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Corporate Governance – In Wider Perspective

Somnath Banerjee
Assistant Professor, NSHM Knowledge Campus, Kolkata, West Bengal, India

Abstract:
Any business has to be so conducted that the final benefit percolates to all stakeholders across the value chain. Most importantly it can not be said and done without the intervention of a legal structure, principles and directives and moreover a strong surveillance mechanism which is followed by an enforcement system. So the requirement of such a legal framework seems to have the requirement of an wider pasture which should encompass almost all areas of activities of the representatives starting from their appointment and covering every dimension of their functioning and decision making.
This should also be understood that such practices in any country should be in line with the best practice codes in the countries having the major share in the world's trade, mostly the European countries and USA. In the following sections we will discuss this issue in greater details and we will look at this in a wider perspective.

1. Introduction

The issue of corporate governance is widely discussed now across all industries and across the world. The main crux of this issue is derived from the theme of dispersed ownership in corporates which leads to the issue of agency problems and best practices that results in maximum value creation for the stockholders and comprehensively to all the stakeholders.
A company as we know procures its funds from the public and mainly from equities. Equity shareholders are the main owners of the companies. But as shareholdings are not concentrated in public companies, there arises the dispersed ownership issue. As it is not possible to manage the operations of the business by the owners, so such business is managed by the representatives of them. In our discussions, these representatives are none but the directors. The directors as per the Indian legal system are in a fiduciary relationship with the major stakeholders that is shareholders. It implies that the directors should run the business with the best of their abilities and prudence so that the business achieves its monetary goals in the immediate time and also the growth and prosperity of the business sustains in the long term.
This clearly means that the business has to be so conducted that the final benefit percolates to all stakeholders across the value chain. Most importantly it cannot be said and done without the intervention of a legal structure, principles and directives and moreover a strong surveillance mechanism which is followed by an enforcement system. So the requirement of such a legal framework seems to have the requirement of a wider pasture which should encompass almost all areas of activities of the representatives starting from their appointment and covering every dimension of their functioning and decision making.
This should also be understood that such practices in any country should be in line with the best practice codes in the countries having the major share in the world's trade, mostly the European countries and USA. In the following sections we will discuss this issue in greater details and we will look at this in a wider perspective.

1.1. Good Governance and Some Considerations

As corporate governance is a pervasive issue it may not be possible to touch all the areas of this in one single definition. This can be explained as in the following statement…
Good corporate governance is characterized by a firm commitment and adoption of ethical practices by an organization in its entire value chain and in all of its dealings with a wide group of stakeholders encompassing employees, customers, vendors, regulators and shareholders (including the minority shareholders), in both good and bad times .
To achieve this certain checks and practices need to be embraced. Some considerations in this regard are as follows.

- Codes of conduct are very important as well as whistle blowers but more important is how they are communicated and implemented and practiced. The Directors and senior managers should lead by example.
- Independent Directors are the directors who do not have any connection with the promoter directors or others in the company. More than to have a few independent directors, it is more important to have a selection process of independent directors which is transparent and rigorous.
- Earnings are important but more than that the sustainability is important. Nowadays a parlane has become very popular i.e., How is more important than How Much.
- Recently there is a wide controversy regarding the sanctity of the rating agencies and their rating process. Rating agencies should act in the best line of ethical practices.

- Executive compensation should be clear and transparent and should bear direct relationship with executive performance. Stock option based compensation should be transparent and surveillance mechanism should exist to detect any earning manipulation therein.
- Regulatory authorities should be proactive and substantial penalties (which should also be defined) should be imposed for non compliance.

1.2. Corporate Governance Codes in India and Some Areas of Concern

In India Clause 49 of the Listing Agreement with the stock exchange issued by SEBI outlines comprehensive code of conduct required for corporate governance. Moreover the New Companies Bill 2009 together with Clause 49 leads towards a well constructed set of codes for corporate governance.

Clause 49 instructs that one third of the Board should comprise of independent directors if the Board chair is independent. If the Board chair is non independent then it demands that half of the Board should be independent.

In this regard few concerns are there which are as follows.

