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Good Governance & Corporate Governance

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Abstract:
The relevance of good governance and spiritual transformation has increased manifold owing to increasing competition among the corporate. The corporate in mad race to maximize profits, have turned into profit churning machines. This has an adverse impact upon the society and the employees of the organization. The recent data from various agencies like Ministry of Corporate Affairs, Ministry of Environment reveal the increasing number of legislations against violation of the environmental and governance norms by the corporate.
The newer emerging regulations have given rise to a "Prisoners' Dilemma". If the corporate cooperate and comply with the existing regulations pertaining to social welfare, they get incentivized in form of tax sops and increase in brand value. If they don't cooperate, they are penalized heavily.
This paper is aimed at analyzing the various factors such as the payment mechanism and group incentive plans, the principal – agency problem arising due to delegation of decision making to managers as the reason for increasing violation of norms and deterioration in governance levels. We intend to do a chi square based hypothesis testing on compliance and good governance for the corporate. The secondary data was collected on whether the corporate has a sustainability policy, number of Corporate Social Responsibility initiatives, number of independent directors, number of women directors, number of litigations if any in the past, amount spend on Corporate Social Responsibility, awards and accolades won by the organization.
More data was collected from Ernst n Young IACC report on Corporate Social Responsibility and KPMG report on CSR (Corporate Social Responsibility). This data collected was further analyzed using Chi square testing and coefficient of determination.
This paper aims to deploy descriptive research to analyze the extent of corporate compliance with Corporate Social Responsibility regulations and its impact on shareholders wealth maximization.

1. Introduction

With increasing globalization and liberalization, there is a sudden increase in the number of corporate scams and scandals. In the mad race to increase the top line, corporate have been compromising on the business ethics and values. As per the data available till year 2011 around 155,392 firms have been black listed for the violation of corporate guidelines. The amendment of the companies act, 1956 has brought about several changes in the way the corporate are managed. The Companies Act, 2013 has made it mandatory for the companies to invest around 2% of its corporate profits in area of corporate social responsibility. Every qualifying company requires spending of at least 2% of its average net profit for the immediately preceding 3 financial years on CSR activities. Further, the qualifying company will be required to constitute a committee (CSR Committee) of the Board of Directors (Board) consisting of 3 or more directors. The CSR Committee shall formulate and recommend to the Board, a policy which shall indicate the activities to be undertaken (CSR Policy); recommend the amount of expenditure to be incurred on the activities referred and monitor the CSR Policy of the company. The Board shall take into account the recommendations made by the CSR Committee and approve the CSR Policy of the company.

In this paper, we have tried to evaluate the various models and various dimensions of corporate social responsibility problem. The unrelentless impetus on corporate profits and efficiency has certainly changed the way the organizations are doing the business. The organizations have been working towards increasing their efficiency at the cost of corporate ethics and value.

2. Objectives

The main objective of this study is to assess the Corporate Social Responsibility initiatives being undertaken by various companies, including the appointment of the independent women directors, submission of the compliance report, number of environmental and other social welfare initiatives being undertaken by the companies. The study also aims to draw a relationship between the corporate social responsibility and increase in the market value of the firm. The objectives of the Corporate Social Responsibility initiatives is given below:

- To study the number of corporate social responsibility initiatives being undertaken by the corporate
- To study the relationship between the legal violation cases and corporate social responsibility expenditure of the companies
- To study the Prisoner's Dilemma, being faced by the corporates;
- To study the various models of social ethics including Hosmer Model;
- To analyze the impact of Corporate Social responsibility initiatives on shareholder wealth maximization

3. Problem Statement

One of the major problems being posed by increasing capitalism, is the increasing social costs and decline in Social Welfare. The capitalists, being the owner of the capital do not find it profitable to compensate the society for all the social losses, that are incurred by the overexploitation of the natural resources.

The amendment in the Companies Act, 2013 have made it mandatory for the corporates to spend at least 2% of their net profits on CSR (Corporate Social Responsibility) activities. But this expenditure is hardly optimally allocated and there is no Government intervention to ensure that Social Costs incurred are minimized. These Social Costs in form of Environmental pollution, degradation, exploitation of natural resources cannot be quantified.

4. Literature Review

In the book “Aristotle on the Constitution of Social Justice”, he has emphasized the relevance of the social justice and virtues, in increasing the social welfare. He has emphasized how virtuous actions and not merely the thoughts are the reason for the happiness of mankind on face of the Earth. The Aristotle has emphasized the need for happy dispositions, social foundations for the happiness in the society. Further adding to the Nicomachean Ethics, that it is the duty the present generation to build legislations to build the capacity to undertake, virtuous activities. Virtuous activities are possible only through a well developed political community”. In this paper we have tried to examine, how only a political will to implement the corporate legislation towards mandatory Corporate Social Responsibility, can help to achieve the vision of developed and progressive society.

