Financial Accounting
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Lecture - 19
Corporate Governance

Namaste. We have already discussed Financial Statements now. I hope you are practicing on the same on balance sheet, then P and L and in last two sessions or last 3, 4 sessions rather we have been discussing on cash flow statement. So, now, we are going to go for some conceptual and theoretical aspects. I am hoping that you will continue your practice on the financial statements while for a week we will discuss on certain conceptual aspects. Keep in mind this conceptual aspects are equally important so that you get overall idea of various aspects related to accounting and they are very much important for the corporate or business world.

Now, one of the hot topics or hot areas which are discussed is known as Corporate Governance. I hope most of you have heard this term. It is often in news often for non wrong reasons that lack of corporate governance has led to some fraud as has led to some problems. So, what is Corporate Governance? This will be discussed in the current ppt. Now what do you understand by it? Can somebody think of it what it is? As the name suggest there are two name parts of it; one is corporate the other is governance. Corporate refers to companies or the corporations; governance refers to the rules for managing the company or operating the company.

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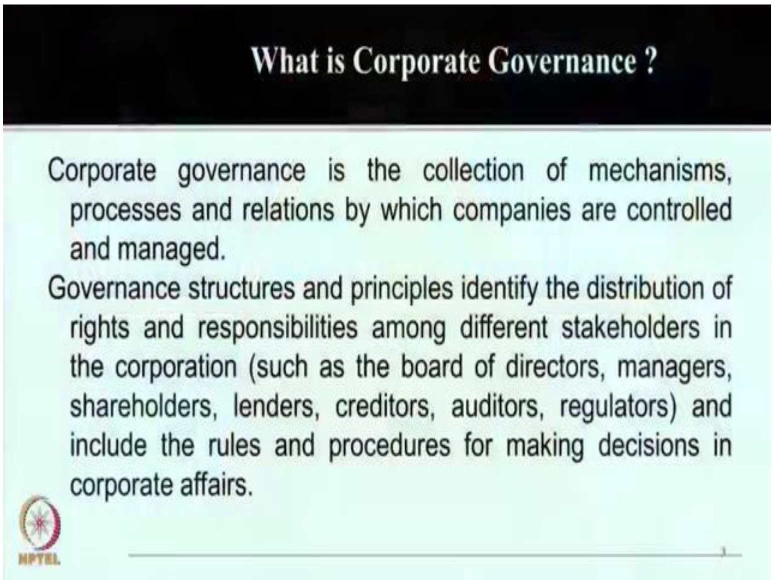

So, these are the norms for managing the company. These are some of the explanations as to what is Governance. Now Governance consists of various mechanisms, processes and relationships by which the company is controlled and managed. We want that company should be ruled properly, should be managed properly, should be operated properly. So, various processes are formed.

Now Governance structures and principles identify the distribution of rights and responsibilities because there are various stakeholders in the company. You all know that the owners of company are the shareholders, but shareholders are large in number, they are spread everywhere. They are not at one place. For a private company may be the number of shareholders are less 2, 3, 4, 5, 10; but for a public company there are lacks of share holders and they are located at different locations, in different cities for bigger companies; they are all over the globe.

So, they cannot manage day to day affairs. So, they appoint their representatives which are known as board of directors which are elected every year. So, we have got two parties now. We have got shareholders as the owners, then there are Board of Directors, there are other stakeholders as well. There are managers who are doing day to day management or regular functioning, who will be the employees of the company, there will and other employees as well.

Now company cannot operate without money. Shareholder is one source, but you know there are lenders in the form of bankers, in the form of institutions, in the form of debenture holders. They are also stakeholder. Apart from that there are creditors, government, auditors. All these stakeholder have different rights and responsibilities. Sometimes there are conflicts, they fight with each other. So, Corporate Governance seeks to form certain rules. We tell them that do not fight with each other, do your responsibility properly, get your rights and see that you do not encroach on other persons rights. That is covered in the governance structure which is integral part of Corporate Governance. Getting it?