- The process of selection of independent directors are not very clear in many cases and the independent directors may have been nominated by the promoter directors. Else there may be some other ways in which an independent director may be known to the company or he is not that independent somehow.
- Another big area of concern is the Chairman CEO duality. If the Chair of the Board is the CEO then power concentrates and independence of power looses much of its presence. Rather an effective system would be where the CEO should be accountable to the Board and the Chairman. The CEO should be answerable in terms of his performance and should justify his pay.
- Many Indian companies are still having a family oriented structure where a big responsibility is given to the senior level managers and the CEOs so much so that even they are not questioned by the Board. They should be made answerable to the CEO and the Board.
- The independent directors also should undergo a peer review process in terms of their performance evaluation and so.

1.3. Audit Committee and Some Concerns

Audit Committee is a committee which mainly comprises of independent directors is entrusted with the responsibility of ensuring integrity of the company's financial statements, managing risks through internal control systems and internal audit mechanism and the regulatory compliance.

When it is the duty of the directors to act in the best interest of the company, the audit committee which functions independently of the executive management has another responsibility of acting in the best interest of the shareholders also. There are a few concerns in these area also.

- Independent Directors are often holding positions very similar in other organizations also and remain packed up with a schedule of meetings. So effectively it becomes very difficult for them to actually get into the internal processes of the organization and to understand them better. So a question may arise that it may not be possible to run an effective internal control without understanding internal processes in detail.
- Another aspect of the functioning of the Audit Committee requires understanding of the application of Standards and IFRS on the final financial results which sometime requires detailed time spending and involvement which many a times may not be possible to have from independent directors. Even in Satyam's case it was very difficult for the independent directors and the Audit Committee to detect by understanding the effect of applications of wrong accounting and financial policies and principles and ignoring risk management or conservative accounting practices. In the advent of IFRS where the accounting practices will see a paradigm shift from the modern practices the functioning of Audit Committee still remains at a very important plane but practically the feasibility of redeeming all the responsibilities envisaged to them remains as a question only.

1.4. Corporate Governance and Corporate Social Responsibility and Concerns

In today's world the terms corporate governance and corporate social responsibility are almost intertwined. As on date in India, according to FICCI, CSR is being interpreted by the manufacturing companies as an effort to compensate the losses caused to the environment because of their operations as well as to improve the quality of life of the people mostly nearby their operating areas.

The activities in CSR can be broadly categorized under environment, society and economy. The areas where very prominent stress is involved are carbon reduction efforts, product recycling, waste disposal, water purification and conservation, animal protection and prevention of cruelty towards animals. In the socio economic front : education, social welfare, motivating people for self help, medical facility, women empowerment, prevention of child labour,care for senior citizens, encouragement for sports, heritage and culture. In such an important area also there are some concerns like

- As this is not yet regulation driven, there is the requirement of strong motivation of the Board towards an inclination for CSR but only after ensuring an ethical and sustainable functioning of the organization internally.
- Peer review of independent directors is very important where substantial space should be there for the motivation and initiatives for CSR activities.

- Still it seems that in India the scenario of CSR is not that loudly accentuated in action than it is in the theories. The first phase CSR should start within the organization through extending benefit to other stakeholders like suppliers, customers and employees. This awareness and culture is yet to be inculcated in the Boards. In many Indian companies where the management and culture is some family oriented, there this is required much more. Moreover CSR creates such an image of the organization when even the relationship with parties like vendors also improve and customers also perceives higher value for the product which makes a value creation at each point of the entire value chain.

2. The Need of Corporate Governance- Past Experiences

The Asian crisis mainly centered around fragile banks and overleveraged companies. The effects of that reverberated although mildly in the developed capital markets also as the developed countries had substantial investments in Asian countries.

If we dig deep into the issue, then it is quite accepted that in such countries there is always a collusion between the government and the private sector which creates problems because regulations become weak in a collusive environment and policies are also highly guided by private interests.

Together with this unrestrained growth objective plays a key role in the disaster. In the above mentioned crisis, panic was created by withdrawal of investment by one big foreign firm and that was followed by panic withdrawals from other ends too. The waves of this leave the currency weak. Imports and inputs become costly. Banks lose value on investments. Jobs stop. EMIs fail and banks slows lending further which again affects production and income generation. Then it is a long stretch of bad time which may be several years before a complete recovery.

But there are a few things which can prevent this like integrity of corporate accounting, sanctity and effectiveness of auditing, effective boards, strong internal controls and sound audit quality, transparency in disclosures ,

After this big collapse came ENRON failure which added to the requirements of a sound governance mechanism. Enron had given birth to a culture where the CEO is unquestionable which created immense power in his hands and kept him beyond scrutiny. The lack of regulation in this area grew in focus and accentuated immediate attention.