As per Sh Ananda Dasgupta (2005), Corporate Social Responsibility is on agenda of number of stakeholders including Government, Non Government Organizations, Investor Groups and other actors in the civil society.

As per Parmar (2012), Corporate Social responsibility encompasses entire gamut of the activities including stakeholder engagement, supply chain management, consumer and customer relations, corporate Governance, Human resources and environment to name a few. This paper also aims at analyzing the impact of Corporate Social Responsibility on various stakeholders.

As per Suma Damodaran (2006) The businesses and corporates have started using various tools to measure the impact of positive and negative externalities on Indian economy. He has also discussed the concept of the Private and Social cost, i.e. loss that is being borne by the corporate and the society to eliminate the negative externalities. With coming up the concept of Corporate Social Responsibility, there is also need to measure the impact of Government responses to externalities in form of taxes, regulation and effluent fees.

As per the Companies Act 2013 all corporate are mandatorily required to spend around 2% of their net profits on compliance and corporate social responsibility activity. Moreover the companies are also required to appoint the women independent directors.. They are also required to submit a copy of the compliance and CSR report to the Ministry of Corporate Affairs.

5. Research Methodology

This paper aims to use the Regression Analysis to establish the relationship between the legal suit and market price of the share of the companies. In this paper we have also used the regression analysis to define the relationship between the Return on Equity (ROI) and CSR (Corporate Social Responsibility) Expenditure.

The secondary data has been taken from the Ernst N Young and IACC report and KPMG CSR (Corporate Social Responsibility) Survey Report.

From the Ernst N Young CSR (Corporate Social Responsibility) Report, 2014, around 64% of the Management personnels agreed that CSR (Corporate Social Responsibility), 2014 should be implemented. Around this data, the information pertaining to CSR (Corporate Social Responsibility) was collected through questionnaires.

6. Data Analysis

Hypothesis Testing using, chi - square was to ascertain whether there is any association between the CSR (Corporate Social Responsibility) policy and its implementation.

- H0 : There is no association between CSR (Corporate Social Responsibility) and its implementation

Ernst n Young, IACC report disclosed that there of the 30 respondents only 64% agreed that CSR (Corporate Social Responsibility) policy should be implemented.

The data collected through questionnaires and KPMG report disclosed that 88% of the respondents corporates have implemented the CSR (Corporate Social Responsibility) initiatives. And around 32% only have given the details of CSR (Corporate Social Responsibility) initiatives in their Director’s Report.

Grand Total	CSR policy is not significant	CSR Policy is significant	Particulars
100	36	64	Ernst n Young Report

Table 1: Ernst n Young IACC Business Insights & CSR

Total	CSR Implementation & No Disclosure	CSR Implementation & Disclosure	Particulars
100	68	32	Observed
100	36	64	Expected
-	1024	1024	(O-E)^2
47.06	15.06	32	(O-E)^2/E

Table 2 : Chi Square Analysis

Chi Square Value : 47.06
For significance level 0.05 and Chi Square value of 47.06

At this value of chi - square, the p value is 0 that indicates that the null hypothesis is insignificant and hence we can reject the hypothesis , that there is no association between the CSR (Corporate policy framing) and its implementation. Hence, the companies which have formally adopted a CSR (Corporate Social Responsibility) are more likely to implement it.
The other dimension of the policy is the CSR (Corporate Social Responsibility) framework and Environmental violations. The Environmental violation leads to increasing **Social Costs**. This increasing social costs raises the concern pertaining to the effectiveness of the Corporate Social Responsibility policy.
A sector wise case study of was undertaken to understand the dynamics of **Cartelization, Collusion and Corporate Misgovernance** in the Mining sector. As per the Shah Commission report around 70 top blue chip companies have violated.

6.1. Coase Theorem

In most of the cases pertaining to the Public property is the absence of ownership over the public property like clean water, clean air, land or the environment. Since the corporates utilizing the Public property for their projects, do not have any *Direct Cost* to incur and the negative Externalities are only in the form of hidden cost, unless and until the party being directly affected comes forward and files a petition, the corporates do not have a economic motivation to stop that activity.
Hence, if the public property is put into the private hands, they can bargain with the users and can arrive at an efficient solution. As in case of the mining companies, around 70 Blue chip companies were framed in serious Environmental violation, despite having a Corporate Social responsibility policy. To avoid this the Indian Government has introduced various standards in form of the Pollution Control Norms and penalty of minimum of INR 10 Crores. It is extremely important that while tendering for the Public Goods proper care should be taken to prevent cartelization and collusion.

