOVERNANCE CHALLENGES IN BUSINESS ENTERPRISES

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INTRODUCTION

The last few years have seen some major scams and corporate collapses across the globe, be it Enron, WorldCom or Satyam. All these events have made stakeholders realize the importance and urgency of good corporate governance. People are concerned how companies are being managed; after all it's the public money/investment which is at stake in most of these companies. International organizations like IMF, WTO and World Bank are also insisting on transparency. Efforts are being made to have a common set of disclosure policies and norms. All these have moved Corporate Governance & transparency up the social agenda.

Everyone is involved with a company in one way or other; either as an investor who seeks for returns from investments as part of income; as an employee who spends a number of hours with his employer; as a customer who buys products in the supermarket. Corporate entities are actually the largest consumers of resources & essential drivers of economy. The accountability, transparency, fairness and responsibility of these companies on legal, social and economical grounds are crucial for well being of every civil citizen in today's economy. This is ensured by Good Corporate Governance.

Corporate governance and ethical behaviour have a number of advantages. Firstly, they help to build good brand image for the company. Once there is a brand image, there is greater loyalty, once there is greater loyalty, there is greater

commitment of the employees, and when there is a commitment of employees, the employees will become more creative. In the current competitive environment, creativity is vital to get a competitive edge.

Good corporate governance makes for good business sense. It increases the confidence of shareholders in the company. This leads to better stock prices. Research by A Hasan, (2009) has shown that good corporate governance brings down the cost of capital for the company. Good disclosure practices lead to a more liquid market for the company. This lowers cost of debt for the company. Thus for CEOs of today, it has become quite essential to comply with principles of good corporate governance.

RECENT DEVELOPMENTS

In the early 2000s, the massive bankruptcies of Enron and WorldCom, as well as lesser corporate debacles led to increased shareholder and governmental interest in corporate governance. This is reflected in the Sarbanes-Oxley Act of 2002 in US.

In India, Corporate governance practices have gained a greater impetus after the adoption of the Securities and Exchange Board of India (SEBI) appointed Kumar Mangalam Birla Committee (KMBC) Report on Corporate Governance. The recommendations are supposed to be enforced through provisions in listing agreements by local stock exchanges where the companies are listed.

Some key **KM Birla Committee, 2002**

recommendations were:

- ✓ At least 50% non-executive members.
- ✓ For a company with an executive Chairman, at least half of the board should be independent directors, else at least one-third.
- ✓ Non-executive Chairman should have an office and be paid for job related expenses.
- ✓ Maximum of 10 directorships and 5 chairmanships per person
- ✓ The board should decide on the remuneration of non-executive directors and all remuneration information should be disclosed in annual report
- ✓ At least 4 board meetings a year with a maximum gap of 4 months between any 2 meetings. Minimum information available to boards stipulated.

Some key **N Murthy Committee, 2003** recommendations were:

- ✓ Training of board members suggested.
- ✓ There shall be no nominee directors. All directors to be elected by shareholders with same responsibilities and accountabilities.
- ✓ Independent directors should be treated the same way as non-executive directors.
- ✓ The board should be informed every quarter of business risk and risk management strategies.
- ✓ Boards of subsidiaries should follow similar composition rules as that of parent and should have at least one independent directors of the parent company.
- ✓ The Board report of a parent company should have access to minutes of board meeting in subsidiaries and should

affirm reviewing its affairs.

- ✓ Performance evaluation of non-executive directors by all his fellow Board members should inform are - appointment decision.

Voluntary guidelines, 2009² by the ministry of corporate affairs cover topics like:

- ✓ Board of Directors
- ✓ Responsibilities of the Board
- ✓ Audit Committee of Board
- ✓ Auditors
- ✓ Secretarial Audit
- ✓ Institution of mechanism for Whistle Blowing

MAJOR CHALLENGES

⇒ **Unlisted Corporate Not Covered**

One of the major problems with respect to applicability of regulations & recommendations are that they are restricted to listed entities only, if mandatory. This makes small & mid size companies to perform those activities which may be legal but are not ethical.