Long after this the recent worldwide economic meltdown which is termed as subprime crisis also showed lacunae in the practice of governance and requirement of better compliance and surveillance mechanisms.

The subprime crisis originated from pursuing growth objectives which could not be sustained in the long term by banks and financial institutions including insurance companies. The crisis originated from extending credits to non worthy customers as well as extending credits to worthy customers at below proper lending rates which is sometimes even below cost of funds. Out of sheer greed of winning competition, financial institutions went for this unrestrainedly.

Then the banks and financial institutions created mortgage backed securities which are bonds and interest payments to these bonds were directly linked with the receipts from loans. These securities offered higher yields than the market. These MBS then started being traded in the secondary market as well.

During such a time some big financial companies were detected to have falsified accounts to hide losses from poor lending. Some banks also were found to have such elements of manipulation in their accounts. With huge accumulated liabilities the assets become meager in value. This made direct effect on IT industry and sooner the ripple spread across continents and subcontinents. Many loans started becoming bad and EMIs stopped in the backdrop of huge retrenchments and uncertainties and with these the MBS got bad as well as their payments were coming from the EMIs only. The developed economies were in shock and as a result the associated companies in developing nations were affected. The world economy is still recovering from such a big shock.

It is to be noted that the financial statements of some of these major giants were audited by very reputed audit companies and these MBS were rated by very renowned rating agencies, whose names come without saying.

Immediate remedies for such a worldwide shock is not available, neither there can be a panacea but this clearly outlines once more the importance of sound regulations and the need of a better corporate governance in all directions along with the importance of independent directors and CEOs and other senior executives who in turn are answerable to the board. Simultaneously the role of rating agencies are under suspicion and regulation of rating procedures are very high under the priority list.

3. Corporate Governance, Investor Protection and Analysts' Recommendation

The emerging markets are very much a place to understand the effectiveness of good corporate governance. There have been several academic studies on Analyst's recommendations in emerging markets and relations with corporate governance.

It has been identified that in emerging markets there are two classes of countries, one with sound codes of corporate governance and the other set without very sound and prominent codes of corporate governance. The academicians mainly tried to enquire into the given set of information that the analysts take into account when recommending stocks. It was observed that the countries where weak corporate governance exists, there companies with strong practice of corporate governance always differentiate them from the others and this creates a strong value in the market. Analysts put heavy weight on these factors and these companies are always at the top of the analyst's recommendations. This is so because in countries with weak investor protection, a company can have a greater impact by strengthening the right of their shareholders and distinguish themselves by improved corporate governance. That means internal corporate governance is critical in a weak investor protection environment.

Of course the countries where strong corporate governance codes exist, there also companies with sound practice of corporate governance attracts analyst's recommendations. In a country with strong corporate governance code, the firm level performance is automatically expected to be better and analysts find a positive relation between the strength of investor protection and dividend payments. Academicians are still after this issue where they could clearly validate this relationship. Not only in the emerging markets, but also from the developed economies such positive correlation between strength of corporate governance and investor protection and dividend payments are well established.

4. Corporate Governance and Sustainability: The Emerging Market Trends

As a multispeed recovery from the downturn accelerates progress towards a multi polar world in which economic power is more widely dispersed, the emerging markets will play a critical role in the future success of multinational companies. As per the Accenture report 2010, Europe grows at 1.5% year on year while the emerging markets are growing at more than 7% year on year. Emerging markets now account for around half of global GDP and which will rise to almost 61% by 2030 as per the same report. During the recession, the emerging markets have consolidated and mostly pulled away from developed economy. As emerging economies continue to grow so do their income, their middle classes and their consumption. Emerging Markets will soon outperform developed markets in the number of households with annual income more than USD 5000 over the next five years. Accenture suggests that as the locus of the global growth shifts to east and south east, the global industry leaders will be rated on the basis of their success in emerging markets and not in the developed economy.

