International Journal of Research
Available at https://edupediapublications.org/journals
e-ISSN: 2348-6848
p-ISSN: 2348-795X
Volume 04 Issue 13
October 2017

Impact of Corporate Governance Practices on the Investment Decisions of Companies

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ABSTRACT

Corporate Governance is needed to create a corporate culture of consciousness, transparency and openness. It enables a company to maximize the long term value of the company which is seen in terms of performance of the company. In this paper, we look at various Corporate Governance practices followed by companies in India and South Korea. This includes parameters like Board Constitution, Board Structure, Different Committees, Independent Directors and their roles, Conflict of interest and Disclosure of information. The objective is to determine if there is a relationship between corporate governance and firm performance. The study tries to see whether higher and better corporate governance leads to better performance of the companies. It is found in the study that corporate governance practices have limited impact on both the share prices of the companies as well as on their financial performance

INTRODUCTION

Business organizations have guidelines that define and specify the roles of different stakeholders in decision-making processes. All stakeholders, including directors, managers, shareholders and auditors, have clearly-defined responsibilities. For instance, whereas shareholders are responsible for approving the appointment of directors, company boards set strategic road maps and play oversight roles over the management of companies. As such, adoption of corporate governance enhances the supervisory and managerial capacities of business organizations.

Corporate Governance Defined

Corporate governance is a framework of stipulations that describe the limits within which each segment of stakeholders must operate to safeguard the interests of the organization. It establishes the scope of control that company boards, management teams and other stakeholders observe when performing their responsibilities. Corporate governance became prominent due to financial improprieties and scandals in several major corporations, with the demise of entities such as Lehman

Brothers and Washington Mutual in 2008 and the global economic crisis that followed bringing corporate governance into particularly sharp focus.

Integrity Thresholds

Companies that embrace corporate governance achieve greater accountability in their investment decision-making processes. Corporate governance sets high integrity thresholds for protecting the interests of shareholders, creditors, suppliers and employees. Company boards that seek to meet these thresholds must be accountable, ethical and sensitive in their investment decisions. As such, corporate governance enables company boards to prioritize accountability when making investment decisions.

Board Independence

Corporate governance grants company boards sufficient independence from the management teams and other stakeholder in companies. It empowers company boards to perform duties without undue interference from the management or dominant shareholders. This way, directors can protect the investment objectives of companies from conflict of interests among competing parties.

Internal Controls

Company boards have the power to impose financial controls and monitor reporting procedures. This oversight role protects the stakeholders of companies from fraud and misrepresentation of financial information. It eliminates past malpractices where some management teams misused their discretionary powers over internal processes to misappropriate investment resources and commit financial improprieties. Corporate governance has been effective in enhancing auditing and financial reporting standards.

The role of the board and the rights of stakeholders

How does the corporate governance framework ensure the board plays a central role in the strategic guidance of the company, the effective monitoring of management, and that the board is accountable to the company and its shareholders? Does the framework also recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises?

Key considerations

The board should play a central role in the governance of the company. It performs the following functions:

- guiding corporate strategy
- monitoring managerial performance and replacing managers if necessary

- ensuring that the corporation obeys the applicable laws
- establishing a code of corporate ethics
- overseeing systems to achieve an adequate return for shareholders
- monitoring and managing potential conflicts of interest of management, board members and shareholders

Boards have a duty to act in the best interests of the company and its shareholders, while dealing fairly with other stakeholder interests, including those of employees, creditors, customers, suppliers and local communities. Corporations should recognise that the contributions of stakeholders constitute a valuable resource for building competitive and profitable companies, contributing to the long-term success of the corporation. The rights of stakeholders as established by law or by mutual agreement should be respected.

Regardless of how the board members are chosen, in order effectively to fulfil their responsibilities, they must be able to exercise informed, objective and independent judgement, acting as representative of all shareholders. Some of their responsibilities are formalised as a duty of care and loyalty, and it is important that these concepts be firmly anchored in law and jurisprudence, and in the understanding and practices of the board members themselves. In some countries, companies have found it useful to articulate explicitly the responsibilities that the board assumes and those for which management is accountable