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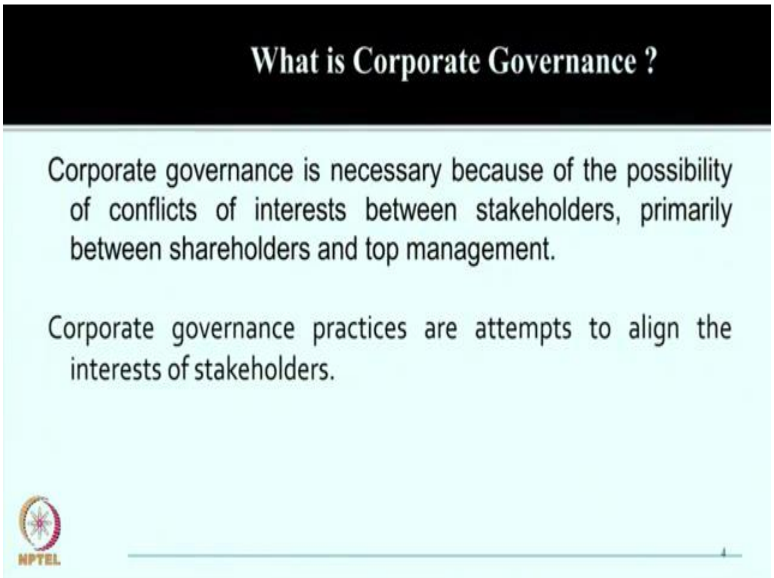

Now, why it is necessary? It is necessary because of the possibility of conflict between different stakeholders. There are natural conflicts of interest. I hope you know the different forms of business, like a proprietary concern, partnership and company. In proprietary concern what happens? There is only one person owner; mostly the same person is a manager. So, there is no conflict of interest. He is the owner and same person is manager. In company that is not the case. Shareholders are the owners, board of directors are their top management. So, there is a conflict. Shareholders want more profit, Board of Directors want more remuneration. So, it is necessary that to avoid their fights and have well defined rights and responsibilities, we need Corporate Governance.

So, what these do is Corporate Governance practices is an attempt to align the interest of each other to tell them that do not fight, have such a mechanism or arrangement or process where all the stakeholders benefit and naturally in the process the company keeps on growing healthily. Getting it?

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Now, these are the main principles of Corporate Governance. Transparency, Accountability, Trusteeship and Ethics. I think you understand all these terms.

Transparency because shareholders are far away, lenders at one place, customers are at other place, they all want to know about the company. So, company should run its affairs in such a way that necessary information is available to all. Board of director should not do partiality that they will have some information or their relatives will have some more information, while other stakeholders are keep kept in dark. That will give a wrong signal to the people. So, one of the essential principle is transparent operations or transparent governance system.

The second is accountability. Now those who are running the company either as board or as employees, they should be accountable. They are taking remuneration, they should be accountable for their decisions. So, accountability.

Next is trusteeship. It is very important that board and the managers consider themselves as trustees. That does not mean they should not take remuneration. They should take remuneration in a legal way, but should not be fraud of the company, should not enter into such transactions which are against the interest of the company for their selfish motive. That is why trusteeship is a very important principle.

And the last, but perhaps the most important is ethics. There is a need for high moral values. We know its business, everybody wants to make money, but they should make it following the moral principles. So, if the board of directors try to cheat shareholders, or a managers try to cheat the technology give to someone else, or those who are in charge tell our strategies to our competitors. It is lack of ethics and that would bring loss to the company, it would also bring loss to the stakeholders. So, it is very important to emphasize and to make all stakeholders realize that they should make money, but in ethical manner. In Hindi, we can call it as a "SHUBH LABH" (GOOD-PROFIT). They should have SHUBH (GOOD), they should have profits, they should have remuneration they should have dividends, but in a ethical manner.

So, these are necessary principles of Corporate Governance.