7. Optimal Allocation of the CSR Resources

In this paper we have tried to do study the efficiency of allocation the CSR expenditure. Ideally, if the expenditure or allocation is equal to the investment, it will certainly lead to Social Welfare and should lead reduction in the Government Expenditure on subsidy for social welfare. Otherwise an equivalent sum will have to be allocated towards social investment by the Government. This expenditure is being passed on to the customers in the form of Tax.
CSR (Corporate Social Expenditure) will certainly lead to increase in GDP (Gross Domestic Product) through a multiplier effect.
Owing to lack of any mechanism to define the damage caused to the environment, a flat penalty INR 10 Crores is being imposed on the violators. In many sectors like Oil and Mining, there is increasing instance of collusion.
An optimal rule should be that the Private players pay Marginal Social Cost of raising the funds to the Marginal Social benefits delivery. The Government decision to raise 2% of the profits as CSR expenditure is not sufficient to dissuade the corporates from creating *negative externalities.*

7.1. Game Theory

In the mining sector, where cartelization is a norm, if the corporate get access to the information, they can collude and cooperate to maximize their private profits at the cost of Social Welfare. As per the Companies Act, 2013, the corporates are required to spent around 2% of the net profits on Corporate Social Responsibility. And if they violate, they will be penalized with maximum penalty of INR 10 Crores. The Payoff Matrix will look like this;

Do Not Violate	Violate Norm	
-(10 + 2% of Net Profits) , 2% of Net Profits	-(10+ 2% of Net Profits) , - (10 + 2% of the Net Profits)	**Violate the norm**
2% of Net Profits, 2% of Net Profits	-(2% of Net Profits), - (10 + 2% of the Net Profits)	**Do not Violate the Norm**

Table 3: Game Theory

If both the players get to cooperate they should opt to spend 2% of Net Profits and should not violate the norm. However, the payoffs are not sufficient dissuade the players from floundering the norms. Since, the public property is not owned by the private players themselves and the profits expected are more than the social cost of exploitation of natural resources, there creeps in *social losses.*

7.2. Licensing

Licensing through contract bidding and auction is sought as the means to reduce the impact of the negative externalities. However, that has not worked in Indian context, where external collusion and cartelization is the norm. The escalating cost of the inputs work adversely in the favour of exploitation of the natural resources.

7.3. Business Model for Shareholder Wealth Maximization

Every qualifying company requires spending of at least 2% of its average net profit for the immediately preceding 3 financial years on CSR activities. Further, the qualifying company will be required to constitute a committee (CSR Committee) of the Board of Directors (Board) consisting of 3 or more directors. The CSR Committee shall formulate and recommend to the Board, a policy which shall indicate the activities to be undertaken (CSR Policy); recommend the amount of expenditure to be incurred on the activities referred and monitor the CSR Policy of the company. The Board shall take into account the recommendations made by the CSR Committee and approve the CSR Policy of the company.

<u>7.3.1. Optimal Allocation of CSR (Corporate Social Responsibility Expenditure)</u>

Every company should create an optimal allocation of the resources between various causes to ensure that *Marginal Social Benefits* are greater than the *Marginal Social Cost* that is being incurred by the corporate. This will create a self policing mechanism, as the gains of the society will be definitely converted into *Return on Investment.*

The corporates can take help of the Government mechanism to create the markets for the positive externalities and social welfare.

<u>7.3.2. Role of a Principal to create the Market for Social Goods</u>

The corporates should adopt a proactive approach to create the market for the Social Goods through advertising, communication and marketing.

<u>7.3.3. Quantifying the Negative Externalities</u>

The corporates should work towards including the cost of negative externalities in their business model to create efficient markets. These costs should be utilized create social welfare and social benefits.

<u>7.3.4. Application of PPP Model</u>

As far as possible as suggested by Besley and Ghatak, for the public goods and projects of public relevance, it is extremely important that Public Private Partnership Models are adopted for the execution of the projects.

8. Recommendations

- There should be a business model to quantify the social costs being incurred by the exploitation of the natural resources. Since most of these costs are incurred by the PSU (Public Sector Undertakings) and Private companies trying to harness the natural resources, which are acquired through the PPP (Public Private Partnership) bidding route. There is need to inbuilt these costs in the Business Model.
- There is a need to build a business model to ensure the optimal allocation of the limited resources through Corporate Social Responsibility expenditure among the various social causes
- To prevent the cartelization and collusion leading to excessive exploitation of the natural resources, there should be proper regulation and pricing models.
- The Managers not being the real owner of the business are merely the agents of their Principals. They hardly have an incentive to work for the welfare of the society. A professional body or affiliation should be set up to make the Managers, owners in the business.

9. Abbreviation

- CSR Corporate Social Responsibility
- EY Ernst n Young
- GDP Gross Domestic Product
- INR Indian Rupee
- IACC Indian American Chamber of Commerce

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