Corporate Governance: Is it an Effective Panacea for ensuring Corporate Ethics?

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Abstract

Recent events advocate the fact that there is continuous decline in the ethics and values as far as States and corporate are concerned. This signifies that there is flaw in system of governance. Corporate Governance refers to the system through which the behaviour of a company is monitored and controlled.

This paper endeavors to explore the effectiveness of current corporate governance framework in ensuring corporate ethics. In this paper, with the help of various scholarly works in recent past, it has been tried to explore significance of corporate governance in corporate functioning, pros and cons of corporate governance and the probable solution to enhance the effectiveness of corporate governance

It has been derived that good corporate governance, adds to competitive advantage, leads to high firm value and fair pricing of shares, yields positive market price reaction, preferred by investors. Fundamental shortcomings of corporate governance framework revolve around implications in real implementation, lack of quality corporate governance practices, problem of dominant shareholders, Distortion in Managerial pay-offs, Divergence from prescribed code, and even Hurting the overall economic growth.

Some of the imperatives for strengthening corporate governance framework comprises of orientation towards investors' protection, improving national standards of regulation to the best, obtaining optimum level of transparency, reducing information asymmetry, enhancing role of media, and controlling managerial distortion resulting from stringent regulation.

Keywords: *Corporate Governance, Dominant Shareholders, Managerial Pay-Offs, Investors' Protection, Information Asymmetry.*

Preamble

Change is the order of the day. Recent development in the field of science and technology has tremendous impact on our way of living. Similarly, globalization and liberalization has also significant impact over the business methodology as well. Today, entire business spectrum is undergoing a phase of change. There are significant changes in the environment, culture and ethics of the business system. Recent events advocate the fact that there is continuous decline in the ethics and values as far as States and corporate are concerned. This signifies that there is flaw in system of governance. This scenario has lead to the debate on the concept of Corporate Governance.

Corporate Governance refers to the system through which the behaviour of a company is monitored and controlled. The significance of Corporate Governance is that in modern economies large corporations are typically associated with a division of labour between the parties who provide the capital (i.e., shareholders) and the parties who manage the resources (i.e., management). Conflict of interest between the two groups might lead to insufficient monitoring of the executive, suboptimal levels of investment in the firm, or some shareholders being expropriated. In these scenarios shareholders might be hurt if there are not sufficient means to ensure that the company is properly monitored. In short Corporate Governance can be defined as "the effective management of relationships

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with integrity to produce enhanced company performance".

Corporate Governance deals with laws, procedures, practices and implicit rules that determine a company's ability to take managerial decisions vis-à-vis its claimants: in particular, its shareholders, creditors, customers, the State and employees. There is a global consensus about the objective of 'good' Corporate Governance: 'maximizing long-term shareholder value'. Since shareholders are residual claimants, this objective follows from a premise that, in well performing capital and financial markets, whatever maximizes shareholder value must necessarily maximize corporate prosperity, and best satisfy the claims of creditors, employees, shareholders, and the state; all aiming at ensuring ethical code of conduct in corporate affairs. The horizons of Corporate Governance have been expanding with the development of strong regulatory framework along with the growing awareness about the requirement of sound Corporate Governance practices in a company.

Objective and Methodology

This paper endeavors to explore the effectiveness of current corporate governance framework in ensuring corporate ethics. There is not any doubt the theoretical contribution of corporate governance in enhancing corporate ethics. However, the asymmetry and divergence in recent times have made it necessary to revisit the tenet. In this paper, with the help of various scholarly works in recent past, it has been tried to explore that

- What is the significance of corporate governance in corporate functioning?
- How does corporate governance help a company?
- What are the shortcomings of current corporate governance framework?
- What can be done to enhance the effectiveness of corporate governance?