For example, companies in chemical industry are allowed to pollute environment within certain limits. Many small companies do not even try to reduce pollution, just because they are allowed.

⇒ **Disclosure of Off Balance Sheet Transactions**

There are many transactions which either cannot be disclosed in balance sheet or even if they can be, then they cannot be in monetary terms.

For instance by creating Special Purpose Entities, companies transfer financial assets

involving transactions that have off Balance Sheet implications. Apart from the common type of assets like customer receivables, notes, mortgages, and bonds, the transfer of more complex financial assets like derivatives, cash reserve accounts, guarantees, and servicing obligations for underlying assets is resorted to for availing advantage of opportunities in financial markets, and, at times, achieving specific accounting results. Keeping certain financial assets off the balance sheet firms can increase their liquidity and also can obtain low-cost funding. As the Accounting Standards AS-30, AS-31 and AS-32, relating to measurement and disclosures of financial instruments, are waiting to be mandatory, firms can easily structure transactions using Special Purpose Entities.

What is to be disclosed & how it is to be disclosed is at discretion of management. Even if mentioned, it may not be sufficient or show the true picture of the situation. Also some information like exposure to sub prime securities' exact value can't be ascertained. It can just be indicated, but again then it's just indicative & not exact information.

⇒ **Family Owned Enterprises**

In India, majority of business enterprises are family owned. Though it has advantages for family members, it also has some limitations with respect to minority shareholders like:-

- There is minimum or no dilution of powers. Ranging from Directors to employees, one can notice presence of family members in all significant positions.
- They do not allow institutional investors to participate in ownership

of enterprises.

- Quite often, especially during the early, start-up stages of the family business, the company and family relationships are not clearly distinguished. This is particularly true with respect to financial relations and accounts — the company's and family's assets are not legally separated. This causes problems in distinguishing company-owned assets, and how company owned assets can be used by the family as a shareholder.

⇒ **Multiplicity of Regulations**

In India, there are many regulatory bodies like Company's Act 1956, Securities Exchange Board of India (SEBI), Reserve Bank of India (RBI), Insurance Regulatory Development Authority (IRDA), etc. The main problem with all of them is that there is lack of co-ordination or there might be over regulation. Many a times there are two or more treatments for a similar event/transaction. This duplicity gives companies opportunity to run away from their mistakes & responsibilities.

Also regulations have been reactive & not proactive. It is only when a scam takes place; regulatory bodies take actions, which if would had been taken earlier could have avoided the pecuniary loss of innocent investors and public in general.

⇒ **Corporate Social Responsibility & Sustainability Reporting**

Triple Bottom Line is gaining importance but still because of its Voluntary status, companies are not adopting it. Many companies especially small & mid size companies can not afford to do CSR from their

minute profits. But the main problem is not mandatory regulation, but on ethical grounds; which is difficult to report.

For example, a cigarette manufacturing company like ITC may carry out its social tasks through e-Choupal but it is nothing if compared to the harm caused by its core product, cigarette.

⇒ **Commitment At All Levels**

In a recent Supreme Court order, in case of the bounce on cheque, Managing Director of a company has to be held responsible. To a certain extent it is justified but it should not be limited to Managing Director. There is a need of commitment at all Levels of Corporate ladder and should not be treated as responsibility of finance functionaries and CEO only. Each and every employee must be made aware of his duties & held responsible for the said task. After all it is not a one man army.

⇒ **Subjectivity**

It's critical for any company that the people they recruit believe in the company's values and imbibe those values. This is an area where major stress should be laid. For example: the Indian business group – 'TATA', lays lot of emphasis on its values-Integrity, Sincerity and transparency, while recruiting people in its group companies. The interview process should be used to judge if the candidates' value system match with that of the company. The candidates past record will also give some indication about him and can be used to judge the fit of the candidate. The personal value system should be of such strength that the candidate is immune to opportunistic actions.