As per the Accenture Report 2010, the CEOs are very much concerned about sustainability in winning competition. A sustainable process starts from good governance. Good governance includes observing the codes of corporate governance relating to Audit Committee, Independent Directors, Minority representation in the Board, Investor protection and transparent disclosure norms which in India are mostly covered in Clause 49 of the listing agreements of SEBI. The global CEOs have expressed few concerns about sustainability in emerging markets like

- ✓ Consumer Uncertainty: The global CEOs opine that sustainability drives purchasing power but they are unclear about to which extent the business and government will respond in case of their purchasing decisions on sustainable products. But they expect that rapid growth in population and speedy urbanization will be the driving force to generate demand for sustainable products in the emerging markets.
- ✓ Regulatory Uncertainty: The CEOs have clearly expressed concerns about the role of Government in the issues of sustainability and governance where many CEOs have welcomed the intervention of Government in the sustainability and governance issues.

4.1. The Survey by Accenture and Some Glimpses of the Outcome

Accenture have conducted a survey taking 130 respondents who are CEOs from reputed companies from all across the world. It was to be inferred whether in their eyes the abovementioned issue is important or very important. It will be noteworthy that 66% CEOs from emerging economies believe that sustainability is very important.

The following matrix expresses the CEO reactions as to the importance of governance and sustainability in business in the days to come.

	Very Important	Important
Overall	54%	39%
Emerging	66%	32%
Developed	52%	40%

In the long term, good governance will lead to sustainable business models and which in turn will directly contribute to the economy, a long lasting development oriented business model will evolve out and the prosperity will persist.

Sustainability, Governance and the role of academicians and educators:

Generating new knowledge: As per the Accenture Report, the CEOs believe that education will be the most important issue for success of the business. Although the definition of education varies from company to company and country to country and from sector to sector, it is apparent that the CEOs see the role of the educators in three key areas – to develop education system for providing skills for sustainable development, to ensure a continued supply force of talent for their worldwide operations and to equip current and future leaders and employees with the abilities to manage sustainability issues as a part of core business.

Actively shaping consumer and customer awareness, attitudes and needs:

To create a market for sustainable products and services, CEOs see the need to increase provision for consumer information and set clear standards for measurement reporting of relevant sustainability matrices. The development of standards within and across industries and will not only depend on innovative companies forging their on approaches, but also on academic and research community to engage with the debate on the perception and measurement of corporate value beyond returns to shareholders.

Leading creation of an investment environment more favorable for sustainable development:

CEOs believe that their companies have to be more proactive in engaging with the investors so that values can be delivered in long term in traditionally measured areas like revenue boosting and cost reduction. The contribution towards this from governance area is enormous and the CEOs have recognized that a well laid down governance code is a pre requisite for sustainable business models.

5. Civil Society, Corporate Governance and Public Governance

5.1. The Civil Society

The concept of civil society blossomed after the fall of communism. By civil society we mean a society where the civilians are much empowered and sometimes the corporate decisions are also taken in a way keeping in mind the demands and the requirements of the civil society. As per the researchers in these areas, this concept of a civil society has emerged as now too many non government organizations are in operations which are closely linked with media and these organizations including the media have some sort of globalization in their operations and approach. On the face of globalization, the asymmetry in the distribution of information is much reduced in the civil society. So customers and users of products and services are much aware of the global standards of benefits and the competitive costs of that. They would never like to be associated with products from the countries where there are less prominent codes for the ethical corporate behavior or say for example where the products are mainly manufactured using child labours.

Linked to Globalization, another important phenomenon is the development of global capital markets. Globalization has created consumerism which has brought about a drastic change in the retail business sector. This coupled with the global imperative of the corporate have increased business manifold which in turn has contributed towards development of capital market in many countries across the globe. According to the data from the Bank of International Settlement, the USD 19.5 trillion market in exchange traded derivatives have grown 31% in between 1998 and 2001. According to (The Economist,2001a, b) USD 90 trillion market in over the counter derivatives has grew 6%. To keep pace with such speed of expansion, many new products have come in the market as well as the average retention time for the investments have significantly come down.

These developments always demand for a sound corporate governance codes and a proactive legal system and a responsive political environment.

5.2. Corporate Governance in New Era

According to Howard Davies a sound corporate governance code plays a very crucial role in the development of national competitiveness and in turn how big the capital market develops into. China is now one of the economies which attracts huge international inward investments. But china is weak in some areas of corporate governance. According to a survey conducted by the World Economic Forum, in terms of inward capital movement and in terms of gross domestic savings and gross domestic investments, China scored very high and even more than European countries like Italy and Greece. But China scored relatively less in effectiveness of the board in monitoring the performance of the management and executives and in terms of representation of the shareholders' interest and also in few areas of regulatory framework.

