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IMPORTANCE OF CORPORATE GOVERNANCE

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ABSTRACT

The term corporate governance came into vogue following the Asian Economic Crisis in July 1997 and has since been bandied about quite frequently in the business press. This paper looks at some of the different definitions of corporate governance as well as the importance of corporate governance. It then looks at the core components that contribute to effective governance by looking at the model developed by the Organization for Economic Cooperation and Development (OECD) Business Sector Advisory Group on Corporate Governance or more commonly known as the Millstein Report.

Keywords: - Corporate Governance, Effective, Term, Governance,

I. INTRODUCTION

Corporate governance creates the structure, in which the company objectives are defined, tools for their achievement and supervision by the owner over the operations of the company. If the corporate governance system is sound, it will give effective incentives to achieve the objectives in the best interest of the company and the shareholders. This will contribute to the more efficient supervision over operations, with direct impact on the effective use of resources in the company.

Dynamic business environment requires from business companies to be flexible and to react quickly to the market demands. 1 In a market economy, corporate governance encourages economic development, ensures economic growth and allows companies to get involved in long-term projects

The prevailing interest among policy makers for corporate governance reform as well as the related interest in reducing corruption and cronyism in business affairs is primarily grounded in economics and a belief in the allocative efficiency of free markets. With globalization and the removal of barriers to the free flow of capital, policy makers have come to recognize the importance of corporate governance in attracting capital inflows. Conversely weak corporate governance systems together with corruption and cronyism distort the efficient allocation of resources thereby undermining the level playing field and ultimately hindering investment and economic development.

The Chairman of the United States Federal Reserve Board Alan Greenspan in his remarks to the World Bank and International Monetary Fund Program of Seminars in 1999 touched on some of the lessons gleaned by policy makers in the aftermath of the Asian Economic Crisis, which started in July 1997. They included the systematic failure of investor protection mechanisms, weak capital market regulation as well

as the existence of "crony capitalism". These in turn led to crises of confidence, which spread, from individual firms to entire nations.

Corporate governance is essentially a blueprint that companies use to manage the business in a way that ensures accountability to stakeholders, protects business integrity, and maximizes profitability. Depending on the individual company, corporate governance includes various components, such as policies, responsibilities, decision-making processes, principles, action plans and financial disclosures.

The main individuals within a company who are responsible for achieving good corporate governance are the members of the board of directors. Each publicly traded company is required by law to have a board of directors who are elected by shareholders to oversee the company. The board of directors are primarily responsible for making high-level decisions, providing strategic guidance and mitigating risk — which are all activities that fall under corporate governance.

Strong and effective corporate governance helps to cultivate a company culture of integrity, leading to positive performance and a sustainable business overall. Essentially, it exists to increase the accountability of all individuals and teams within your company, working to avoid mistakes before they can even occur.

When a company has solid corporate governance, it signals to the market that the organization is well managed and that the interests of management are aligned with external stakeholders. As a result, it can provide your company with a strong competitive advantage.

II. DEFFINATION OF CORPORATE GOVERNANCE

The providers of finance to corporations be it individuals, mutual/pension funds, banks, financial institutions or even governments require assurances that their investments are both productive and protected. Effective corporate governance is about providing those assurances. According to Millstein (1998), the term corporate governance can be defined both narrowly as well as more broadly.

The Millstein Report (1998) goes on to add however that stakeholder and shareholder interests are not necessarily mutually exclusive. She observes that corporations do not succeed by consistently neglecting the expectations of the other stakeholders but at the same time neither can they attract much needed capital from the equity markets if they fail to meet shareholders' expectations of a competitive return. Hence the most successful corporations from the corporate governance perspective are those that are able to strike the right balance between the interests of shareholders and the interests of the other stakeholders

III. THE IMPORTANCE OF EFFECTIVE CORPORATE GOVERNANCE

As a result of globalization and the increasing complexity of business there is a greater reliance on the private sector as the engine of growth in both developed and developing countries. Corporations are legal entities created by societies because they are an efficient form of organization and society benefits from their existence. Corporations contribute to economic growth and development, which in turn leads to

improved standards of living as well as the alleviation of poverty. The end result of all this activity is the creation of more stable political systems.

