UNIT- 5
CORPORATE GOVERNANCE

INTRODUCTION

Corporate governance is the system of rules, practices and processes by which a company is directed and controlled. Corporate governance essentially involves balancing the interests of the many stakeholders in a company these include its shareholders, management, customers, suppliers, financiers, government and the community. Since corporate governance also provides the framework for attaining a company's objectives, it encompasses practically every sphere of management, from action plans and internal controls to performance measurement and corporate disclosure.

Governance provides the structure through which corporations set and pursue their objectives while reflecting the context of the social, regulatory and market environment. Governance is a mechanism for monitoring the actions, policies and decisions of corporations.

Meaning

Corporate governance refers to the system of rules, practices, and processes by which a company is directed and controlled. It encompasses a set of principles, values, and best practices that define the relationship between a company's management, its shareholders, and other stakeholders, such as employees, customers, and suppliers.

Objectives Of Good Corporate Governance

- Make sure your company's management considers the best interests of all involved, from employees to investors, suppliers, and others.
- Focus your business transactions on your company's values.
- Set up your company to deliver long-term success and economic growth.
- Maintain investors' confidence so you can raise capital efficiently and effectively.
- Constantly improve control over management and information systems.
- Keep the goals and objectives of the company at the forefront of what you do.
- Minimize waste, risk, mismanagement, and corruption.
- Build and maintain a strong brand reputation by bringing a high level of satisfaction to your employees, customers, investors, and the community at large.
- Provide adequate reporting to shareholders and other stakeholders through quarterly, semi-annual, and yearly performance and operating results.

Importance of corporate governance

The importance of CG lies in shaping a company to be a good governed company in all the spheres of its operation. The spheres include the following.

1. The good performance of the board and individual directors, which includes good thinking and taking fair and impartial decisions, create long-term faith between the company and its stakeholders and enhance company image.
2. The ethical tone of the company will help in cultivating ethical standards in management.
3. The good relationship between board and executive management which enhances their understanding to serve ethically.
4. Periodical assessment of directors helps cultivating good performance.
5. Adoption of risk management tools will help in meeting corporate compliance, implementing internal controls, promoting transparency in operations and reduce defrauding and illegal practices.
6. Promotes effective communication between the Board and shareholders and other stakeholders.
7. Presentation of audited financial report presents real status of finance which helps in taking sound financial decisions.

Thus, corporate governance is important as it "affects and dictates the sound internal functioning and morale of a company and it also projects externally well to the public". This leads to better decision-making.

Scope of Corporate Governance

Corporate Governance is the system of rules, practices, and processes by which a company is directed and controlled. Its scope can be broadly categorized into the following areas:

1. **Value based corporate culture**: Corporate governance best practices include having a values-based business culture. It is a set of unwavering values, ethics, and beliefs. There can be a vision, or a dream that needs to be realised, a mission and purpose, an objective, a goal, or a target. It can also be a motto, which is a unique phrase that makes an organization stand out. Any corporation needs certain ethical ideals in order to operate effectively. Corporate culture must be based if a business is to last.

2. **Holistic view:** This holistic view is more or less godly, religious attitude which helps in running organization. It is not easier to adopt it, it needs special efforts and once adopted it leads to developing qualities of nobility tolerance and empathy.