According to the same survey, the case with UK is exactly opposite in many respects. UK has a very high score in regulation, governance and board's effectiveness in monitoring management performance but in terms of domestic investments and domestic savings, of course UK scores much below China.

Hong Kong SAR scored very high in this as because it has probably managed to incorporate the best features of the East and the West.

One interesting result of the study conducted by some US researchers has proved that the cost of capital of the companies in the countries where there is weak regulation and governance, is 3% more than those countries with a sound code of corporate governance and regulatory framework. This clearly lays down the importance of corporate governance in a world with more awareness of the people and a civil society so much informed about laws, governance and investments.

These findings are in place of a strong arguments against those who fail to understand the effectiveness of a sound governance systems. But the main problem in finding out an effective solution is discussed in the following sections.

The main problem in modeling a most effective corporate governance system is that which model is to be followed. Some authors have stated that ENRON disaster was caused by the inefficiency of US model in detection of sanctity of auditors, banking organizations, rating agencies, functioning of the boards and also the loopholes in the regulatory frameworks. The aftermath of this is that the US authorities are desperately trying for a model which can prevent such further disasters.

As per the then Accounting Standards in USA, the SPV (Special Purpose Vehicles) did not find a place in consolidated accounts and this was the area which allowed problems of ENRON to remain undetected. But the present accounting system in UK requires SPVs and their results also to be incorporated in the Consolidated Accounts. So the ENRON problems would have been detected (at least to some extent) in UK, as claimed by some authors. But the UK system is not also a foolproof one as there has been the case of many corporate failures in UK also.

In USA most companies are run with a single unitary board with a single chairman and a chief executive officer. Many times there are no other executives in the board and the board meets 3 times usually in a year which can go upto 6 times at maximum.

Whereas in UK also companies have a unitary board but the board consists of mostly non executive directors and most importantly the function of the chairman is clearly separated from the chief executive mostly as per the Cadburry Committee Report.

In Germany the companies operate in a two tier system with a supervisory board including representatives of the employees overseeing a management boards which is composed of executives.

5.3. Countries with Different Practices and Common Concerns

- More than the composition of the boards, the most important thing is that the people should operate with right degree of independence. The problem comes from the practice of appointing non executive directors. In many cases he non executive directors are appointed from the acquaintances of the chairman and many times to fulfill regulatory provisions or sometimes to fill up any gap that remains in the board. In such a situation it is very common that many of them may not be having the expertise in very important areas like understanding the implications of application of accounting policies and their implications. Moreover many non executive directors hold such positions in many companies and as a result it may be so that they are not available at a time when they are much needed say in a crisis situation.
- Shareholders' representation is still a question in many boards. Hence shareholders do not have any say on the reporting and decisions. They do not participate mostly in decision makings. They do not vote in appointment of auditors, they do not vote

on important resolutions and remain passive entirely. The role of non executive directors becomes very important here. They should understand that they are the representatives who are appointed to protect the interest of the shareholders as a whole.

- Appointment of auditor is an important area of concern. According to a statement expressed by one audit company in USA, auditing has become a relationship with a company. But this is something which uproots the very essence of auditing. External auditors should be absolutely independent as the system demands and there should be no relation or minimum relationship with the management and the board. It is also very prominent to see that all big corporate failures in USA or in UK some way or the other were associated with some ignorance or miscertification by the auditors.
- Disclosure is an important area of concern. It seems that after the ENRON collapse, as a response many countries have made stricter disclosure requirements. UK seems to be very proactive in this. In our country also we have a well laid down set of rules in disclosure requirements. With the advent of IFRS, a new era in accounting and disclosures will come. As per the IFRS, companies will have to disclose information in many new areas where hereto they were not required to disclose data. One of such areas are disclosure regarding investment in derivatives which is very crucial to assess the financial risks of an organizations. Hereto the derivatives were off balance sheet items.
- Remuneration policies are very focused area of concern. The executive pay structure should be clearly disclosed on one side and it should also be constantly monitored to see that in frantic efforts to pursue incentives, the CEOs should not damage the long term objectives of the company. This was the same case with ENRON also.
- Incentive linked executive remuneration process is mostly comprises of executive stock options or direct stockholdings of the company. It is imperative in modern and efficient financial markets that disclosure of earnings have a direct effect in the prices of the stock. Earnings can be manipulated by intelligent application of accounting principles. This type of manipulations is often guided by CEOs to fulfill their own suit. The recent global economic recession has also pointed out companies with highly stock linked incentive schemes have suffered from unfettered willingness of executives to inflate profit for the immediate goal of boosting current market prices of stock in order to maximize the pay off from the stock options even at the cost of long term objectives.