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Now, we are already discussed it, but now you can just see it in a form of a figure. There is a large body known as share holders. I have put it in the red because they are at a risk. They have put in the money, but they do not have control and you have another body called as senior managers. I have put the general term it includes the board and also many other managers who have day to day control over the company. So, ownership and control is separated. The relationship should not be ownership versus control that managers are trying to cheat the share holders. They should go hand in hand for the benefit of both.

So, senior managers always try to get more remuneration and they want more discretion that they should have all the freedom to take any decision they want. That is where the control is needed. They should get remuneration, but in a proper manner. They should have discretion, but the decisions which they are taking should have some control mechanism, that is why you have a Corporate Governance System.

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Now, separation of ownership and control is the main reason for need of governance. Now, controlling owners have their own interest. What happens is in the earlier figure we have seen that there are two groups share holders and senior managers, but within share holders also there are many groups. You may have a promoter group or a controlling group. Now they have the controlling stake. They are able to take all the decisions. There are lacks of small shareholders who will be scattered and who do not have any control. So, it is not just a conflict between shareholder and mangers. Between the shareholders also there are many groups. Major group is a controlling owner. This is often a long term owner and they have got lot of financial strength.

Often we call about talk about business groups. You know for example, there is a Birla group, there is a Tata group; there is a Reliance group. Now this groups means they have controlling stake in their companies and then there are lot of other shareholders who do not have controlling stake. Within other shareholders also sometime there are strategic shareholders who may have big chunks of shares like 5 percent, 10 percent, 15 percent like financial institutions or like foreign institutional investors. So, they are also having though not full control, but the partial control. Now often conflict of interest between controlling and small shareholders lead to certain investor protection issues.

Because regulators, government. In India, you know there is a regulator called SEBI Securities and Exchange Board of India. In US, there is a regulator called SEC S, E, C Securities and Exchange Commission. They try to intervene to ensure that small holders, shareholders are not cheated by the controlling shareholders or by managers. All these issues are very important for governance.

Now how is this executed?

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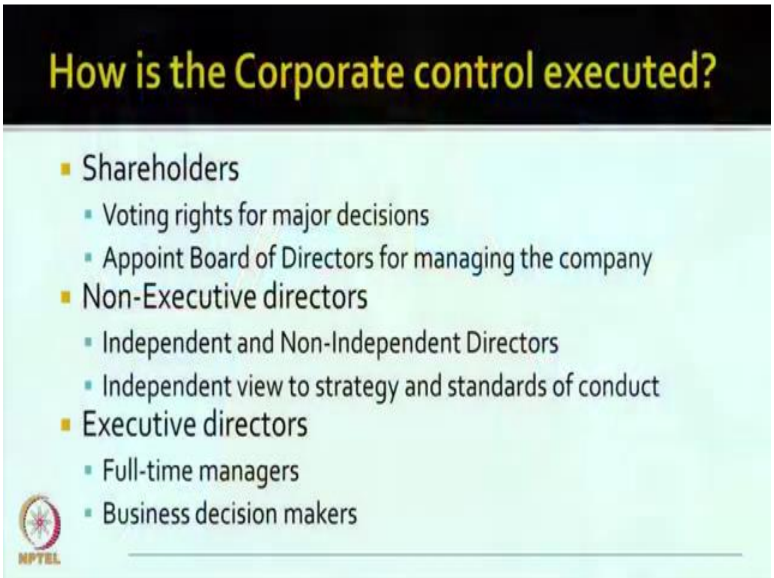

So, you know the owners are shareholders. What rights they have? The most important is they have got voting right. They have a voting right to appoint the Board of Directors for managing the company. So, in the annual general meeting, elections are held and board is appointed. That's their main right. Apart from that they have got voting right for doing several things like appointing Auditors, like taking major business decisions for mergers (Refer time: 13:19) or for making fresh issue, for coming out with right issue, or for taking a very large quantum of loan. So, any matters need to go to general meeting for getting the shareholder approval where shareholders above voting right.