3. **Compliance with laws**: Those companies which really need progress, have high ethical values and need to run long run business they abide and comply with laws of Securities Exchange Board of India (SEBI), Foreign Exchange Regulation Act, Competition Act 2002, Cyber Laws, and Banking Laws etc.
4. **Corporate Governance and Human Resource Management**: For any corporate body, the employees and staff are just like family. For a company to be perfect the role of Human Resource Management becomes very vital, they both are directly linked. Every individual should be treated with individual respect, his achievements should be recognized. Each individual staff and employee should be given best opportunities to prove their worth and these can be done by Human Resource Department. Thus, in Corporate Governance, Human Resource has a great role
5. **Board of Directors:** Corporate governance is concerned with the composition, structure, and functioning of the board of directors. The board's role includes setting the company's strategic direction, overseeing management, and ensuring that the company's operations are conducted in a legal and ethical manner.
6. **Shareholder Rights:** Corporate governance includes protecting the rights and interests of shareholders. This includes ensuring that shareholders have a say in major corporate decisions and are treated fairly and equitably.
7. **Transparency and Disclosure**: Corporate governance requires companies to be transparent in their operations and to disclose relevant information to shareholders and other stakeholders. This includes financial reporting, risk management, and other relevant information.
8. **Ethics and Corporate Social Responsibility**: Corporate governance is concerned with the ethical and social responsibilities of the company. This includes ensuring that the company operates in a socially responsible and ethical manner and takes into account the interests of all stakeholders, including employees, customers, suppliers, and the community.
9. **Risk Management**: Corporate governance involves identifying and managing risks to the company, including financial, operational, and reputational risks.
10. **Executive Compensation**: Corporate governance also involves setting appropriate levels of executive compensation and ensuring that executives are incentivized to act in the best interests of the company and its shareholders.
11. **Lessons from Corporate Failure:** Every story has a moral to learn from, every failure has success to learn from, in the same way, corporate body have certain policies which if goes as a failure they need to learn from it. Failure can be both internal as well as external whatever it may be, in good governance,

corporate bodies need to learn from their failures and need to move to the path of success.

Overall, the scope of corporate governance is to ensure that companies are managed in a responsible, ethical, and sustainable manner that protects the interests of all stakeholders and promotes long-term value creation.

Principles of Corporate Governance

Corporate governance refers to the set of principles and processes that guide the direction and management of a company, including how decisions are made, how the company is run, and how it is held accountable to its stakeholders. Here are some of the key principles of corporate governance:

1. **Accountability:** Corporate governance requires that companies be accountable to their stakeholders, including shareholders, employees, customers, and suppliers. This means that the company must act transparently, providing information on its activities and financial performance, and must be held responsible for any misconduct or negligence.
2. **Fairness:** Corporate governance requires that companies treat all stakeholders fairly and equitably, without favouritism or discrimination. This includes fair treatment of employees, customers, suppliers, and shareholders.
3. **Transparency:** Corporate governance requires that companies operate transparently, providing timely and accurate information to stakeholders about its activities, financial performance, and risks.
4. **Responsibility:** Corporate governance requires that companies take responsibility for their actions and decisions, including any negative impacts on the environment, society, or other stakeholders.
5. **Integrity:** Corporate governance requires that companies operate with integrity, maintaining high ethical standards and avoiding conflicts of interest.
6. **Leadership:** Corporate governance requires strong and effective leadership, with a clear strategy and direction for the company, and a commitment to achieving the company's goals while also protecting the interests of its stakeholders.
7. **Risk management:** Corporate governance requires that companies identify and manage risks effectively, including financial, operational, and reputational risks.
8. **Compliance:** Corporate governance requires that companies comply with all relevant laws and regulations, as well as any ethical or social standards that the company has set for itself.

9. **Performance measurement**: Corporate governance requires that companies measure and report on their performance, including financial performance and other indicators of success, in order to demonstrate accountability to stakeholders.
10. **Audit Committee:** The audit committee is required to promptly deliver to management an audit report that details all financial transactions. The internal audit committee ought to be sensible, open, and impartial.
11. **Interest of stakeholders:** The board must maintain a friendly relationship with shareholders and uphold their interests. Corporate governance should acknowledge all stakeholders.

Overall, the principles of corporate governance are designed to ensure that companies operate responsibly, ethically, and in the best interests of all stakeholders. By following these principles, companies can build trust and credibility with their stakeholders, which in turn can help to build long-term success and sustainability.

Significance Of Corporate Governance

The significance of corporate governance are listed below:

1. **Changing Ownership Structure**: In recent years, the ownership structure of companies has changed a lot. Public financial institutions, mutual funds, etc. are the single largest shareholder in most of the large companies. So, they have effective control on the management of the companies. They force the management to use corporate governance. That is, they put pressure on the management to become more efficient, transparent, accountable, etc. They also ask the management to make consumer-friendly policies, to protect all social groups and to protect the environment. So, the changing ownership structure has resulted in corporate governance.
2. **Importance of Social Responsibility:** Today, social responsibility is given a lot of importance. The Board of Directors has to protect the rights of the customers, employees, shareholders, suppliers, local communities, etc. This is possible only if they use corporate governance.
3. **Growing Number of Scams:** In recent years, many scams, frauds and corrupt practices have taken place. Exploitation and misappropriation of public money are happening every day in India and worldwide. It is happening in the stock market, banks, financial institutions, companies and government offices. In order to avoid these scams and financial irregularities, many companies have started corporate governance.

