Background of corporate governance in business

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Businesses around the world need finance to investors in order to grow and expand. Before investing investors need to have trust that the business is being well managed and will continue to more profitable. In order to have this, Investor looks to the annual report and other information releases. They expect that the annual report and other accounts present a true and present picture of company. There have been number of high profile corporate collapse that has arisen despite the fact that the annual report and accounts fine. These collapses have had a bad effect on investors and all of us.

We believe it is essential that firms give great attention to ensuring that they have the right people in the right roles, doing the right things.

Corporate governance is a broad term that has to do with the manner in which the rights and responsibilities are shared among owners, managers and shareholders of a given company.

Among economists and legal scholars refers to ‘ the defence of shareholder interests’. Classical take corporate governance as ‘ the separation of ownership and control’.

It is important for number of reasons, and it is vital for well managed companies to ensure that they operate at optimum efficiency. Some of important features of corporate governance are:

It helps to ensure that an adequate system of controls operates within a company so assets may be safeguarded.

It prevents any single having too influence n power.

It is concerned with the relationship between company management, board of directors, shareholders and stakeholders.

It aims to ensure that the company is managed in the best interests of the shareholders and stakeholders.

It tries to encourage transparency and accountability, which investors’ want.

Stage 1

Corporate Governance Mechanisms

Monitoring by the board of directors

The board of directors have legal authority to hire, fire and compensate top management, safeguards invested capital. The principal role of the board of directors – as representatives of the shareholders, is to oversee the function of the organization and ensure that it continues to operate in the best interests of all stakeholders. Given the complexity of today's organizations, that is no simple or straightforward task. Effective boards build capabilities within themselves and their organizations that allow them to do both, protect existing assets (compliance role), as well as, manage threats to future growth (strategy oversight role). This section of the site includes a range of useful publications relating to improving the effectiveness of the board.

Board of directors represent the primary control for ensuring that top managements work in the best interest of shareholders. Consequently, efforts to increase the effectiveness of corporate control have historically been focused on ways of improving the functioning of such boards. Although recommendations have ranged from chartering and appointing " public directors" to requiring all directors to own substantial blocks of the corporation's stock

Internal control procedures and internal auditors

Internal controls ensure company directors and shareholders have access to accurate and comprehensive information, especially in relation to financial reporting. This is essential for decision-making and ensuring companies attain their long-term business goals. Internal controls reduce business and financial risk especially in the appropriation of funds and can safeguard business assets from fraud and theft by providing segregation in decision-making and a structure of authorisation.

“ Furthermore, internal controls can help to develop a level of ethical guidance within a company. Controls guide individuals to act in the best interests of the company at all times and particularly in relation to the proper management of conflicts of interest. Cases of ethical misconduct decrease as guidelines and procedures demand accountability and transparency with each business activity. Cases of misconduct are flagged quicker when internal controls are in place and controls equally provide guidelines to audit or disciplinary committees

Balance of power

The simplest balance of power is very common; require that the President be a different person from the Treasurer. This application of separation of power is further developed in companies where separate divisions check and balance each other’s actions. One group may propose company-wide administrative changes, another group review and can veto the changes, and a third group check that the interests of people (customers, shareholders, employees) outside the three groups are being met.

Ownership Concentration

The number of large-block owners and the total percentage of the company’s shares that they own define ownership concentration. Large-block shareholders are investors who typically own at least five percent (5%)

of the company’s shares. Diffuse ownership (characterised as a large number of shareholders with smallholdings and few, if any large-block shareholders) produces weak monitoring of managerial decisions.

The greater the extent to which ownership of a company is concentrated, with large blocks of shares held by a few shareholders, the greater the incentive of the company’s owners to monitor and control managerial actions. Shareholders’ incentive to monitor is small when shareholders own few shares of stock–ownership are diffused–or when their investments are well diversified. While all shareholders bear the cost of monitoring, shareholders benefit from monitoring to the extent of their ownership. Owners of large blocks (whose investments are not diversified) have the greatest interest in monitoring.

Monitoring is important because it may encourage managers not to over diversify the company’s portfolio of products and/or businesses. Weak monitoring may result in diversification beyond the preferences of shareholders. High or strong levels of monitoring may encourage managers to avoid excessive levels of diversification. Another result of monitoring is that it also may hold down the level of top management compensation (as a result of limiting diversification and, in turn, limiting the size of the company). Research indicates that ownership concentration is associated with lower levels of company diversification.

External Mechanisms

Product -market competition, external auditors and the regulatory framework of the corporate-law regime and stock exchange.

