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THEORIES AND PRACTICES OF CORPORATE GOVERNANCE

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ABSTRACT

Past has proved that there is endless evolution of theories or models of corporate governance. One of the reasons is due to the very essence of social consciences that is minimal and profit making took center stage. All over the world, companies are trying to instill the sense of governance into their corporate structure. With the surge of capitalism, corporation became stronger while governments all over the world had to succumb to its manipulations and dominance. Hence, this article attempts to provide a theoretical framework for the corporate governance debate. The review of various corporate governance theories enhances the major objective of corporate governance which is maximizing the value for shareholders by ensuring good social and environment performances. The theories of corporate governance are rooted in agency theory with the theory of moral hazard's implications, further developing within stewardship theory and stakeholder theory and evolving at resource dependence theory, transaction cost theory and political theory, Hence, it is suggested that a combination of various theories is best to describe an effective and good governance practice rather than theorizing corporate governance based on a single theory. Various theories and philosophies have provided the foundation for the development of alternative forms of corporate governance systems around the world. Furthermore, as economies have evolved through time it appears that corporate executives have deviated from the sole objective of maximizing shareholders' wealth. Owners of the capital have responded to these forces for the purpose of preserving their wealth and earning a reasonable return on their invested capital.

KEYWORDS
corporate governance, corporate structure, shareholders' wealth.

1. INTRODUCTION

Common stockholders have the right to elect their representatives on the board of directors of a corporation. Members of the board of directors assume the responsibility of monitoring, directing and appointing the firm's managers. In this manner disperse shareholders are potentially empowered in setting direction, monitoring performance, and controlling distribution of profits of the corporation. In particular, this internal control mechanism is purported to integrate the interests of common stockholders and the executive managers of a corporation by rewarding good corporate performance. The board of directors has the right and responsibility to remove poorly performing managers. Historically, dissatisfied shareholders have "walked away" from the corporation by selling their shares at depressed prices and thereby incurring losses. Alternatively, major shareholders either through hostile actions, "investor activism," or a friendly approach, "relationship investing," have pursued their objectives of monitoring corporate managers. Furthermore, to the extent U.S. corporate laws permit, competing managers would remove incompetent ones and take over poorly performing firms. These aforementioned actions collectively are purported to add value for the existing shareholders. The business judgment rule followed by the U.S. courts, has kept the courts out of corporate decisions. The U.S. Business Law rests on the belief that actions of corporate managers are evaluated and approved by members of the board of directors of the corporation. In particular, corporate actions that have direct effects on shareholders' wealth are assumed to be communicated to them in a timely manner. Therefore, the U.S. courts would not interfere in corporate matters except for fraudulent activities. If members of the board of directors are not able or motivated to control managers, relationship investing is purported to achieve that. Relationship investing is an example of involved ownership of a business enterprise. Large investors tend to act as mentors to the managers of the firm and behave in a supportive and friendly manner. Investors pursue different approaches for maintaining corporate internal control for the purpose of creating a well-functioning business enterprise. The underlying reason for the corporate governance system is the stakeholders' pursuit for preserving their respective share of profit earned by business enterprises.