4. **Indifference on the part of Shareholders:** In general, shareholders are inactive in the management of their companies. They only attend the Annual general meeting. Postal ballot is still absent in India. Proxies are not allowed to speak in the meetings. Shareholders associations are not strong. Therefore, directors misuse their power for their own benefits. So, there is a need for corporate governance to protect all the stakeholders of the company.
5. **Globalization:** Today most big companies are selling their goods in the global market. So, they have to attract foreign investor and foreign customers. They also have to follow foreign rules and regulations. All this requires corporate governance. Without Corporate governance, it is impossible to enter, survive and succeed the global market.
6. **Takeovers and Mergers:** Today, there are many takeovers and mergers in the business world. Corporate governance is required to protect the interest of all the parties during takeovers and mergers.
7. **SEBI:** SEBI has made corporate governance compulsory for certain companies. This is done to protect the interest of the investors and other stakeholders.

Strengthening of Corporate Governance

1. **Recognising that good governance is not just about compliance:** Boards need to balance conformance (i.e., compliance with legislation, regulation and codes of practice) with performance aspects of the board's work (i.e., improving the performance of the organisation through strategy formulation and policy making). As a part of this process, a board needs to elaborate its position and understanding of the major functions it performs as opposed to those performed by management.
2. **Clarify the board's role in strategy:** It is generally accepted today that the board has a significant role to play in the formulation and adoption of the organisation's strategic direction. The extent of the board's contribution to strategy will range from approval at one end to development at the other. Each board must determine what role is appropriate for it to undertake and clarify this understanding with management.
3. **Monitor organisational performance:** Monitoring organisational performance is an essential board function and ensuring legal compliance is a major aspect of the board's monitoring role. It ensures that corporate decision making is consistent with the strategy of the organisation and with owners' expectations. As a board, the directors should establish an agreed format for the reports they monitor to ensure that all matters that should be reported are in fact reported.

4. **Understand that the board employs the CEO:** In most cases, one of the major functions of the board is to appoint, review, work through, and replace (when necessary), the CEO. The board/CEO relationship is crucial to effective corporate governance because it is the link between the board's role in determining the organisation's strategic direction and management's role in achieving corporate objectives.
5. **Recognise that the governance of risk is a board responsibility:** Establishing a sound system of risk oversight and management and internal control is another fundamental role of the board. Effective risk management supports better decision making because it develops a deeper insight into the risk-reward trade-offs that all organisations face.
6. **Ensure the directors have the information they need:** Better information means better decisions Regular board papers will provide directors with information that the CEO or management team has decided they need. But directors do not all have the same informational requirements, since they differ in their knowledge, skills, and experience. Briefings, presentations, site visits, individual director development programs, and so on can all provide directors with additional information.
7. **Build and maintain an effective governance infrastructure:** Since the board is ultimately responsible for all the actions and decisions of an organisation, it will need to have in place specific policies to guide organisational behaviour. To ensure that the line of responsibility between board and management is clearly delineated, it is particularly important for the board to develop policies in relation to delegations.
8. **Appoint a competent chair:** Research has shown that board structure and formal governance regulations are less important in preventing governance breaches and corporate wrongdoing than the culture and trust created by the chairperson. As the "leader" of the board, the chairperson should demonstrate strong and acknowledged leadership ability, the ability to establish a sound relationship with the CEO, and have the capacity to conduct meetings and lead group decision-making processes.
9. **Build a skills-based board:** What is important for a board is that it has a good understanding of what skills it has and those skills it requires. Where possible, a board should seek to ensure that its members represent an appropriate balance between directors with experience. Directors should also be considered on the additional qualities they possess, their "behavioural competencies", as these qualities will influence the relationships around the boardroom table, between the board and management, and between directors and key stakeholders.