Evolution of Corporate Governance

The form of governance has kept changing from time to time, and the process is still not over. Though the terms governance, good governance and corporate governance are gaining momentum in business spectrum more in recent times, it is obvious to know that the concept of governance is not a new one. In fact, the concept of governance is as old as human civilization. Few historical evidences of it can be traced below:

- Manu, the son of Prajapathi was the first king who brought out a comprehensive code of conduct or governance for men, society and the state as a whole in his treaty called Manu Dharma Shastra.
- In Mahabharata, while Bhishma delivered his first formal disclosure on polity, he says in ambivalent terms that the king should always prioritize interest of his subjects over that of his own.
- The great political thinker of 3rd century BC namely Kautilya in his treaty Arthasastra has laid down the ideals at which the king was expected to aim.
- In eastern literature a good society is one wherein a high, ethical standard of life is characterized by the pursuit of wealth, employment and liberation. It is the prevalence of dharma, which characterizes an ideal society. Such a society is possible if the governance of the country is based on clear, efficient and effective administration and all the rulers aim at this goal in the ancient times.

In last century there were significant developments in Corporate Governance due to a number of events and their respective responses. The summary of such events and their respective responses have been illustrated ahead:

Table 1: Characteristics of Corporate Set-up & Counter-Response

Timeline	Characteristics	Response
1950s	The Era of Excessive Managerial Power	The Trustbusters
1960s and 1970s	The Age of Conglomerates	The Hostile Takeover
1980s	The Rise of Insider Trading	The Stock Option Boom
1990s	CEO Pay: Nowhere to Go but Up	Shareholder Activism
2000s	The Age of Scandal	The Downsized CEO

Relationship of Corporate Governance and Corporate Ethics

There is a well sought theoretical relationship between corporate ethics and corporate governance. Due of dilution of ownership in corporate structure, it has been observed that managers have been indulged in practices which lead to substantial harms to not only to shareholders but also to stakeholders at large. Corporate governance emerged as a mechanism requiring companies to exhibit their functional aspects which gives stakeholders an insight of what is happening in within the internal domain of companies.

Major concerns for corporate ethics in last few decades have been

- Insider Trading
- Corporate Scandals
- False (overstated / understated) Financial Statements
- Information Symmetry
- Dominance of family-owned business
- Divergence from requisite legal framework

As a result, the concept corporate governance was coined to make sure that companies exhibit ethical functioning. However, as regulators frame a way to reach the diverging entities, diverging entities keep coming with new mechanisms of divergence. Hence, in practical the corporate governance framework needs to be robust enough to ensure no opportunity of any divergence.

Significance of Corporate Governance

Corporate governance is the need of the hour. Some people argue about the relevance of the mechanism which is not utterly effective in achieving for what is meant for. However, one needs to understand that any robust system doesn't evolve overnight. The significance of corporate governance can be illustrated with the following points:

- **Number and scope of corporate collapses in recent times** clearly illustrates that corporate accountability practice is failing to match the rhetoric, even when regulatory enforcement is being mandated by law and enforced by criminal and civil penalties (Sarre, 2002). Corporate scandals have increased in number as well as their extent has expanded manifold, which gives a prime rationale for having a more robust corporate governance framework.

- **Providing for penal provisions in not enough.** With the discovery of massive frauds in the Indian as well as International capital markets, regulators and legislatures have increasingly turned towards making Corporate Governance standards mandatory and have attached penalties to violation of these Corporate Governance 'guidelines' (Parekh, 2003). But it is important to understand someone, who is not ethical, doesn't care for law and attached penal provisions as well. Such people always seek a justification for their code of conduct and power of money make them over-confident for finding a way to escape from so-called penal provisions.

- **Corporate governance can act as way of identifying that something is wrong** in the corporate set-up. It has found that in the year before fraud detection, fraudulent firms exhibit governance weakness, such as the percentage and number of outside directors, the number of audit committee meetings, the number of financial experts on their audit committees, the quality of the external audit firms, the proportion of firms with the combined CEO-chair position, and the percentage of block-holder ownership (Farber, 2005). Even it has been observed that after fraud detection, corporate governance move towards the established codes more vigilantly. So stakeholders if being rational and sensitive to corporate governance indicators, it can give them an insight of a probable scandal.