Corporations have become a powerful and dominant institution. They have reached to every corner of the globe in various sizes, capabilities and influences. Their governance has influenced economies and various aspects of social landscape. Shareholders are seen to be losing trust and market value has been tremendously affected. Moreover, with the emergence of globalization, there is greater deterritorialization and less of governmental control, which results is a greater need for accountability (Crane and Matten, 2007). Hence, corporate governance has become an important factor in managing organizations in the current global and complex environment. In order to understand corporate governance, it is important to highlight its definition. Even though, there is no single accepted definition of corporate governance but it can be defined as a set of processes and structures for controlling and directing an organization. It constitutes a set of rules, which governs the relationships between management, shareholders and stakeholders The term "corporate governance" has a clear origin from a Greek word, "kyberman" meaning to steer, guide or govern. From a Greek word, it moved over to Latin, where it was known as "gubernare" and the French version of "governer". It could also mean the process of decision-making and the process by which decisions may be implemented. Henceforth, corporate governance has much a different meaning to different organizations (Abu-Tapanjeh, 2008). In recent years, with much corporate failures, the countenance of corporate has been scared. Corporate governance includes all types of firms and its definitions could extend to cover all of the economic and non-economic activities. Literatures in corporate governance provide some form of meaning on governance, but fall short in its precise meaning of governance. Such ambiguity emerges in words like control, regulate, manage, govern and governance. Owing to such ambiguity, there are many interpretations. It may be important to consider the influences a firm has or affected by in order to grasp a better understanding of governance. Owing to vast influential factors, proposed models of corporate governance can be flawed as each social scientist is forming their own scope and concerns. Hence, this article reviews various fundamental theories underlining corporate governance. These theories range from the agency theory and expanded into stewardship theory, stakeholder theory, resource dependency theory, transaction cost theory, political theory and ethics related theories such as business ethics theory, virtue ethics theory, feminists ethics theory, discourse theory and postmodernism ethics theory.

As a legal entity, a corporation enters into contracts to produce goods and services and it has the right to own property. Furthermore, the firm can borrow from various lenders and raise cash by issuing shares of its ownership. Shareholders would not only benefit from the earnings generated by the corporation, but by electing members of the board of directors they could indirectly oversee actions undertaken by the managers. These managers, as agents of the shareholders, are expected to perform for the best interest of the owners of the corporation. Corporate managers can add value to common stockholders without decreasing the welfare of the other corporate stakeholders. For example, borrowing a portion of the capital that is needed for financing activities of the firm, would lead to a higher return to common stockholders. This is because borrowing is generally inexpensive for the firm in the face of taxation benefits available to business enterprises. Executive decisions may result in a transfer of wealth from one group of shareholders to the other. For example, by undertaking risky investment projects, greater rewards may be available to common stockholders without any such benefits to bondholders, except for suffering from excessive risk. Corporate managers can also destroy wealth. History tells us numerous examples in which actions undertaken by corporate executives have resulted in bankruptcy of the firm. The managers of a business enterprise, however, could add value for all corporate stakeholders including owners of the capital, labor, and the society at large. This would be a case of Pareto optimality in which the welfare of some group is increased without any decrease in benefits to the others.

2. OBJECTIVES OF THE STUDY

1. To provide an overview of the concept of corporate governance
2. To study about the theories and philosophies which resulted in strong foundation of corporate governance.

3. CORPORATE GOVERNANCE IN INDIA

The corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets. India has a well-established corporate governance framework and it remained unaffected by the Asian financial crisis of the late 1990s. Indeed, the move towards adopting good corporate governance practices, better financial and non-financial disclosures and the promotion of transparent and efficient markets in India had built up well before the Asian debacle. The corporate governance framework in India primarily consists of the following legislations and regulations:

- The Companies Act, 1956: Companies in India, whether listed or unlisted, are governed by the Companies Act. The Act is administered by the Department of Companies Act (DCA). Among other things, the Act deals with rules and procedures regarding incorporation of a company; prospectus and allotment of ordinary and preference shares and debentures; management and administration of a company; annual returns; frequency and conduct of shareholders' meetings and proceedings; maintenance of accounts; board of directors, prevention of mismanagement and oppression of minority shareholder rights; and the power of investigation by the government, including powers of the CLB.
- The Securities Contracts (Regulation) Act, 1956: It covers all types of tradable government paper, shares, stocks, bonds, debentures, and other forms of marketable securities issued by companies. The SCRA defines the parameters of conduct of stock exchanges as well as its powers.
- The Securities and Exchange Board of India (SEBI) Act, 1992: This established the independent capital market regulatory authority, SEBI, with the objective to protect the interests of investors in securities, and promote and regulate the securities market.
- The Depositories Act, 1996: This established share and securities depositories, and created the legal framework for dematerialization of securities.
- Listing Agreement with stock exchanges: These define the rules, processes, and disclosures that companies must follow to remain as listed entities. A key element of this is Clause 49, which states the corporate governance practices that listed companies must follow.

