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SOCIETY FOR PUBLIC WELFARE AND INITIATIVES

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GOOD GOVERNANCE IN CORPORATE SECTOR - PRESENT SCENARIO

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Abstract: *Good corporate governance is an important step in building market confidence and encouraging more stable, long-term international investment flows. The business corporation is an increasingly important engine for wealth creation worldwide, and how companies are run will influence welfare in society as a whole. In order to serve this wealth-creating function, companies must operate within a framework that keeps them focused on their objectives and accountable for their actions. Many countries see better corporate governance practices as a way to improve economic dynamism and thus enhance overall economic performance.*

Keywords: *corporate governance, ownership, shareholders, top management.*

Introduction

The compatibility of corporate governance practices with global standards has also become an important part of corporate success. The practice of good corporate governance has, therefore, become a necessary prerequisite for any corporation to manage effectively in the globalized market.

The term “corporate governance” is a relatively new one both in the public and academic debates, although the issues it addresses have been around for much longer, at least since Berle and Means (1932) and the even earlier Smith (1776). In the last two decades, however, corporate governance issues have become important not only in the academic literature but also in public policy debates. During this period, corporate governance has been identified with takeovers, financial restructuring, and institutional

investors' activism. One can talk about the governance of a transaction, of a club, and, in general, of any economic organization. In a narrow sense, corporate governance is simply the governance of a particular organizational form - a corporation. Viewing the corporation as a nexus of explicit and implicit contracts, Garvey and Swan (1994) assert that governance determines how the firm's top decision-makers actually administer such contracts.

Shleifer and Vishny (1997) define corporate governance by stating that it deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. A similar concept is suggested by Caramanolis-Cötelli (1995), who regards corporate governance as being determined by the equity allocation among insiders and outside investors. John and Senbet (1998) propose the more comprehensive definition that corporate governance deals with mechanisms by which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected. They include stakeholder's not just shareholders, but also debt holders and even non-financial stakeholders such as employees, suppliers, customers, and other interested parties. Hart (1995) closely shares this view as he suggests that corporate governance issues arise in an organization whenever two conditions are present. First, there is an agency problem, or conflict of interest, involving members of the organization – these might be owners, managers, workers or consumers. Second, transaction costs are such that this agency problem cannot be dealt with through a contract. Zingales (1997) defines corporate governance as the complex set of constraints that shape the ex-post bargaining over the quasi-rents generated by a firm. All the governance mechanisms discussed in the literature can be reinterpreted in light of this.

Definition

An OECD study (1999) considers that corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance.

A few studies have examined corporate governance in emerging markets, although none has estimated the link between CEO turnover and corporate performance. Researchers (La Porta, Lopez-de-Silanes, and Shleifer, 1999; Claessens, Djankov, Fan and Lang, 1999; Lins, 2000) have studied the implications of the concentrated corporate ownership that is common in many emerging and developed markets and conclude that the principal agency problem in large corporations around the world is that of restricting expropriation of minority shareholders by the controlling shareholders.

Importance of Corporate Governance

Corporate governance matters for the distribution of rents. Zingales (1997) considers that there are three main channels through which the conditions that affect the division of quasi-rents also affect the total surplus produced:

1. *Ex-ante incentive effects.* The process through which surplus is divided ex post affects the ex-ante incentives to undertake some actions, which can create or destroy some value, in two main ways. First, rational agents will not spend the optimal amount of resources in value-enhancing activities that are not properly rewarded by the governance system. Second, rational agents will spend resources in inefficient activities, whose only (or main) purpose is to alter the outcome of the ex-post bargaining in their favor.
2. *Inefficient bargaining.* A second channel through which a governance system affects total value is by altering ex-post bargaining efficiency. A governance system, therefore, can affect the degree of information asymmetry between the parties, the level of coordination costs, or the extent to which a party is liquidity constrained.
3. *Risk aversion.* Finally, a governance system might affect the ex-ante value of the total surplus by determining the level and the distribution of risk. If the different parties have different degrees of risk aversion

Principles for Corporate Governance

Corporate governance is only part of the larger economic context in which firms operate, which includes, for example, macroeconomic policies and the degree of competition in product and factor markets. The corporate governance framework also depends on the legal, regulatory, and institutional environment. In addition, factors such as business ethics and corporate awareness of the environmental and societal interests of the communities in which it operates can also have an impact on the reputation and the long term success of a company. OECD has assembled a system of principles that are intended to assist member and non-member governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries, and to provide guidance and suggestions for stock exchanges, investors, Corporations and other parties that have a role in the process of developing good corporate governance. The principles cover five areas:

1. The rights of shareholders;
2. The equitable treatment of shareholders;
3. The role of stakeholders;
4. Disclosure and transparency;
5. The responsibilities of the board.

Briefly, those principles are:

- I) The corporate governance framework should protect shareholders' rights.
- II) The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.
- III) The corporate governance framework should recognize the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.
- IV) The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.
- V) The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

The Principles are Primarily Intended to Provide Assistance to Governments

They also provide guidance and direction for stock-exchanges, investors, corporations and other parties that have a role in developing good corporate governance. They can indeed be a useful point of reference for many emerging markets and economies in transition. Not only do the principles provide a benchmark for internationally accepted standards, but they also offer a solid platform for analysis and practices in individual countries taking into account country-specific circumstances, such as legal and cultural traditions.

The Institutions of Corporate Governance

Mark Roe defines corporate governance as the relationships at the top of the firm—the board of directors, the senior managers, and the stockholders. In his opinion institutions of corporate governance are those repeated mechanisms that allocate authority among the three and that effect, modulate and control the decisions made at the top of the firm. Core corporate governance institutions respond to two distinct problems, one of vertical governance (between distant shareholders and managers) and another of horizontal governance (between a close, controlling shareholder and distant shareholders). The principal institutions are about ten: the market, the board, gate-keeping, coalescing (via takeovers, proxy fights, and shareholder's voice), incentive compensation, professionalism, lawsuits, capital structure, and bankruptcy. Some institutions deal well with vertical corporate governance but do less well with horizontal governance. The institutions interact as complements and substitutes, and

many can be seen as developing out of a “primitive” of contract law. Arguably a system must get contract enforcement, as well as basic property rights, satisfactory before it embarks on more sophisticated corporate governance institutions.

The Search for Good Corporate Governance Practices

Corporate governance affects the development and functioning of capital markets and exerts a strong influence on resource allocation. In an era of increasing capital mobility and globalization, it has also become an important framework condition affecting industrial competitiveness and economies. Corporate governance mechanisms vary depending on industry sectors and type of productive activity. Corporate governance framework can influence the development of equity markets, R&D and innovative activity, and the development of an active SME sector, and thus influence upon economic growth.

Identifying what constitutes good corporate governance practice, and under what circumstances, is a difficult task. This is partly because the effectiveness of corporate governance systems is influenced by differences in countries’ legal and regulatory frameworks, and historical and cultural factors, in addition to the structure of product and factor markets. The challenge, therefore, is not only to identify the strengths and weaknesses in each individual system or group of systems but also to identify what are the underlying conditions upon which these strengths and weaknesses depend. One of the main challenges facing policymakers is how to develop a good corporate governance framework which can secure the benefits associated with controlling shareholders acting as direct monitors, while at the same time, ensuring that they do not expropriate excessive rents at the expense of other stakeholders. The search for good corporate governance practices should be based on an identification of what works in defined countries, to discern what broad principles can be derived from these experiences, and to examine the conditions for transferability of these practices to other countries.

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