- **Effective corporate governance can reduce corruption.** Empirical evidences indicate that companies with good corporate governance in practice are less involved in unethical conduct. Corporate Governance is among the important factors determining the level of corruption and Corporate Governance standards can have profound impacts on the effectiveness of the global anti-corruption campaign (Xun, 2005). However, some big companies (Enron, WorldCom, Tyco, Satyam) have been found in corporate scandals, which have added to questions to relevance of the framework. However, tenet remains valid in most circumstances.

- **Shareholder activism has made it inevitable.** At present, shareholders' awareness level is increasing and institutional as well as individual investors are giving significant weight to corporate governance which has created an implicit pressure on board of directors to adhere with the good governance norms. If directors do not show leadership on Corporate Governance reforms, investors will; Boards that embrace reform may well reap a trust premium, while those that continue to ignore the call for change will be serving neither management nor shareholders well (Felton, 2004).

What companies gain from Good Corporate Governance?

Companies exhibiting the good corporate governance practices tend to reap out advantages as they are perceived as 'responsible' companies. These can be Various benefits a company derives from adhering to good corporate governance norms are as follows:

- **Good corporate governance adds to competitive advantage.** In current competitive scenario, a firm's strategic transparency is heavily related with its relative market position as well as the degree of competitiveness it can achieve. One of the common factors that determine the success of Corporate Governance structure is the extent to which it is transparent to the market forces within particular institutional arrangements (Eldomiate *et. al.*, 2005).

- **Good corporate governance leads to high firm value.** Stakeholders feel positive for the firm who exhibit the requisite governance practices. Now companies are focusing on value maximization rather than profit maximization because maximizing value of firm provides them a sustainability quotient. Both company-level as well as country-level Corporate Governance play a significant role in understanding when risk management is associated with higher value as risk management is one channel through which stronger Corporate Governance translates into higher firm value (Allayannis *et. al.*, 2007).

- Now a days various independent agencies provide ranking to companies' governance. Stakeholders also seek to have higher transparency so that they can be assured that their interest is protected and company is moving in the desired direction. Firms scoring higher in governance and transparency rankings are more greatly valued in the stock market (Durnev & Kim, 2004). Firms with low governance rankings may as yet have an unrecognized and inherent equity gain that could attract potential investors who wish to engage with the board to improve the firms' adoption and disclosure of governance principles that would be recognized by the market and create increased demand positively affecting equity values (Walker, 2013).

- **Good corporate governance leads to fair pricing of shares.** It becomes obviously easier to market participant to go into details of pricing equations of shares. Mispricing of share is a desirable state neither for investors nor for company. Share mispricing, which is more exogenous and market determined is a simple but effective measure of Corporate Governance as shares of good governance companies are less mispriced compared to bad governance companies (Marisetty & Vedpuriswar, 2001). Hence, it becomes inevitable for companies to ensure that their governance doesn't lead to mispricing of shares and making firm more prone to market volatility.

- **Good corporate governance yields positive market price reaction.** Now Indian capital market is gaining efficiency, where investors have started reacting to price sensitive information. Corporate governance being a prime investors' protection vehicle has a strong weight in terms of market price reaction. Companies which are doubtful in terms of governance are given negative market reaction. The market price reaction is positive and significant when a firm announces its decision to commit to greater transparency and minority shareholder protection and the liquidity impact of improved governance is also positive since trading costs decrease after incorporation into the differentiated segments (Chavez & Silva, 2006). Thus, it can be derived that stock exchanges can play a critical role in leading, but obviously not with the weak investor protection regulation.