10. **Evaluate board and director performance and pursue opportunities for improvement:** Boards must be aware of their own strengths and weaknesses, if they are to govern effectively. Board effectiveness. can only be gauged if the board regularly assesses its own performance and that of individual directors. Improvements to come from a board and director evaluation can include areas as diverse as board processes, director skills, competencies and motivation, or even boardroom relationships. Boards should consider addressing weaknesses uncovered in board evaluations through director development programs and enhancing their governance processes.

Benefits of Good Corporate Governance

1. Good corporate governance ensures corporate success & economic growth.
2. Strong corporate governance maintains investors' confidence, as a result of which, company can raise capital effectively & efficiently.
3. It lowers the capital cost
4. There is a positive impact on the share price
5. It provides proper inducement to the owners as well as managers to achieve objectives that are in interest of the shareholders and the organization.
6. Good corporate governance also minimizes wastages, corruption, risks & mismanagement.
7. It helps in brand formation & development.
8. It ensures organization is managed in the manner that fits the best interests of all.

Limitations of Corporate Governance

1. The board of directors have to discharge their fiduciary duties in the best interest of the corporation. Sometimes, deliberately or without their knowledge breach their duties. This is the laps on the part of directors.
2. In order to have good governance, corporate have to spend more on various governance activities. Increased cost is the limitation of corporate governance.
3. Another limitation is that while performing corporate governance activities, directors & key officers have to perform with good intention and objectivity. Failure to perform in tune with the company policy frame works, rules & regulations result in bad governance.
4. In corporate structure, shareholders cannot take active part in administration. In spite of several controls are laid down in company's act, directors many a times ignore the provisions and act according to their personal whims. This goes against good governance.

Role and Composition of Board

Director: A director is someone who has authority over the direction, conduct, management, or supervision of a company's affairs. A director is a person who is chosen or appointed to oversee a company's operations. A minimum of one director is required for every registered business, and according to Section 149 of the Companies Act, only an individual may be appointed as a director. No corporation, organization, or firm may, therefore, be appointed as a director of a company.

Board of Directors: The group of directors that is in charge of directing, controlling, and supervising all business-related activities for the corporation. In order to run the business and protect the interests of the stakeholders, its member or directors are typically chosen by the firm's shareholders during an annual general meeting. Simply said, a board of directors is a group of people who have been elected to serve as stakeholders' representatives and to formulate corporate management-related policies and make key business decisions. These concerns range from executive salaries to dividend policies and executive hiring and firing.

Functions of BOD

1. Creating the company's vision
2. Hiring and evaluating the CEO
3. Defining strategies
4. Allocating and protecting resources
5. Ensuring legal compliance
6. Overseeing finances
7. Making financial decisions
8. Managing board members
9. Improving public opinion
10. Setting company goa**ls.**

Roles of the Board of Directors

1. Establish vision, mission and values

a) Determine the company's vision and mission to guide and set the pace for its current operations and future development.
b) Determine the values to be promoted throughout the company.
c) Determine and review company goals.
d) Determine company policies.

2**. Set strategy and structure**

a) Review and evaluate present and future opportunities, threats and risks in the external environment and current and future strengths, weaknesses and risks relating to the company.
b) Determine strategic options, select those to be pursued and decide the means to implement and support them.
c) Determine the business strategies and plans that underpin the corporate strategy.
d) Ensure that the company's organizational structure and capability are appropriate for implementing the chosen strategies.

3. **Delegate to management**

a) Delegate authority to management and monitor and evaluate the implementation of policies, strategies and business plans.
b) Determine monitoring criteria to be used by the board,
c) Ensure that internal controls are effective,
d) Communicate with senior management.

4. **Exercise accountability to shareholders and be responsible to relevant stakeholders**

a) Ensure that communications both to and from shareholders and relevant stakeholders are effective.
b) Understand and take into account the interests of shareholders and relevant stakeholders.
c) Monitor relations with shareholders and relevant stakeholders by gathering and evaluations of appropriate information.
d) Promote the goodwill and support of shareholders and relevant stakeholders.
e) Find out more about corporate governance.