4. THE NATIONAL FOUNDATION FOR CORPORATE GOVERNANCE

There is no doubt that once the government and the regulators establish an efficient and effective regulatory framework for corporations to function in, the market would push these corporations to raise the bar constantly. There is also no doubt that India is progressing towards the inevitability of market-driven corporate governance practices. The corporate governance ratings introduced by some rating agencies in India, and the willingness showed by many companies to volunteer for these is a case in point. In the midst of this transition, the NFCG will play an important role. The Foundation, on a continuous basis, would collaborate with the regulators and concerned authorities to develop regulations which are in line with the dynamics of the emerging business environment and at the same time help corporations implement these regulations in letter and spirit. This would, however, not be a two-pronged approach but a multi-pronged one and would include:

- Creating awareness on the importance of implementing good corporate governance practices both at the level of individual corporations and for the economy as a whole. The foundation would provide a platform for quality discussions and debates amongst academicians, policy makers, professionals and corporate leaders through workshops, conferences, meetings and seminars.
- Encouraging research capability in the area of corporate governance in the country and providing key inputs for developing laws and regulations which meet the twin objectives of maximizing wealth creation and fair distribution of this wealth.
- Working with the regulatory authorities at multiple levels to improve implementation and enforcement of various laws related to corporate governance
- In close coordination with the private sector, work to instill a commitment to corporate governance reforms and facilitates the development of a corporate governance culture
- Cultivating international linkages and maintaining the evolution towards convergence with international standards and practices for accounting, audit and non-financial disclosure.
- Setting up of 'National Centres for Corporate Governance' across the country, this would provide quality training to Directors and aim to have global recognition and acceptance. In addition, the NFCG proposes to focus on the following initiatives:
- Encourage Corporate Governance cooperation in South Asia particularly relating to SAARC countries;
- Hold seminars in collaboration with World Bank and Asian Development Bank on Corporate Governance Audit;
- Explore the desirability and possibility of including Whistle Blowers' Policy as an essential feature of Corporate Governance; Work out feasibility of Corporate Governance guidelines for large institutional investors;
- Institute an annual award for the best Centre for Corporate Governance
- Work out the modalities for setting up of a database of independent directors with wider interactions with eminent groups, persons and societies.

These initiatives will be carried out after extensive consultations with concerned stakeholders. All these initiatives will be totally non-mandatory in nature. It will be entirely up to individual companies and institutional investors to decide whether they want to adopt the model whistle blowers' policy or the model corporate governance policies suggested by the NFCG. Similarly, the participation in the corporate governance audit, too, will be optional. The NFCG would also like to play a role in promoting corporate governance throughout South Asia. It will explore the possibility of linkages and cooperation with other countries in the SAARC region and seek to establish 'National Centres for Corporate Governance' as centres for excellence in the entire region. Once these centres become fully functional they could provide training to persons from South Asia Region in the area of corporate governance.

5. FUNDAMENTAL CORPORATE GOVERNANCE THEORIES

5.1. AGENCY THEORY: Agency Theory is used to understand the relationships between agents and principals. The agent represents the principal in a particular business transaction and is expected to represent the best interests of the principal without regard for self-interest. The different interests of principals and agents may become a source of conflict, as some agents may not perfectly act in the principal's best interests. The resulting miscommunication and disagreement may result in various problems within companies. Incompatible desires may drive a wedge between each stakeholder and cause inefficiencies and financial losses. This leads to the principal-agent problem.