- **Good corporate governance companies are preferred by investors.** Besides, other traditional yardsticks of investment decision making, now corporate governance has also emerged as an important indicator for investment decision. Nobody wants to put hard-earned money at stake by investing the same in company with poor governance. The nature of Corporate Governance in international investors' home countries affects their portfolio choice abroad and therefore that these investors should not be lumped together in analyses of their portfolio choice (Kim et. al., 2008).

Shortcoming of Corporate Governance in Indian Scenario

Inspite of various pros of the concept, corporate governance has not been truly effective for what it was meant for. Unless these shortcomings are identified and sorted out, corporate governance framework cannot serve the purpose. The key shortcomings can be narrated as follows, which results in divergence from being ethical.

- **Good on paper only.** India suffers from bureaucratic characteristics badly. Good norms are drafted and equally well implemented on 'papers only'. Framing laws and implementing them on paper doesn't serve the purpose alone. There has to be good understanding of the norms as well as intent behind the norm, otherwise any good legislation becomes a mere piece of paper responded by another piece of paper. While on paper the India's legal system provides some of the best investor protection in the world, the reality is different with slow, over-burdened courts and widespread corruption; mainly caused by highly concentrated ownership and family business groups continuing to be the dominant business model; leading to significant pyramiding and tunneling among Indian business groups and, notwithstanding copious reporting requirements, widespread earnings management (Chakrabarti *et. al.*, 2007).

- **Fundamental shortcomings.** Indian companies still lack quality corporate governance practices, which needs to be rectified as soon as possible. There are evidences of ineffectiveness of boards in Indian companies, the lack of transparency surrounding transactions within business groups, the divergence of Indian accounting practices from international standards, and the changing role of, and controversy surrounding, institutional shareholders (Banaji & Mody, 2001).

- **Less effective in disciplining the dominant shareholders.** The biggest lacuna of corporate governance framework in Indian scenario is that most of businesses run in corporate form are family owned business. This leads to concentration of ownership leading to creation of minority shareholders whose protection is at stake in the process. The problem in the Indian corporate sector (public sector or the multinationals or private sector) is that of disciplining the dominant shareholder and protecting the minority shareholders and this problem of Corporate Governance abuses by the dominant shareholder can be solved only by forces outside the company itself, viz. the regulator and the capital market (Varma 1997). So far, regulatory bodies have not been able to come up with something which can ensure disciplining the dominant shareholders and ensuring minority protection.

- **Distortion in Managerial pay-offs.** In recent days, managerial pay-offs have been a point of debate. Sometimes, extremely high managerial pay-offs are characterized by bad governance companies. Acharya & Volpin, (2008) has derived that When firms compete in the managerial labor market, the choice of Corporate Governance by a firm affects and is affected by the choice of governance by other firms. Firms with weaker governance give higher payoffs to their management to incentivize them. This behavior forces firms with good governance to pay their management more than they would otherwise. This externality reduces the value to firms of investing in Corporate Governance and produces weaker overall governance in the economy.

- **Divergence from prescribed code.** Corporate legislative framework is very vast, complicated and overlapping as well. In the process, Companies have the choice to deviate from their national Corporate Governance standards by opting into another system; They can do so via contractual devices - such as cross-border mergers and acquisitions, (re)incorporations, and cross-listings - which enable firms to choose their preferred level of investor protection and regulation (Goergen & Renneboog, 2008). There is a need to come up with a comprehensive legislative framework so that this ambiguity can be minimized which exist to overlapping and contradicting norms.

- **Hurting the fiscal revenue.** Interestingly weak corporate governance can also impact the fiscal earnings of the company. Because when things are not in order, it takes less than a little to distort things a bit further but if affects economy badly. In a scholarly work, it was found that when the Corporate Governance system is ineffective (i.e., when it is easy to divert income) or when ownership concentration levels are high, an increase in the tax rate can reduce tax revenues generating a corporate version of the Laffer-curve (Desai *et. al.*, 2004).