Corporate governance contributes to growth and development of the corporation itself, the related activities and the state in general. For a long time now the role of the company is not only to produce or provide services and make profits in this way. Companies take responsibility for development of the social environment. It is not possible to ensure development of the company relying only upon the interest of the company, while neglecting the overall development of the community. Corporate governance contributes to improved efficiency and effectiveness of the economic system. The existence of an efficient system of corporate governance within a company or the economy as a whole helps to reach the level of trust necessary for proper operations of a market economy. As a result, we have lower cost of capital; companies are encouraged to efficiently use resources, thus supporting growth.

IV. CHARACTER OF THE STATE IN CORPORATE GOVERNANCE

Role of the state in corporate governance consists of improving and encouraging development of companies and ensuring responsibility in the exercise of power, as well as protection. Local entrepreneurs in the markets of the developing countries need political initiative to convince local and foreign sources of finance to enter the market.

- Ensure incentives and sanctions for companies
- Balance gap between wages in the public sector and private companies
- Protect the interests of persons who have an interest in the company

Lessons to be learned from successful market economies are that the state policy should strive to create an environment that leads to the following: -

- Easing the initiation of business activity
- Reducing the obstacles for business arrangements
- Friendly and fair tax environment
- Service oriented state administration
- Provision of export incentives
- Incentives for job creation and regional objectives
- Protection of persons having an interest in the company (suppliers, clients and employees)

V. THE MODULES OF CURRENT CORPORATE GOVERNANCE

Gregory and Simms (1999) observed that corporate governance's practices vary across countries and industries, reflecting both differing societal values as well as differing ownership structures, business and competitive conditions. It can also be due to differences in the strength and enforceability of contracts, the political standing of shareholders and debt holders as well as the development and enforcement capability of the legal system.

In the developed countries, the elements of effective corporate governance include well positioned and regulated securities markets; laws which recognize shareholders as the legitimate owners of corporations whilst at the same time ensuring the equitable treatment of minority and foreign shareholders; enforcement mechanisms protecting the rights of shareholders; laws to protect against fraud on investors; sophisticated courts and regulators; an experienced accounting and auditing sector and significant corporate disclosure requirements. In addition to this, the developed countries also have well-developed private sector institutions such as organizations of institutional investors, professional associations of directors, corporate secretaries and managers, as well as rating agencies, securities analysts and a sophisticated financial press.

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On the other hand, many emerging countries have not yet developed fully their legal and regulatory systems, enforcement capacities and private sector institutions required for effective corporate governance. There is in many of these countries, a need for further development of the stock exchange, systems for registering share ownership, enactment of laws for the protection of minority shareholder interests, the empowerment of a vigilant financial press, the improvement of audit and accounting standards and a paradigm shift in the mindset against the widespread tolerance of bribery and corruption as an unavoidable cost of doing business in some of these countries.

On top of differences in the stage of development of each countries legal and regulatory system, they also differ remarkably in their cultural values, which underpin their financial infrastructure as well as their chosen model of corporate governance. Greenspan (1999) in his remarks to the World Bank and the IMF Seminar Program noted that the development of financial infrastructure and all the institutions that support it is "invariably molded by the culture of a society". In the final analysis, corporate governance and the framework underpinning it must be pertinent to each countries unique legal environment and cultural values.

VI. CONCLUSION

Corporate governance contributes to growth and development of the corporation itself, the community around it and the state in general. For long now the role of the company is not onlyto produce or provide services, thus acquiring profit. Companies now take the responsibility for development of the social surroundings.

Corporate governance represents a key element in improving economic efficiency and growth and increasing the trust of investors.

Corporate governance is important for economic development and its important role is to encourage local and foreign investments in the economy. However, there will be no inflow of investments until the investors are convinced that the risk is reduced and until they get tangible evidence that the government activities do not involve mere rhetoric.

There is a heightened awareness worldwide that effective corporate governance as manifested by transparency, accountability as well as the just and equitable treatment of shareholders is now a pre-requisite towards efforts to promote sustainable development. Towards this end, there is a need for both public (as represented by governments) and private sector partnership to raise the awareness of the importance of corporate governance improvements and to assist in implementing corporate governance reform.

This together with globalization and the attendant fall in regulatory barriers between countries will ensure that investment capital flows to those corporations that have adopted efficient corporate governance standards including internationally acceptable accounting and auditing standards; adequate investor protection mechanisms as well as board practices designed to provide independent and accountable oversight of managers.

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