LITERATURE REVIEW

Content analysis on the shareholder value sustainability factors mentioned in the scientific articles proves that the corporate governance factor gains importance (Bistrova, 2014). It enjoys more attention than it used to both from the corporate and from the active investors' side, who often see the necessity to integrate this factor into the portfolio selection process. A number of studies conducted on the developed markets state that the corporate governance has strong influence on the stock market returns. Gompers, Ishii and Metrick (2003) constructed ―Governance Index‖, which covered the assessment of shareholders'rights at 1,500 companies in 1990s. Based on the index, they have modelled the portfolio strategy that would consider ‗long'companies with strongest rights (lowest decile) and ‗short' companies with weakest rights (highest decile). As a result, the investor could earn 8.5% outperformance. Similar study was done by Drobetz et al. (2003) in Germany showing the monthly difference in performance of well and poorly governed firms of 1.73%. The significant correlation

of such factors as CG index, CEO-Chairman separation and independence of board members with stock performance was found by Bhagat and Bolton (2008). But they did not find any evidence to prove the assumption that the quality of CG is a proxy for future stock performance. The findings of their study also show that given the low quality of corporate governance of a certain entity and given its poor performance, there is a high probability of management turnover. Positive correlation between the firm value and the quality of corporate governance in case of 300 largest European companies (FTSE Eurotop 300) has been indicated by Dutch scientists Bauer, Guenster, Otten (2004). But when adjusting for country difference, the relationship is weakening. Based on the studies of Chung and Zhang (2011) and Ferreira and Matos (2008) that revealed a positive association between the proportion of a firm's shares held by institutional investors and its governance quality, we also hypothesize that there is a positive relationship between the major shareholdings and CG. According to agency theory, companies with better CG have lower agency costs, generate higher returns, and perform better (Henry, 2010; Klapper & Love, 2004).

IMPACTS OF CORPORATE GOVERNANCE

Demand for information:

In order to influence the directors, the shareholders must combine with others to form a voting group which can pose a real threat of carrying resolutions or appointing directors at a general meeting.

Monitoring costs:

A barrier to shareholders using good information is the cost of processing it, especially to a small shareholder. The traditional answer to this problem is the efficient market hypothesis (in finance, the efficient market hypothesis (EMH) asserts that financial markets are efficient), which suggests that the small shareholder will free ride on the judgments of larger professional investors.

Supply of accounting information:

Financial accounts form a crucial link in enabling providers of finance to monitor directors. Imperfections in the financial reporting process will cause imperfections in the effectiveness of corporate governance. This should, ideally, be corrected by the working of the external auditing process.

Investors are willing to pay a premium for better-governed emerging market firms Investors interviewed said they would pay more for a better governed firm in an emerging market than they would for a firm that came with some governance gaps. Although it was difficult to put an exact number on the value of governance given the range of other country and firm-

level factors to consider, all surveyed investors expected to pay a higher premium for better governance in an emerging market firm than the premium they might pay for a firm with better governance in developed markets. What is the reason for this variance? There is an assumption that more developed markets come with stronger institutional frameworks and better institutional governance. The perception among investors is that a well-functioning governance framework in a country can help minimize their concerns. The reverse also appears to be a strongly-held perception among investors.

Implications and Recommendations

In the current market situation where external pressures existing can also be taken into proxy. When managers making a capital investment decision they need to take in view other non-financial aspects that also influences the decisions to a certain extent. Furthermore, financial intermediaries having a certain level of involvement and sharing information sensitive to the market can also be a major factor that might be giving a varying result against Investment.

Investing in profitable-investment projects can bring in greater resources to the firm in future and it entails a huge decision burden upon the shoulders of the managers. Shareholders expecting to earn a greater return through investing in them can also be undermined when manager decided to have a low payout policy. Funds generated internally is a possibility where there is a healthy cash flow, but it is also preferable if this free cash is invested into marketable security for allocating the resources into a profitable venture for a time being to make it a positive impression.

Future Research

In future studies there may be more aspects of cash flow-investment relationship which can be studied for assessing the degree impact it has on this relationship, i.e. sales, debt performance, capital structure, firm size, etc. The research study may also be improved if the observation of firms are increased that will in turn reflect a more clear picture about the relationship in the current scenario.

CONCLUSION

Well-defined and enforced corporate governance provides a structure that, at least in theory, works for the benefit of everyone concerned by ensuring that the enterprise adheres to accepted ethical standards and best practices as well as to formal laws. To that end, organizations have been formed at the regional, national, and global levels. In recent years, corporate governance has received increased attention because of high-profile scandals involving abuse of corporate power and, in some cases, alleged criminal activity by corporate officers. An integral part of an effective corporate governance regime includes provisions for civil or criminal prosecution of individuals who conduct unethical or illegal acts in the name of the enterprise.

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e-ISSN: 2348-6848
p-ISSN: 2348-795X
Volume 04 Issue 13
October 2017

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