Stage 2

The logic underlying this recommendation rests on the notion of director independence. Although there may be equality within the confines of the board room, surely inside directors cannot forget that once they step outside their director role they are subordinates of the chief executive officer (CEO). As boards are responsible for the monitoring and evaluation of top management activities, it is apparent that insiders are quite likely to suffer from an inherent lack of independence that severely restricts their ability to effectively fulfil these responsibilities. The following highlights the dilemma faced by the inside director:

In contrast, outside directors do not find themselves dependent on the organization’s top management for promotions, salary increases, performance appraisal, and so forth. Outside directors do typically receive fees for their services, but these amounts do not usually constitute a substantial portion of their total income. Given that most outside directors are employed full-time, the average director pay of $22, 000 would not seem to represent a major threat to their independence. As a result of this greater independence of judgment, increasing the representation of outside directors on the board will presumably result in improved board performance.

Directors should have all the degrees of freedom necessary to perform their steward function. To hope that an inside executive director will stay independent when the crunch comes in a management confrontation is too much to expect of a person who has no independent income and professional identity (Muller 1978, p. 68).

Internal auditors tend to emphasize attitude or rationalization warning signs. This finding is consistent with research results reported indicating that practitioners and forensic experts weigh management characteristics as significantly more important than industry conditions, operating characteristics, or financial stability. On one hand, CPAs can derive comfort from the similarity between internal and external auditors' ranking of warning signs, but on the other hand, CPAs should give adequate attention to the other two categories.

Recent egregious instances of fraudulent financial reporting have caused external auditors to become more concerned about their ability to detect fraud during audit engagements. External auditors that leverage their clients' internal auditors' knowledge will be more effective in obtaining information needed to make informed fraud risk assessments, and better able to detect fraudulent financial reporting.

By successfully leveraging auditors' insights regarding fraud, external auditors will be able to utilize internal auditors as partners in the prevention and detection of fraudulent financial reporting. Training and education about fraud risk factors are useful for external auditors, but identifying warning signs is only the first step. The more demanding task is effectively and efficiently responding to the identified warning signs of fraud.

A research has found that the appointment of non-executives directors is associated to a company stock price increases. An Executive that wants to take the company in a direction that might be more in its personal interests could be sacked. Another research has found a positive relationship between the percentage of shares owned by managers and board members and firms' market-to-book values.

However, some argue that the increase in share price was also associated with a decline in the value of the firm's outstanding debt. And corporate performance cannot be reliably increased simply by adding outsiders to the board of directors or by increasing the CEO's stockholdings.

Stage 3

For last few decades press played a vital role to attribute the financial and governance scandals. However, before I go into more detail on this, I would like to stress two key points that are not always properly understood.

Firstly numerous commentators (journalists, head-hunters and firms) have asked why are we " interfering", in what should be a firm's decision, on who they recruit? The answer is that under Section 61(1) of FSMA we have a legal duty to do so – i. e. FSMA states: ' we may grant an application for approval only if we are satisfied that the candidate is fit and proper to perform the controlled function to which the application relates. Secondly, there is an onus on the applicant firm to demonstrate to us that the candidate is fit and proper.

One example, may be in the area of takeovers and top executive compensation. It is fairly easy for a top executive to reduce the price of his/her company's stock-due to information asymmetry. The executive can accelerate accounting of expected expenses, delay accounting of expected revenue, and engage in off balance sheet transactions to make the company's profitability appear temporarily poorer.

Crescent Bank Fraud the entire board of directors and CEO Anjum Saleem of Crescent Standard investment bank were legally stopped from running their offices on evidences of suspected fraud and irregular accounting. External Auditors had predicted a missing amount of over Rs. 6 Billion, apart from illegal maintenance of parallel accounts, concealment of bank assets, un-authorized massive funding of group companies, unlawful investments in real estate and stock market, etc. the SECP took legal action against the companies officers, although much of the actions taken were criticized as insufficient.

It has co-filed a shareholder proposal over concerns that Wal-Mart Stores Inc, the US supermarket group, is failing to comply with its own governance standards. Karina Litvack, head of governance and sustainable investment.

Despite strong policies on paper, Wal-Mart has struggled to implement its standards across its US business.' Weaknesses in internal controls have eroded the company's reputation as an attractive employer and are adding fuel to the fires of Wal-Mart's critics. Its failure to deliver on these policy commitments is inhibiting Wal-Mart's ability to expand into new domestic markets. Over ' the past several years', it has become increasingly concerned by signs of failure in internal controls that have led to government investigations and class action lawsuits by employees. Allegations include requiring employees to ' work off the clock' during breaks and after shifts systematic discrimination against women, and alleged questionable tactics to prevent workers from voting for union representation. It got off to a promising start in 2005 with expectations of a dialogue with the independent directors on the audit committee. But when this simply withered on the vine, Wal-Mart had little choice but to bring concerns about internal controls, labor violations and the erosion of the company’s reputation to fellow shareholders. Company was not interested in engaging in a productive discussion about how it builds and supports a compliance culture and, as a result, they have joined an international group of large filers led by the New York City Employees’ Retirement System to file a shareholder proposal.