But unfortunately in Asian countries, nepotism plays crucial role in recruitment. In majority cases the selection of a candidate for a job is on the basis of reference instead of his past performance & values.

⇒ **Challenge of Existing Practices**

Some existing practices of corporate governance are faulty in themselves. Some of the common loopholes in the existing practices include:

- a. Failure by Board of Directors to understand the risk their firm is taking.
- b. Conflict of interest and lack of 'independent' (independently minded) Board members or senior executives.
- c. Corporate culture which does not promote to raise questions
- d. Problems in Whistle blowing – Whistleblowers may often be wrong in their accusations and their motives are not always pure. Their actions can disrupt a workplace, and may cause serious harm to individuals wrongly accused.

⇒ **Impediments Due to Sectoral Nature**

This can be explained with an example of public sector, in which many countries are underperforming (Especially airlines-Air India, British Airlines, China Air, etc). Of course it's due to poor governance, some of which includes:

- a. Political interference in the working management & many a times in Board.
- b. Government as a shareholder have different risk, return appetite which are not same as retail or institutional investors.
- c. Last mentioned but most felt reason is corruption (Red Tapism).

⇒ **Relative Transparency**

Even transparency has its own limits. Management often argues that everything can not be disclosed just for the sake of disclosure & transparency. Much information if disclosed may be used by competitors. Thus, 'how much is enough', will always be a question which will have a relative answer.

⇒ **Dependence on Independent Directors**

This has much to do with the choice of directors and the skills that they bring to the board; the conduct of board meetings; the quality and quantity of financial, operational and strategic information supplied by the management to the board; management's appetite for independent evaluation and criticism of strategies and performance. It also depends on the extent to which promoters and management truly want healthy debate and independent oversight; the de facto role of the various committees of the board; and, of course, how much a company is willing to pay for the experience and skill sets of professional independent directors.

Independent directors should maintain objectivity and stand firm on some issues, although it is a difficult task. They should also have the will and courage to say no when things are not moving in the interest of the company and its stakeholders.

CONCLUSION

There is no doubt that Corporate Governance, if implemented properly, has immense benefits for all stakeholders, majorly shareholders, management, employees, customers, and community at large.

Some of the ways which might help to overcome the challenges of governance in business enterprises are:

- 1) Compliance costs which in the initial phase seem to be huge, can prove to be investment in long run if appropriated at right time & suitable place. Simplified & unambiguous regulations will encourage high standard of corporate governance and help to reduce compliance cost.
- 2) Corporate Governance extends beyond corporate law. Its objective is not mere fulfilment of legal requirements but ensuring commitment on managing transparently for maximizing shareholder values. As competition increases, pronounced technology shortens the distance and speeds up communication. In this dynamic environment the systems of Corporate Governance also need to evolve, upgrade in time with the rapidly changing economic and industrial climate of the country.
- 3) Standards and incentives are required for the mid size new entrants of capital market. Large pool of unlisted companies should also be bought in the purview of governance for healthy competition and better quality goals.
- 4) Directors should have integrity and independence of thought; the courage to express their independent thought; a grasp of the realities of business operations; an understanding of the changes taking place regionally, nationally and internationally; and an understanding of business and financial language.

5) Many a time's promoters play with investors' money, gain from market & disappear from country. Watching the recent scenario, regulators vigilance should be made stricter and if anyone is found guilty, the culprit must be punished.

6) Cost Accountants should statutorily be made more responsible like Chartered Accountants. This in turn will help in better presentation and disclosure of segment-wise & product-wise information (AS-17).

Quality of governance depends upon competence and integrity of Directors, who have to diligently oversee the management while adhering to impeccable ethical standards. Strengthened systems and enhanced transparency can only further the ability. Transparency about a company's governance process is critical. Implementing Corporate Governance structures are Important but instilling the right culture – work culture is the Most Essential. After all, well defined governance is just '**Artificial Legal Entity**'.

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