The principal-agent problem occurs when the interests of a principal and agent are in conflict. Companies should seek to minimize these situations through solid corporate policy. These conflicts present normally ethical individuals with opportunities for moral hazard. Incentives may be used to redirect the behaviour of the agent to realign these interests with the principal's. Corporate can be used to change the rules under which the agent operates and restore the principal's interests. The principal, by employing the agent to represent the principal's interests, must overcome a lack of information about the agent's performance of the task. Agents must have incentives encouraging them to act in unison with the principal's interests. Agency theory may be used to design these incentives appropriately by considering what interests motivate the agent to act. Incentives encouraging the wrong behaviour must be removed and rules discouraging moral hazard must be in place. Understanding the mechanisms that create problems helps businesses develop better corporate policy.

5.2. STEWARDSHIP THEORY: A steward is defined as someone who protects and takes care of the needs of others. Under the stewardship theory, company executives protect the interests of the owners or shareholders and make decisions on their behalf. Their sole objective is to create and maintain a successful organization so the shareholders prosper. Firms that embrace stewardship place the CEO and Chairman responsibilities under one executive, with a board comprised mostly of in-house members. This allows for intimate knowledge of organizational operation and a deep commitment to success. Stewardship theory assumes that managers are stewards whose behaviors are aligned with the objectives of their principals. The theory argues and looks at a different form of motivation for managers drawn from organizational theory. Managers are viewed as loyal to the company and interested in achieving high performance. The dominant motive, which directs managers to accomplish their job, is their desire to perform excellently. Specifically, managers are conceived as being motivated by a need to achieve, to gain intrinsic satisfaction through successfully performing inherently challenging work, to exercise responsibility and authority, and thereby to gain recognition from peers and bosses. Therefore, there are non-financial motivators for managers.

The theory also argues that an organization requires a structure that allows harmonization to be achieved most efficiently between managers and owners. In the context of firm's leadership, this situation is attained more readily if the CEO is also the chairman of the board. This leadership structure will assist them to attain superior performance to the extent that the CEO exercises complete authority over the corporation and that their role is unambiguous and unchallenged. In this situation, power and authority are concentrated in a single person. Hence, the expectations about corporate leadership will be clearer and more consistent both for subordinate managers and for other members of the corporate board. Thus, there is no room for uncertainty as to who has authority or responsibility over a particular matter. The organization will enjoy the benefits of unity of direction and of strong command and control.

5.3. STAKEHOLDER THEORY: Stakeholder theory, on the other hand, states that a company owes a responsibility to a wider group of stakeholders, other than just shareholders. A stakeholder is defined as any person/group which can affect/be affected by the actions of a business. It includes employees, customers, suppliers, creditors and even the wider community and competitors.

Edward Freeman, the original proposer of the stakeholder theory, recognized it as an important element of Corporate Social Responsibility (CSR), a concept which recognizes the responsibilities of corporations in the world today, whether they be economic, legal, ethical or even philanthropic. Nowadays, some of the world's largest corporations claim to have CSR at the Centre of their corporate strategy. Whilst there are many genuine cases of companies with a "conscience", many others exploit CSR as a good means of PR to improve their image and reputation but ultimately fail to put their words into action.

5.4. RESOURCE DEPENDENCY THEORY: *Resource dependence* ideas were originally developed by Pfeffer and Salancik (1978) in the late 1970s. Unlike agency theory, their original ideas were inductively derived from empirical studies. Their key contribution is the observation that the board, and in particular the constitution of the non-executive element of a board, can provide the firm with a vital set of resources: 'When an organization appoints an individual to a board, it expects the individual will come to support the organization, will concern himself with its problems, will variably present it to others, and will try to aid it'. Seeing the board as a source of resources for a company opens up a very different way to think about the board's role in creating high performance. Resources can take a variety of forms each of which can be argued to add to the 'capital' of a company (Hilman and Dalziel 2003).

Non-executive directors can be a source of expertise which executives can draw upon, both in the form of specific skills as well as advice and counsel in relation to strategy and its implementation. They can also serve as an important source of contacts, information and relationships that allow executives to better manage some of the uncertainties in the environment. These relational resources can be both practical and symbolic; the association of particular individuals with a company has the potential to enhance the reputation or perceived legitimacy of an executive team.