5.4. Public Governance

It is very important to understand that in a society which is in the transformation state towards a more structured civil society, the role of unitary Government intervention also reduces substantially. With a more and more shrinkage in the intervening powers of the government, it is also viewed like as if the government's role is privatized itself and that is more through a very active participatory role played by the non government and semi government organizations.

This creates a new challenge to the government and existing policies and techniques of policy making in the sense that there is a constant pressure from the society on the government to issue regulations in certain areas and that too in accordance with the global standards.

Here the problem for the government is mainly a selection problem i.e., when the intervening power reduces, the government can select between a choice of either enforcing stronger regulatory practices which under such situation is difficult or to enhance self governance of course along with a generally applicable set of rules. In the question of self compliance which broadly is called as self governance, the role of awareness and education in this area is very important.

As per the researches from USA, the role of academics in the areas of governance, compliance and self governance is going to play a crucial role in modern times. Self governance can work only under

- A very aware media
- A very educated set of shareholders
- A well disclosed remuneration policy
- A very aware and equipped set of executive directors.
- A very conscious set of independent directors
- A very knowledgeable set of executive directors who take care of the interest of the shareholders.

6. Corporate Governance in South East Asia: Facts and Figures from a Famous Survey

One survey of corporate governance was conducted in 49 south Asian countries and the findings were published in a well known academic paper by La Porta et al, 1998. The South East Asian countries were categorized under three classes as:

Common Law Countries: Malaysia, Singapore, India, Pakistan, Srilanka, Singapore, Thailand and Hong Kong.

French Origin Countries: Indonesia and Philippines.

German origin countries: Japan, Taiwan, South Korea.

The most important statistical data from La Porte's research are the rule of law and five enforcement variables which are efficiency of judicial system, rule of law, corruption, risk of expropriation and the risk of contract repudiation. Each factor has a maximum score of 10. The following table is very relevant in understanding where these countries are in terms of law and enforcement.

Country	Judicial System	Rule of law	Corruption	Expropriation	Repudiation
Hong Kong	10	8.22	8.52	8.29	8.82
INDIA	8	4.17	4.58	7.75	6.11
Malaysia	9	6.78	7.38	7.95	7.43
Pakistan	5	3.03	2.98	5.62	4.87
Singapore	10	8.57	8.22	9.30	8.86
Thailand	3.25	6.25	5.18	7.42	7.57
Indonesia	2.50	3.98	2.15	7.16	6.09
Philippines	4.75	2.73	2.92	5.22	4.80
Japan	10	8.98	8.52	9.67	9.69
South Korea	6	5.35	5.30	8.31	8.59
Taiwan	6.75	8.52	6.85	9.12	9.16

Table 1

7. Board Size and Governance Quality: A New Area of Discussion

A growing body of empirical research examines the structure and effectiveness of corporate governance systems. An important insight from literature is that the top manager's decisions appear to be influenced by executive compensation, takeover threats, monitoring by board of directors and other control mechanisms. This paper particularly examines whether limiting the size of the board improves effectiveness.

Practically it is true that directors rarely criticize the policies of top managers or hold candid discussions about corporate performance. Believing that this things increase with the number of directors some authors have spoken about limiting the size of the board to eight to ten directors only. The argument goes as even though the capacity of the board for monitoring increases with more numbers but that is at the cost of slower decision making, less clear discussions about management policies and biases against risk taking abilities.

Some studies have shown, that reducing board size has become priority for institutional investors seeking to relieve poor performing units. The authors tried to prove this both with cross sectional data and time series data and in both forms this holds true. The authors use the proxy of Tobin's Q for market valuation. There are substantial literary research evidences that the investors react positively when the size of the board reduces in anticipation of better performances and reduced costs and increased clarity in the process of decision making.