<u>Composition of Board</u>

Board of Directors Composition

The board of directors are can be called the brain of the company. They are responsible for taking all the big decisions and making policy changes. These decisions are taken in special meetings members of the board hold together, called ‘Board Meetings’.

- Section 149 of the Companies Act states that every company's board of directors must necessarily have a minimum of three directors if it is a public company. two directors if it is a private company and one director in a one-person company.
- The maximum number of members a company can assign as directors is fifteen. However, the company can pass a special resolution in a general meeting to allow for assigning more than fifteen members to the board of directors.
- The maximum number of companies that an individual can become a director of, is 20 companies.
- At least one director, who has lived in India for a minimum of 182 calendar days of the previous year, shall be appointed by every company's board. It is a mandatory rule.
- At least, one woman director must be appointed by the company.
- All listed companies must have at least one-third proportion of their board of directors as independent directors.

Types of Directors

1. **Executive Directors:** Executive directors are present internally and are involved in the company – s.149(12).

   They are two types – Managing Directors and Whole-Time Directors
   - **Managing Director** – A director who is the CEO and entrusted with substantial management powers under s. 2(54).
   - **Whole-Time Director** – A director employed on a whole-time basis, not the CEO of the company, and is under a special contract, appointed under s.2(94)

2. **Non-Executive Directors**

   Non-executive directors are external professionals and are uninvolved in the everyday activities of the company – s.149(12).They are of two types – independent directors and nominee directors.

   - **Independent Directors** – They are appointed to ensure transparency and provide expertise.

   Must have the following qualifications
   - ✓ Industrial expertise and knowledge
   - ✓ Must not have any stock options or stake in the company
   - ✓ It can only be appointed for a maximum of 5 years and for two terms, with a minimum cooldown of 3 years between the term sheet.

- **Nominee Directors** – Representative of the stakeholders appointed to the board of directors. Must have the following requirements – s.149(7) and s.161(3)
- ✓ Must be appointed if provided in the Articles of Association (AoA)
- ✓ Must have unfettered discretion to protect the interests of both the company and the shareholders

3. **Women Directors**
   - Provided for in s.149(1), requires three types of companies to have a minimum of one women director
   - Every listed company
   - Every public company without a paid-up share capital of 100 cr or a turnover of 300 cr.
   - Companies registered before the Companies Act, 2013: https://www.mca.gov.in/Ministry/pdf/CompaniesAct2013.pdf shall appoint women directors within a year of this act coming to force, while new companies post-2013 act shall appoint women directors within six months of registering.

Duties of Directors

CA 1956 did not contain any provisions that specifically identified the duties of directors, CA 2013 has set out the following duties of directors:

a) To act in accordance with company's articles
b) To act in good faith to promote the objects of the company for the benefit of the members as a whole, and the best interest of the company, its employees, shareholders, community and for the protection of the environment.
c) Exercise duties with reasonable care, skill, and diligence and exercise of independent judgement.

The director is not permitted to:

a) Be involved in a situation in which he may have direct or indirect interest that conflicts or may conflict, with the interest of the company.
b) Achieve or attempt to achieve any undue gain or advantage, either to himself or his relatives, partners or associates.

Committees of the Board

CA 2013 envisages 4 types of committees to be constituted by the board:

1. **Audit committee**: CA 2013 requires the board of every listed company & certain other public company to constitute the audit committee consisting of a minimum of 3 directors, with the independent directors forming the majority. It prescribes that the majority of members including its chairman have to be persons with the ability to read & understand financial statements. The audit committee has been entrusted with the task of providing recommendations for appointment & remuneration of auditors, review of independent of directors, providing approval of related party transactions & scrutiny over other financial mechanisms of the company.

2. Nomination & remuneration committee: CA 2013 requires the board of every listed company to constitute a remuneration committee. Consisting of 3 or more non-executive directors out of which not less than one half are required to be independent directors. The committee has the task of identifying persons who are qualified to become directors & provide recommendations to the board regarding their appointment & removal, as well as carry out their performance evaluation.

3. Stakeholder's relationship committee: CA 2013 requires every company having more than thousand shareholders, debenture holders, deposit holders & any other security holders at any time during of financial year to constitute a stakeholders relationship committee to resolve the grievances of security holders of the company.

