Corporate Governance

Introduction

Corporate governance is the system by which companies are directed and controlled. Good corporate governance is important because the owners of a company and the people who manage the company are not always the same. In some companies, directors and shareholders are the same. But in most of the cases, especially in listed companies, shareholders are different from the management. In these scenarios, a need arises for a properly designed code to ensure no stakeholder remains disadvantageous. As board of directors manages the companies, they are the responsible parties for the compliance with guidelines in corporate governance codes.

IMPORTANT

The aim of Corporate Governance is to ensure that companies are run well in the interests of their shareholders, employees and other key stakeholders such as the wider community. The aim is to try and prevent company directors from abusing their power which may adversely affect these stakeholder groups.

Key Components of Organization's Governance Framework

a) Structure

This includes, Organizational design and reporting structure and the structure of Committees

b) Infrastructure

This includes all the facilities, which includes policies and procedures, reporting and communication and technology

c) Talent and Culture

This includes Performance Management and Incentives, Leadership development and Talent programmes

d) Oversight Responsibility

includes Board's oversight and responsibilities, Management Accountability and Authority

Principles of Corporate Governance

1) Keep the interest of stakeholders in mind.

Corporate governance recognizes that the stakeholders in the business must be acknowledged in all areas of society, the market, legality, and their contracts.

2) Treating shareholders equally

Companies must not only respect shareholders and their rights, but also assist shareholders regarding exercising their rights. This could be done by letting and inspiring shareholders to contribute in company events such as meetings.

3) Identifying the roles of the Board of Directors

Board of the directors is people who are at the highest level of a company. The responsibilities of the board are varied and it necessitates people needing both talent and knowledge to assess worker conduct. In addition, the corporate governance assists to assure that the board is committed and has the required size to operate the business effectively and efficiently

4) Ethical behaviour

Other vital principles of corporate governance are ethics and integrity. Any person positioned in corporate office or in the board must have a high level of integrity. They need to follow a code of conduct and display ethical behaviour during the decision-making process of the business.

5) Transparency

The concept of disclosure or transparency is the concluding principle of corporate governance. This means that the company should always let it be known what the responsibilities and duties are of those that work for the corporation as well as who is management in order to keep stakeholders accountable. In addition, to be transparent, companies should material information related to the business in a way that promises anyone who is investing can have clear access to information.

Advantage of Corporate Governance

- Greater transparency and Greater accountability - Corporate governance allows improve the procedure and gives individuals responsibility, so everyone is accountable for their respective activities and transparent in all business relationships.

- Operational efficiencies – Starting from top to bottom, proper responsibilities are assigned to different stakeholders and which leads effective utilization of limited resources with the objective of getting maximum benefits.

- Better risk responding abilities – Corporate Governance, mitigating or decreasing the amount of Risk that is engaged. If the business organization is having a good Corporate Governance, implementation of a proper Risk Management Framework is not thar difficult.

- Less likely to be mismanaged – Corporate Governance develops the Public Image and the Company takes more responsibility for its activities.

Role of Board of Directors under the CG perspective

- Every public company should be headed by an effective Board, which should direct, lead and Control of the Company
- The Board should meet regularly. Board meetings should be held at least once in every quarter of a financial year in order to effectively execute the board's responsibilities, while providing information to the board on a structured and regular basis; ideally monthly, or as agreed by the Board.
- The chairman's role in preserving good Corporate Governance is crucial. As the person responsible for running the board, the chairman should preserve order and facilitate the effective discharge of Board functions.
- The Board should ensure the availability within it of those with sufficient financial acumen and knowledge to offer guidance on matters of finance.
- It is preferable for the Board to have a balance of Executive and Non-Executive Directors such that no individual or small group of individuals can dominate the Board's decision taking.
- There should be a formal and transparent procedure for the appointment of new Directors to the Board.
- All Directors should be required to submit themselves for re-election at regular intervals and at least once in every three years.
- Boards should periodically appraise their own performance in order to ensure that Board responsibilities are satisfactorily discharged.
- Shareholders should be kept advised of relevant details in respect of Directors.

Role of Shareholders under the CG perspective

- Participation for the AGM's
- Exercise the Voting Rights

Audit Committee

Functions of the Audit Committee

- Overseeing of the preparation, presentation and adequacy of disclosures in the financial statements of a Listed Entity, in accordance with Sri Lanka Accounting Standards.
- Overseeing of the Entity's compliance with financial reporting requirements, information requirements of the Companies Act and other relevant financial reporting related regulations and requirements.

- Overseeing the processes to ensure that the Entity's internal controls and risk management are adequate to meet the requirements of the Sri Lanka Auditing Standards.

- Assessment of the independence and performance of the Entity's external auditors.

Benefits of an Audit Committee

- Improved credibility of the financial statements through an impartial review of the financial statements and discussion of significant issues with the external auditors.

- Increased public confidence in the audit opinion as the audit committee will monitor the independence of the external auditors.

- Stronger control environment as the audit committee help to create a culture of compliance and control.

- The skills, knowledge and experience of the audit committee members can be invaluable resource for a business.

Agency Theory and Stewardship Theory

Agency occurs when one party, the principal, employs another party, the agent, to perform a task on his behalf.

Stewardship is the responsibility to take good care of resources of the organization. A steward is a person entrusted with management of another person's property.

This relationship, where one person has a duty of care towards someone else is known as 'fiduciary relationship'. This relationship of 'good faith' can be seen between the directors of a company and the shareholders of the company. There is a 'separation of ownership and control in the sense that the shareholders own the company, while the directors make the decisions. The directors must make their decisions in the interest of the shareholders rather than in their own personal interest.

Therefore,

A) The Directors are the Stewards of the Company

B) The shareholders are the principals, employing the Directors as agents to run the Company on their behalf

C) The Directors are accountable to the shareholders for the way in which they run the Company.

What is Agency Conflicts?

The separation of owners and management in many businesses leads to the classic 'agency problem'. In Business, the agency problem usually refers to a conflict of interest between a company's management and the company's owners or shareholders.

A conflict of interest is inherent in any relationship where one party is expected to act in another's interests. The problem is that the agent who is supposed to make the decisions that would best serve the principal is naturally motivated by self-interest, and the agent's own best interests may differ from the principal's best interests.

In present business scenarios, directors have the delegated responsibility for managing the affairs of the company by the owners. So they act as trustees/agents for the shareholders. Agents are likely to have motives different to these principals. They may be influenced by factors such as financial rewards, labor market opportunities and relationships with other parties that are not directly relevant to principals. In this kind of a situation, we are facing to a Agency conflicts.

The Financial Statements are the primary mechanism for shareholders to monitor the performance of directors. However, as a result of the separation of ownership and control, there may be tension in the shareholder-director relationship. Shareholders have limited access to information about the operations of a company and may believe, therefore, that they are not getting the right information they need to make informed decisions or that the information being provided by way of financial statement is biased.

As such shareholders may lack trust in the directors and in such a situation the benefits of an audit in maintaining confidence and reinforcing trust are likely to be perceived as outweighing the costs. The audit provides a mechanism for shareholders to help ensure that the directors are acting in the Company's best interests and therefore plays a fundamental stewardship role. The purpose of audit is to enhance the degree of confidence of intended users in the financial statements.