So, these are the main rights of shareholders. Of course, many time these are on paper because lacks of shareholders are there, but they don't have time and money to actually come and exercise their right. So, often the rights are in the hands of controlling shareholder groups, but in any case as a shareholder as a body they have these rights.

Next are Non-Executive directors. So, within directors there are two groups, Executive and Non-Executive. Executive are Full-time managers. They take day to day business decisions. They are at the helm of affairs of company. There are also other type of directors who do not come everyday, they are on the board. So, they attend board meetings, they are part of important decisions, but they are not in the process of execution of decisions. Executive directors are there in taking decisions and also executing them. Okay, so where share holder is one group second is Non-Executive and third is Executive Directors. Now within Non-Executive Directors also there are 2 types Independent and Non-Independent Directors. Now Non-Independent Directors belong to the promoter groups.

For example, I think most of you know Reliance industries. Now who are the promoter groups in Reliance? The promoter group is Mukesh Ambani group because Mukesh Ambani and family owns major stake in the company and Mukesh Ambani is Chairman and Managing Director. So, belongs to the Executive Director position. He is able to take the decision and he is also in charge of actual running of the company. Now in the Non-Executive Director we have go to wife of Mukesh Ambani, Neeta Ambani. She is not day to day manager or Executive Director, but she cannot be considered as Independent, but she belongs to Ambani family. That's why she is a Non-Independent, but Non-Executive Director. Getting it? Then there are Independent Directors.

So, these are professionals like Charted Accountants or Cost Accountants or lawyers or professors who are many times invited on the board, they should not be from the owner family, but there is seat on board for giving a independent view of strategy. These people are called as Non-Executive Independent Directors. So, are you getting? So, these are the major groups. Independent directors are supposed to also maintain the standard of conduct. So, if something is wrong in the happening in the company, this seat on the board they are attending Board of Directors meeting. So, they are able to take major decisions and they should have some check on how the company is functioning.

At least they should see that wrong things do not happen. This is expected from Independent Non-Executive Directors. Getting it? So, this is the major structure.

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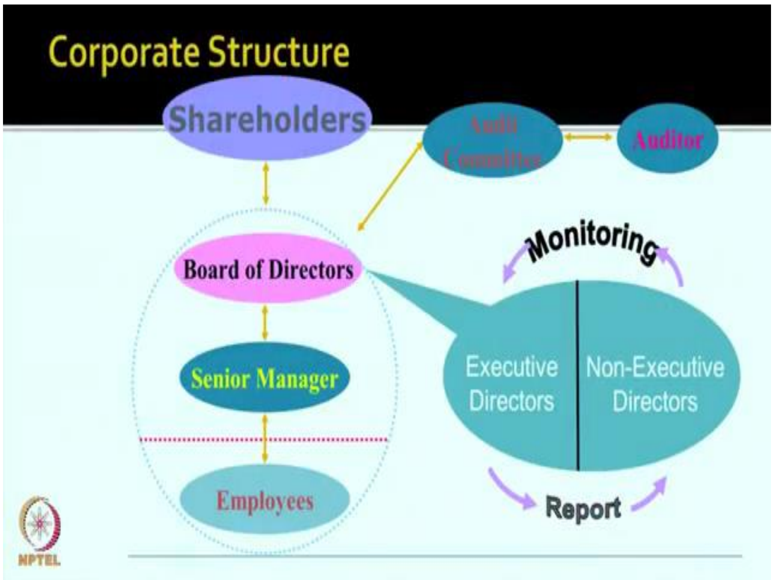

Now, here in the graphical form. So, you can see here shareholders they appoint board. Board intern appoint Senior Managers for regular running of company. Senior Managers intern appoint employees of the company. So, this is as per as the operation is concerned now to keep check you know there are Auditors. Who are Auditors? Auditors are independent professionals who certify the financial statements of the company.