Resource dependence theory allows us to think of the very different needs that companies have at different stages of their life-cycle. The young entrepreneurial firm, even if owner managed, can look to its non-executive directors as a source of skills and expertise that it cannot afford to employ full time. Here, the non-executive is a relatively cheap source of part-time legal, financial or operational management skills that are not otherwise available to the entrepreneur. Once a firm is publicly listed, then the provision of expertise will have to be blended with what one of our participants called 'grown-up governance'. Here the value of the non-executive lies not only in their expertise but also through their networks that give the company ready access to new markets or to sources of finance, as well as in the reputation benefits that arise from an individual's association with the company.

5.5. TRANSACTION COST THEORY: Transaction cost theory originated from the 1930s, when the economist Ronald Coase was investigating the reasons companies exist and why they were growing so large.

Transaction costs are incurred in spending time researching, negotiating and agreeing a transaction. Transaction cost theory examines the theory that directors would rather enter into agreements for their sources of goods and services as this reduces uncertainty as they have everything they need for the foreseeable future. By doing this the time and expense of sourcing materials is avoided.

Coase believed that, on average, directors would prefer to lose the flexibility of searching for inputs in order to have the certainty of predicting what would happen with their business in the future. Whilst committing to long-term agreements and contracts avoids uncertainty and is easier to control, it could mean that better opportunities may be missed.

Coase's concern was that directors were making their own life easier at the expense of opportunities that would improve shareholder wealth. However, if directors are not concerning themselves with constantly sourcing and renegotiating resources, they have more time to spend on longer-term strategy issues. Transaction cost theory explains why companies are getting bigger. Transaction cost theory says that in order to reduce uncertainty and to increase control, a company should tie itself up in more agreements and this therefore means more staff, more assets, more contracts and a larger company. Alternatively, a board of directors who are worried about the security of their supplies may choose to buy the company that supplies them. This is called vertical integration. The downside to vertical integration is that supplies will always come from that one company and there may be better quality or prices to be had elsewhere.

Social Contract Theory: Among other theories reviewed in corporate governance literature social contract theory, sees society as a series of social contracts between members of society and society itself (Gray, Owen & Adams 1996). There is a school of thought which sees social responsibility as a contractual obligation the firm owes to society (Donaldson 1983). An integrated social contract theory was developed by Donaldson and Dunfee (1999) as a way for managers make ethical decision making, which refers to macrosocial and microsocial contracts. The former refers to the communities and the expectation from the business to provide support to the local community, and the latter refers to a specific form of involvement.

5.6. POLITICAL THEORY: Political theory brings the approach of developing voting support from shareholders, rather by purchasing voting power. Hence having a political influence in corporate governance may direct corporate governance within the organization. Public interest is much reserved as the government participates in corporate decision making, taking into consideration cultural challenges (Pound, 1983). The political model highlights the allocation of corporate power, profits and privileges are determined via the governments' favor. The political model of corporate governance can have an immense influence on governance developments. Over the last decades, the government of a country has been seen to have a strong political influence on firms. As a result, there is an entrance of politics into the governance structure or firms' mechanism (Hawley and Williams, 1996)

6. CONCLUSION

A good corporate governance practice is an outcome of an accountable board of directors who ensures that the investors' interests are not put in danger The accountability and transparency component of corporate governance would help companies gain shareholders' and investors' trust. These stakeholders need assurance that the company will be run both honestly and cleverly. This is where corporate governance is critical. Corporate governance improves stakeholders' confidence and this would help the sustainability of business in the long run. The present corporate governance theories cannot fully explain the intricacy and heterogeneity of corporate business. Governance may differ from country to country due to their various cultural values, political and social and historical circumstances. In this sense, governance in developed countries and developing countries can be different due to various cultural and economic contexts of individual countries. However, the literature has confirmed that even with strict regulations, there have been loopholes in corporate governance. Hence it is very important that a rounded recognition be motivated across the corporate world that would bring about a different perspective towards corporate governance.

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