How to improve the scenario? : The probable solution

After looking at prominent pros and cons of the corporate governance at business spectrum, it is equally significant to explore the probable solution. First and foremost fact is that developing a robust system is quite dependent on state of development of economy as well. At a given level of country investor protection, better governance mechanisms are more likely to be accepted at the firm level as a country's financial and economic development improves (Doidge *et. al.*, 2006). Any system tends to get robust and comprehensive as and how economic progression takes place.

Secondly, regulators' orientation towards investors' protection is very imperative. A country's legal system has a significant influence on various aspects of Corporate Governance, especially the extent to which it protects investor rights (Denis & McConnell, 2003). SEBI, in India, has been very vigilant in this regards since its inception. Recently they have announced that they will come up with a set of comprehensive guidelines.

Third, Individual countries should first focus on improving national standards of regulation and corporate practice rather than attempt to reach a common set of matrices from the start and when appropriate governance standards are in place in individual countries, codes of best practice could then be integrated into a consistent framework for all countries to develop more regionally integrated capital markets (Cheung & Chan, 2004). Without developing a framework which suits entities of a particular nation and strengthening it to the best, we cannot dream of integrating norms and coming up with a universally accepted code of conduct. It has been argued that globalization should pressure firms to adopt a common set of the most efficient Corporate Governance practices, while others maintain that such convergence will not occur because of a variety of forms of path-dependence (Palepu *et. al.*, 2002).

Fourth, one of the common factors that determine the success of Corporate Governance structure is the extent to which it is transparent to the market forces within particular institutional arrangements (Eldomiaty & Choi, 2004). Hence, it is vital to pay attention to the desired transparency from companies. However, there has to a be a limit but the balance has to be obtained.

Fifth, impact of information asymmetry in building market discipline needs to be highlighted. Cai *et. al.* (2007) has examined the impact of asymmetric information on three main mechanisms of Corporate Governance: the intensity of board monitoring, the exposure to market discipline, and the pay-for-performance sensitivity of CEO compensation and found that firms facing greater asymmetric information tend to use less intensive board monitoring but rely more on market discipline and CEO incentive compensation. Thus, corporate governance framework needs to address this issue as well.

Sixth, Role of media in building market discipline cannot be avoided. Media has expanded its wings and has a solid force on corporate as well. Thus, some vehicles can be figured out where corporate officials can be asked about the discrepancy as and when it comes in notice. Media affect companies' policy toward the environment and the amount of corporate resources that are diverted to the sole advantage of controlling shareholders and media play a very important role to play in pressuring corporate managers and directors to behave in ways that are "socially acceptable" (Dyck & Zingales, 2002).

Last, Regulation of large shareholder intervention may provide better protection to small shareholders, but such regulations may increase managerial discretion and scope for abuse (Becht, *et. al.*, 2005). So after drafting regulations it is equally important to explore that enhanced regulation should not add to managerial distortion.

Concluding Remarks

Thus, it can be concluded that corporate governance has been a system with positives as well as some underlined negatives. The disclosure is widely believed to play an important role in Corporate Governance. However, disclosure is a two-edged sword (Hermalin & Weisbach, 2008). Increase in transparency by detailed disclosure is the soul of corporate governance framework. However there are costs and benefits attached to it as disclosure can reduce firm profits, raise executive compensation and increase the rate of CEO turnover.

For developing corporate ethics culture, strong corporate governance is must. At present companies have adopted a repetitive format for reporting on corporate governance merely as a part of annual financial report mainly for compliance of norms (primarily, SEBI Clause 49). But there is a need to create an ethical environment which is self driven as self driven discipline is better than the imposed one.

Hence, it can be derived that both regulators and companies need to align a balance between the costs and benefits of corporate disclosure. However, there is a strong need to revisit the tenets of corporate governance and come up with a system which ensures corporate ethics at work. The more stringent corporate governance rules will strengthen the system asking companies to remain ethical in their code of conduct. However, at the same time, it will also provoke unethical players to find a new ways of divergence. This is a never-ending web. Hope, the ethical wins it in the end.

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