In India, Chartered Accountants are the Auditors. Now whom will Auditors report. Suppose there is a fraud in company. When they are doing audit they realize that there is some fraud. Now Board of Directors are engaging in fraud or Senior Managers engaged in fraud then whom will the report? Will they again go and tell the board because they cannot go and tell all the shareholders, shareholders are scattered. So, within the board, Audit Committee is formed and that Audit Committee should have majority of Non-Executive Directors. So, that Auditors are able to report their findings to Audit Committee.

So, Audit Committee though is a part of board is supposed to overlook the functioning of the board to whom the Auditors make interim reporting, this is interim reporting. The final reporting Auditors will make directly to the shareholders, but that's in the AGM. Are you getting? During the year as and when the things are happening, the Auditors will provide their reports to Audit Committee who are overlooking the functioning of the board. Now within the board as we have already discussed there are 2 types of directors Executive and Non-Executive. Non-Executive Directors are meant to do monitoring function on the Executive Directors who are running the company.

So, Executive Directors are supposed to report to Non-Executive Directors. This is the overall structure. Are you waiting it? Now my request is you have already downloaded the annual report of your company. Go to the Board of Directors section. They would have given the list of the board. In that list, there will be a category of Executive and Non-Executive Directors. So, go through that. Look at various types of directors.

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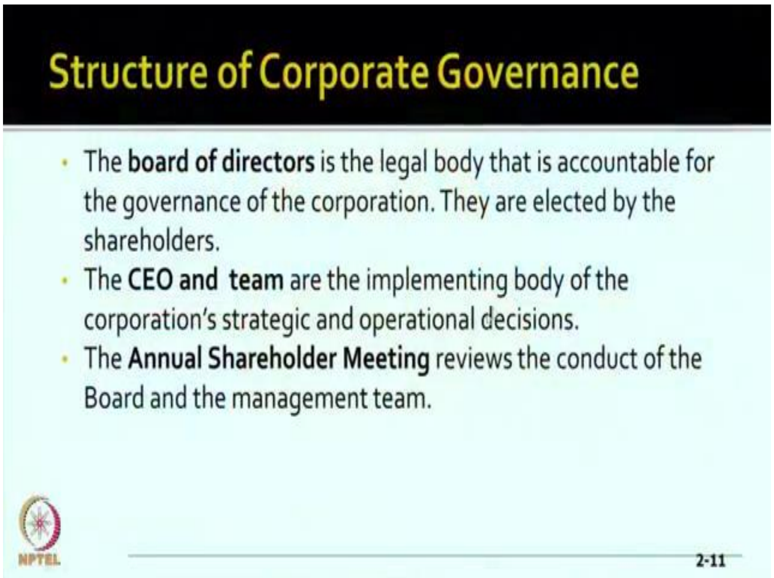

Now, further into the structure, we already know there is a board that some major body accountable for governance and that is a elected body by the shareholders. Then there is CEO and team which is an implementing body and there is Annual Shareholders Meeting. So, shareholders cannot meet every now and then, they meet only once a year and that is where they review the conduct of the board. Okay.

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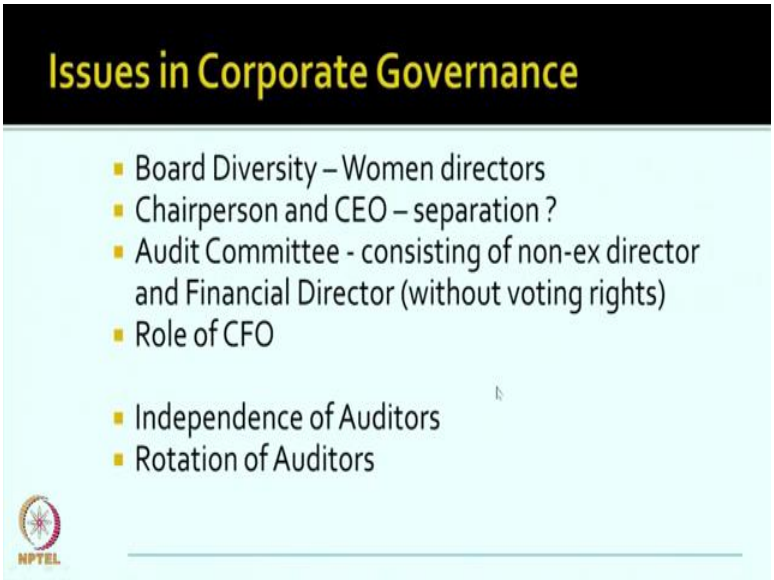