8. Corporate Governance in SMEs- Latest Concerns

Traditional SMEs and affiliation to corporate governance:

Traditionally corporate governance is a concern of larger companies and this is because the larger companies are always with agency problems. Agency problem comes between the shareholders and managers. This is mainly because of ownership and control and the management of the firm.

It would be wrong to assume that corporate governance is not required in the SMEs as the agency problem does not exist in SMEs. SMEs tend to have a very less prominent separation of ownership and management as mostly SMEs are run by sole proprietors and managers. Some argue that as SMEs have less number of employees and as they are mostly relatives of the owners or somehow related with the owner, separation of ownership and control is not there. Again the accountability of the SMEs to the public is very less as they do not depend on the public funds. Moreover the sole proprietary business is not subject to disclosure requirements also. As there is no agency problem, profit maximization, increasing market share and minimizing cost are the common objectives of small and medium enterprises.

In spite of the above arguments there is a global concern for corporate governance in the small and medium enterprises sector. It is often under academic concern now that similar code of corporate governance should also exist for SMEs. To put very generally, a good governance system should be characterized by the following few points like

- Limited partnership agreement at the top level that prohibit headquarters from cross subsidizing one division with the cash from the other.
- High equity ownership on the part of board members and the managers.
- Board members who in their funds directly represent a large fraction of the equity owners of each subsidiary company.
- Small board of directors typically consisting of no more than eight members.
- CEOs who are only the insider to the board.
- CEOs who are not the chairman of the board.

The stakeholder approach particularly is of very much worth for the SMEs. According to this, a business should not only be concerned with its shareholders, but it should be delivering some value to all the stakeholders in terms of growing relations, long term business development, increased market share, growth in relations with suppliers and customers. Such an approach is inevitable in case of SMEs.

Benefits of corporate governance in SMEs:

SMEs are mostly driven by growth orientation and they grow by drawing resources continuously to expand beyond their existing state of affairs. They need inputs on business operations, good strategy and best practices in the industrial sectors. Research has proved that strategies affect business performance and external board members like non executive directors can challenge the strategies. SMEs can seriously understand this area so that their strategies and policies are put to review by external experts so that their growth becomes long term and sustainable. Procurement of finance is an everlasting concern for the SMEs. This area also can be addressed by including external members in the board like non executive directors as they can always bring innovative proposals in the areas of funds and they can always suggest the alternative areas of getting finance. According to some literature, Japanese SMEs make use of non executive directors or the external board members in bringing innovative ways of getting finance and doing business even more than some big and well renowned organizations.

In family oriented SMEs , appointing external members in board may again bring in separation of control and ownership to some extent, but the benefits of this will always outperform the problems in terms of contribution to more professional management and adopting innovative and modern business operation techniques mainly adoption of technologically upgraded processes.

Appointment of expert managers can lead a SME towards a very comprehensive developmental path. This is to be accepted that in family oriented businesses or in very closely held companies appointment of professional managers and external members can even resolve and minimize operational disputes which arise from day to day operations. The issue of separation of management and control and ownership may arise from this area but this in turn may instill many professional culture and values in the organization. This will be in fact a learning phase of the organization also but the benefits will produce long term advantages.

The terms which have to be fulfilled in case of listing in the stock exchanges, are strict and requires a disciplined and professionally managed organization which can give disclosures in the areas as required by the stock exchange guidelines like past trends of profit, the employee qualities, the discussion about the prospects and probable risk areas of the organization, internal and external risks, opportunities and fulfillment of business and larger objectives like stakeholders value creation, investors' protection, composition of boards, qualification of directors, details and number of meetings held, external and minority representation, minority interest protection, accounting and financial disclosures and many more.

A SME will always look ahead to increase its business and in pursuit of growth it may plan to procure funds through IPOs and coming to company structures. In case of securing permission for IPOs they have to give such disclosures in length. So management and control of SME business should be a learning and growing process.

There are many countries, according to the literature which encourages SMEs to grow and go public by IPOs and further to make them visible by listing. Even in some sub Saharan African countries like Ghana this practice is very well known and our previous literature has already mentioned that it is very much tested that in countries with less prominent codes, adoption of governance oriented practices do increase the image of the business manifold.