4**. Corporate social responsibility committee ("CSR Committee")** CA 2013 requires certain T companies to constitute a CSR committee, which would be responsible to devise, recommend & monitor CSR initiatives of the company. The committee is also required to prepared a report detailing the CSR activities undertaken & if not, the reasons for failure le comply.

Remuneration of the directors & senior executives (Managerial remuneration)

Managerial remuneration refers to the remuneration payable by a company to its managerial personnel, managing director, whole time directors, managers & other directors. The provisions regarding managerial remuneration have been outlined in sections 197 & 198 & schedule V of the Indian companies act, 2013.

According to the provisions, "remuneration' includes,

1. Monthly salary
2. Any expenditure incurred by the company in providing any rent-free accommodation or any other benefit or amenity in respect of accommodation free of charge, to the directors or manager.
3. Any expenditure incurred by the company in providing any other benefit or amenity free or charge or at a concessional rate to the directors or manager.
4. Any expenditure incurred by the company in respect of any obligation or service, which, but for such expenditure by the company, would have been incurred by the directors or manager.
5. Any expenditure incurred by the company to affect any insurance on the life of, or to provide pension & annuity or gratuity for the directors or manager, or his spouse or child.

Remuneration does not include:

1. Directors sitting fees (for attending board or committee meetings) &
2. Remuneration to the directors for services rendered in their, professional capacity (only if, in the opinion of the central government, the director possesses the requisite professional qualifications).

Ceiling on remuneration payable-

The act provides for a maximum limit for the remuneration payable to the 'managerial personnel'.

The maximum limit or the ceiling for the managerial remuneration situations-

- When company has adequate profits:
- When company incurs a loss or does not have adequate profits.

1. When company has adequate profits: in this case, the maximum remuneration is fixed as the percentage of 'net profits'.

Under section 1, part II & schedule V of the companies' act, 2013 subject to the provisions of section 197, a company having profits in a financial year may pay remuneration to the managerial person or persons not exceeding the limits specified in such section.

The following table summarizes the provisions regarding the same:

Condition Maximum	**Remuneration In Any Financial Year**
a) When there is one whole time director, managing director or manager.	5% of net profit
b) When there is more than one whole time director, managing director or manager.	10% of net profit
c) When there is one part time director without whole time director, managing director or manager.	3% of net profit
d) When there is one part time director with whole time director, managing director or manager.	1% of net profit
e) When there is more than one whole time. director, managing director or manager & a part time director.	11% of net profit
All managerial personnel put together	11% of net profit

Therefore, the overall maximum managerial remuneration for the entire year is 11% of net profits.

2. When company has inadequate profit or no profits:

In case a company has inadequate profits or no profits in any financial year, no amount shall be payable by way of remuneration except if these provisions are followed-

Where The Effective Capital is:	Limits of Yearly Remuneration:
Negative or less than 5 crores	60 lakhs
Five crores and above but less than 100 crores	84 lakhs
100 crores & above but less than 250 crores	120 lakhs
250 crores and above	120 lakhs plus 0.01% of the effective capital in excess of Rs. 250 crores.

These restrictions do not apply to the sitting fees of the directors (managing director, whole time director or manager).

Assignment Questions

2 Marks Questions

1. What is corporate governance?
2. Name the objectives of corporate governance?
3. What do you mean by audit committee?
4. State any two principles of Corporate Governance.
5. State any two importance of good corporate governance

5 Marks Questions

1. Give a note on corporate governance.
2. Write an analytical note on objectives of corporate governance.
3. Write a note on importance of corporate governance.
4. Give a note on the role of company directors in relation to corporate governance.
5. Write a note on the role of Board Committee regarding corporate governance.

6. Write a note on remuneration of company directors.
7. Briefly Explain the Benefits and Limitations of Corporate Governance.
8. Briefly Explain the Principles of Corporate Governance.

15 Marks Questions

1. Explain the meaning, objectives and importance of corporate governance.
2. Explain in detail about the Significance of Corporate Governance.
3. Explain the steps to strengthen Corporate Governance.