Now, a few more issues in Corporate Governance. One important issue is Board Diversity. Now if all the members of board belong to the same family, they would think in the same way that decision making of the company may not be that good. That's why on the board you need different type of people. So, over last many years these principles are getting evolved that you need more diverse board. That's why out of family or out of the promoter you need some Independent Directors. There is also now a requirement of having women directors. So, all boards for long where all male dominated.

Now, more and more women are being inducted into the board. There are also other ways to bring in diversity like employee representatives or representatives of some more groups. Now there are 2 important positions in the company Chairperson and CEO. Chairperson is the person who heads the shareholders body and also heads the Board of Directors and CEO or the Chief Executive Director Chief Executive Officer is in charge of regular day to day activities. Now same person may be Chairman and CEO. Like in case of Reliance, Mukesh Ambani is Chairman, he is also CEO of the company. Some of the groups have done a separation that have a separate person as Chairperson to overlook the activities, CEO for regular conduct of activities.

For example, most of the banks, Chairman is different, CEO is different. In Tata group you know Ratan Tata is Chairman of all Tata group companies, but he is not CEO of any company. There are professional CEOs. Nowadays for some of the companies like TCS even the Chairman is not from Tata family, but there are 2 different persons acting as Chairman and CEO. There are some advantages of the separation, though it is not necessary these are some of the issues. Next is Audit Committee. I think we have already discussed that Audit Committee is here to monitor the activities. So, Audit Committee consists of Non- Executive Director and a Finance Director because Finance Director is suppose to help them in understanding the financial statements, but the Finance Director does not have any voting right in the Audit Committee.

The role of CFO is also becoming important. CFO is Chief Executive Officer because CFO is will be accountable for proper preparation of financial statements. CEO may not have time of course, CEO is overall in charge of everything, but CFO is has a particular importance for heading the finance team of the company. Then we have already seen there are independence of Director, but the independence of Auditors are also very important. So, here we have got Auditors which are appointed technically by shareholders, but if Auditors listen to everything of the board then the independence is lost. That's why some principles have been brought in like Auditor should not provide other services to the company. So, that Auditor is independent. Same Auditor if auditing for so many years they become too much familiar

So, you need rotation of Auditors. So, like this various principles, new principles are coming in the Corporate Governance. There is one more type of control known as Market Corporate Control.

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Now, if the company is not doing properly. Now there is a market for voting shares and that gives the ultimate control. So, what will happen is if company is not transfer run, if there are frauds, if there is improper governance that message goes to stock market and in the stock market the demand for company shares may drop. So, the price of the company may drop. That brings in some check on the directors. That is possible if you have got a active secondary market, there will be some check because that will prevent managers from becoming lazy or pursuing selfish or unethical practices. Getting it? Because, their share prices will drop, but that is not the only thing.

Further if share price is dropped too much, other groups will try to take over the company that is through mergers and amalgamation because now it will become a cheaper company from them for them to take over. So, if there is a active market for mergers it becomes further check on promoters because they have some fear factor that if they are not working properly other companies may take over and may remove them and put their own managers. Getting it? So, this is one important and powerful mechanism of Corporate Governance. So, we have tried to summarize somewhat is Corporate Governance, what are the important principles and what is a structure of Corporate Governance. So, I hope you have understood it we will stop here. Namaste.