9. Governance and SMEs: Corporate Entrepreneurship

With the advent of awareness in the areas of governance and the benefits of this, a new concept has evolved altogether termed as corporate entrepreneurship. It is rather an imperative now among youth, to have something of their own and to generate employment rather than seeking employment. At the macro level also the governments of almost all the countries are taking serious initiatives in spreading the idea of entrepreneurship.

Entrepreneurship efforts start with generation of some initial funds from known sources, venture capitalists and angel funds and operating in sectors where there is a latent demand or which is already a niche and which requires constant innovations and upgraded services and solutions.

Again this is very much a fact that such business is started mostly by individuals and sometimes in the backdrop of family business traditions. This creates the scope of a self managed and traditionally maintained business which is not very much professionally managed. The ownership and control are seldom separated and upgraded business solutions are hardly tried with.

But with the change in time and with the advent of a civil society and an environment where distribution of information is speedy due to the existence of a very proactive media and of course because of the globalization of the business environment, modern small business concerns now are very much focused on expansion. In the quest for expansion the shortcomings and bottlenecks are still existing in the areas of financing where the traditional banking system till date are not very keen to provide big money to newly growing business houses.

The only route for growth can come from being converted to company and acquire finance form public by IPOs and there the role of governance is obvious.

So right from the beginning,

1) The business has to be managed with professionalism where the control and ownership should be separated

2) It should be value driven that generates value for all stakeholders i.e. adopting globalized standards and techniques of using innovative processes and adopting relationship management and HR management methods and policies within the organization

3) Having a professional culture right from the beginnings

4) Change to web based solutions as e -procurement of business as is prominent in case of HR consultancies which mainly operates through web based systems to generate talent pool and to connect them to right requirements

5) To put the internal accounts and internal control processes under constant review by external experts.

6) To keep in mind the future disclosure requirements and to operate keeping in mind those things right from the beginning.

7) To include external members in the top assessing board and their functions should be just like external directors in the corporate.

8) To maintain the business structure in such a way so that in the event of going big and going corporate there should not be any big and drastic changes in the culture and environment of the organization.

So the vibrations of a corporate entrepreneurship derive its very root from the practice of corporate governance even at the micro level only.

10. Corporate Governance Structure Disclosure and the Effect on Firm's Earning Quality

It was a well known and much addressed area of study that whether the corporate governance disclosures regarding structure of the board and structure of the audit committee influence the earning quality of the firm.

The earning quality is difficult to define and this may vary from author to author.

According to some famous study, earning quality means the earning informativeness which is measured through discretionary accruals. Discretionary accruals as already has been explained in the previous sections, is nothing but the portion of total earnings which arises from the intended manipulation of numbers by the management in pursuit of their own benefits in the form of incentives like stock options or stockholdings. As per the literature more will be the component of discretionary accruals less is the earnings informativeness of the firm.

According to one famous paper this earnings informativeness was tested when the firm gave corporate governance disclosures and when the firm did not detail the governance structures.

In this study the American Sarbanes Oxley Act directives was considered. The firms which gave disclosures after the SOX act and the firms which did not give disclosures regarding corporate governance before the SOX was enacted and implemented were put to test.

The test was aimed at enquiring whether SOX disclosures can reduce discretionary accruals and hence improve the earnings informativeness.

The results were very interesting and very informative also.

The boards with more independent directors and audit committees with all outside independent directors cause a firm to construct less discretionary accruals i.e. Disclosure of corporate governance structures effectively increases earnings informativeness as there is less scope of constructing accruals.

Another important finding: It will be noteworthy to understand the effect of SOX disclosures in relation with CEO Chairman duality. Some authors argue in favour of CEO Chairman duality by saying that in case where the chair is independent, there the chairman has to depend on the CEO itself for internal or operational information which then is easy to hide or guide. On the other hand when the CEO himself is the chairman, the strategies and operations can go in unison which can create a smooth flow in the processes.

But this concept was again tested by some authors. They took data of firms after SOX disclosure requirements and examined the firms with CEO Chairman duality and without CEO Chairman duality and their effect on the level of discretionary accruals and earnings informativeness.

It was found that the disclosure of a CEO Chairman duality reduces earnings informativeness which is very much expected and explained also. The scope of construction of accruals decreases when the chairman is an independent director of the firm.

11. Conclusion

This is a subject with enormous depth and pervasiveness. It is difficult to capture all aspects in a single literature. With advent of codes in many countries, we believe that many new areas will come up in the literature to come in recent future in this area.

12. References

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