

Issues in Corporate Governance

Driving Globalisation without its Discontent: Role of Corporates

Following are excerpts from the paper presented by Prof. Poonam Kumar, Chairperson, Mega Ace Consultancy at the 5th International Conference on Corporate Governance on May 13, 2004 organized by the International Centre for Corporate Governance, London held at the London Business School, London UK.

The corporations of today are no longer sheer economic entities. These are the engines of national transformation. In an age where capital flows worldwide, a culture of corporate governance has become the need for future growth and stability of the company as well as the economy. The process of capital re-allocation has not only increased the long-term earnings growth potential of the economy as a whole, but has also widened the degree of uncertainty for individual firms.

Virtually in every country throughout the world, companies can be classified into five broad categories based on ownership and control :

- Companies with widely dispersed public shareholders
- Companies with a few dominant shareholders such as banks or large investors
- Companies with major corporate cross-holdings
- Family controlled businesses
- Privatised companies with a large residual government stake

The dynamic pace of corporate change in response to globalization of capital markets has produced so many exceptions to these "rules" in every country that it is now much more productive to look at companies in terms of their ownership structures, scale of operations and age of corporation which largely dictate their governance structures.

Each country has a different and changing regulatory infrastructure (company law, stock exchange listing requirements, enforcement and monitoring processes, etc.), which in turn prompts a different set of investor risk assessments and a different set of voluntary governance initiatives (codes, training programs for directors, etc.).

Strong corporate governance is thus indispensable to resilient and vibrant capital markets and is an important instrument of investor protection. Corporate Governance

reports now supplement the bridge between a company's management, directors and its stakeholders.

Demonstrably good corporate governance practices are increasingly important to determining the cost of capital in a global capital market.

The most outstanding feature of the New Millennium as all of us would agree is the fact that the world has become a global village. Globalisation and deregulation of markets all around mean that businesses can no longer remain isolated and secure in their individual turfs as they used to be earlier. Businesses which were once protected now need to compete with global giants.

Tremendous shifts have happened in the world leading to the modern, industrial era. The first phase of industrialization which commenced some 200 years ago lasting roughly till World War II, belonged to era of entrepreneurial capital. From the East India Company to Henry Ford, entrepreneurs, either singly or in cartels, built huge empires across businesses. This gave way to the second phase of industrialization, which came to the fore roughly in the last six decades. It belongs to the era of managerial capital. The same entrepreneurs who built empires in the earlier phase graciously withdrew to allow professional managers to manage the affairs. However, while these managers with passage of time became better at managing their companies, there has been a sea change in the nature of businesses, as well as the manner in which they are conducted. The environment in which they have to generate profits has changed dramatically. This, argue many industry watchers, is what's kicking off the third shift in the series, an era of intangible assets.

Ours is the first generation in the history of mankind that dares to believe in the sharing of knowledge and the practicality of the concept of making the benefits of civilization available to the whole human race. It is here that we welcome a new era of knowledge capital. We all possess knowledge but we continue to lack awareness for "awareness arises when knowledge accompanies action."

Globalisation and economic liberalization have brought about changes and each one present here and around the world realize the need to adapt to this changed business environment. Change management has today become one of the most critical factors of success for implementing economic decisions around the world.

However, with the huge global opportunities available, there also seem to be great challenges to ensure that corporates are able to derive maximum economic value on the resources they have raised and ensure that there is a fair return given to each stakeholder.

The collapse of some of the world's most envious companies like Enron, Adelphia, Global Crossing, Tyco, Worldcom and Parmalat have positioned issues of

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Prof. Poonam Kumar, Chairperson, Mega Ace Consultancy along with Former Chief Justice of India A.M. Ahmadi, Former Chief Justice of India M.N. Venkatachelliah & Sheela Bhide (then Joint Secretary Govt. of India) at the 5th International Conference on Corporate Governance in London



corporate governance as most critical.

Corporate governance is the system on how the objectives of the company are set and achieved, how risk is monitored and assessed, and how performance is optimized.

Good corporate governance structures encourage companies to create value through entrepreneurship, innovation, development and exploration) and provide accountability and control systems commensurate with the risks involved.

There is no single model of good corporate governance.

Fundamental to any corporate governance structure is establishing the roles of management and the board, with a balance of skills, experience and independence on the board appropriate to the nature and extent of company operations.

There is a basic need for 'integrity' among those who can influence a company's strategy and financial performance, together with responsible and ethical decision-making.

The impact of company actions and decisions is increasingly diverse and good governance recognizes the legitimate interest of all stakeholders.

The company's framework should be designed to

- enable the board to provide strategic guidance for the company and effective oversight of management
- clarify the respective roles and responsibilities of board members and senior executives in order to facilitate board and management accountability to both the company and its shareholders
- ensure a balance of authority so that no single individual has unfettered powers.

We have new techniques today on monitoring issues of governance namely rating corporates on the governance issues. We also have evaluation of performance of independent directors.

Sarbanes Oxley, Derek Higgs and in India, Nareshchandra Committee talk of independent directors, where 50% of the directors have to be independent.

"How independent are the outside directors?"

Enron had the most effective Board and more than 50% of its Directors were independent.

One of the biggest collapses in corporate history have been that of Enron which has forced a refocused attention on a plethora of core issues such as accountability and corporate governance.

There have been a reaction by the regulators following collapse of these Corporates.

The bankruptcy of Enron has inspired a wave of proposed legislative reforms from the Bush administration.

Sarbanes Oxley is described as a hefty piece of legislation. It has many excellent parts notably tougher regulation of auditors and restrictions on what non-audit work they may

do but however, the general feeling is that it risks benefiting mainly the lawyers.

Corporate Governance : Indian style

The listed companies in India were required by Securities Exchange Board of India (SEBI) to comply with a corporate governance code with effect from January 2000. The code was revised in 2003 by a new committee, headed by Mr. Narayana Murthy, who defined a good corporate governance system as one which attaches "a high degree of priority to the interests of shareholders who have placed their trust in the company to use the funds wisely and effectively".

While the original Cadbury report has suggested setting up of several Committees, but the two Committees which are most important for effective governance of corporates, are (i) the Role of the Independent Directors, and (ii) Audit Committee.

Further, the linkage of the corporates with the banks and how the banks monitor the corporates and use of the credits provided by them plays a major role in bringing about corporate efficiency.

Banks as drivers of Corporates: In order that banks serve as drivers of corporate governance, the banks themselves need to be efficient and strong. They must have their internal controls properly placed in line with the requirement of the BASEL Accord and the supervision arrangements by their Central Banking authority. Not only financial reporting by the banks should be reliable but they should also serve as a watchdog in the proper functioning of the corporates through their monitoring mechanism.

As the governance of corporates is guided by the laws relating to listings, the enforcement of listing requirements by the stock exchanges and the Regulatory Authority (SEBI in India, SEC in USA, FSA in UK, ASX in Australia), has to be highly effective in the sense that the corporates must not only file report in complying with the laws and regulations, but must also submit the mandatory information required by the regulators.

The greatest need for stronger independence and oversight, however, may lie in the boardroom itself. The current system does not need more financial disclosure rules. Rather it needs stronger oversight of those rules. These recommendations can help boards of public companies ensure that their members are informed and independent, and can fulfill their oversight duties with integrity.

Globalisation offers great opportunities for both developed and developing economies. Economic potential of developing economies can be fully achieved by collaborations and inflow of technical expertise and skill sets achieved by the experience of decades old companies in Europe, U.S.A. and other developed regions.

It is important that there is transparency in the deals and good governance is essential to drive these emerging economies to achieve their full potential.

Thank you.

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