Business Ethics
Prof. Susmita Mukhopadhyay
Vinod Gupta School of Management
Indian Institute of Technology, Kharagpur

Lecture – 22
Shareholders as stakeholders: understanding Corporate Governance

(Refer Slide Time: 00:25)

Welcome today, we will be discussing on contextualization of business ethics. And in that context, we will be discussing corporate governance accounting and finance; major part of this discussion will be based from the book of Crane and Matten by Oxford University Press. Before we begin discussing on corporate governance, let us understand what contextualization of business ethics means. If you have followed the earlier discussions, there we have discussed till today the major theories of business ethics, the normative theories and descriptive theories, and you have tried to mention like the application of these theories will vary according to the nature of the situations in which they are getting applied.

When we are talking of contextualization of business ethics discussion which will follow from today onwards, we will be taking of various situations and various stakeholders like the shareholders, the customers, the suppliers, the employees the government, and we will try to see the application of business ethics theories and management with respect to these different stakeholders. What we are going to see is the brief explanation of the importance of this stakeholder with the particular stakeholder which will be discussing in the context of business ethics, and with respect to other relevant stakeholders.

Second, we will try to discuss on the ethical issues related to the specific stakeholders, and how to manage it with respect to that specific stakeholder. And based on the potential responses and solutions of the issues are identified, and the potential responses at solutions from the business ethics perspective. We will also see the problem of that specific stakeholder in the context of globalization. We will also try to understand how the concept of corporate citizenship that we have learned earlier is applied to this specific stakeholder, and how the ethical issues seen in those slide.

We will also try to understand the how the issues and the ethics management are relevant to that specific stakeholder with respect to the issues of sustainability. So, these will be the major coverage given for the context related factors and contextualizing business ethics in this different situations and with respect to different stakeholders. The first stakeholder that we are going to discuss today into two different modules is the shareholder. So, today's discussion we will cover corporate governance, accounting and finance.

(Refer Slide Time: 04:28)

The discussion will be through five modules. The first module is going to discuss shareholders as the stakeholders of the organization, and understanding corporate governance. The second module will cover ethical issues and corporate governance.

Third module will look into shareholder as the citizens of the corporation. Fourth module will look into share holding for sustainability. And fifth module will look in financial management over view and ethical prospective. So, this will be the flow of discussion through the five modules for covering corporate governance, accounting and finance.

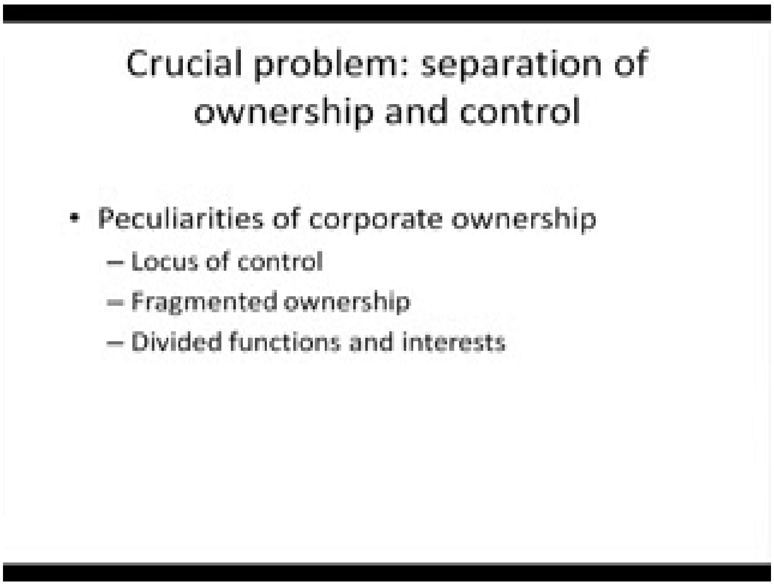
Let us begin with the first module, which discusses on shareholders as stakeholders and understanding corporate governance. Let us begin with discussing shareholders as stakeholders and understanding corporate governance. We have already tried to discuss about the role of shareholders where we have found that the belief goes as such like corporations exist, solely for the benefit of the shareholders. So, persuade profitability is keeping in interest the shareholders interest and so that the organization can give dividends to the shareholders as well as it is the motive is directed towards increase of share prices. So, it comes to appear that as if the corporation exist for answering to their responsibility to the shareholders.

On the other side, we can also see shareholders the broader perspective if we see through the processes of ethical investment, through the processes of following indices of sustainability or investing in socially responsible stock are showing their role, where they are guided not only by their self interest, but also for societal interest. In our discussion, we will try to see this nature of the shareholder as a stakeholder, where they show their responsibility also for societal patterns through their way of investing in different organizations.

Also here we will try to discuss the role of shareholder with respect to other stakeholders. What we are found in our earlier discussion also like shareholders with respect to other stakeholders do have some unique and superior responsibility claim apart the corporation; and these are stated as their rights and responsibilities towards the corporate. And this can be exercised through the power of control which we will discuss under corporate governance. So, and this is how we will try to see also what are the role plays during in-sided trading, then ethical issues regarding executive space, remunerations and money laundry. So, all these type of issues we will be discussed over here. And we will also try to see the shareholders role in the sustainability of the organization.

So, let us first try to see what are the roles of the shareholder. Generally, what is seen is there is a separation of ownership and management in modern times. The owners of the corporation are no longer managing the corporations also. Managing the corporation is left to board of directors, managers and employees who are expected to work in the greater interest of the shareholders and also the owners. The owner here is; the owner's right to the organization remains in forms of the shares holds in the organization. The owner's right the organization remains in forms of the shares hold in the organization, but the management is given by this owner to the managers, the directors and the employees who are expected to run the organization in the interest of the owner's and the other shareholders.

(Refer Slide Time: 11:28)



So, in this context, we can discuss the role of shareholders with respect to three aspects. One is the locus of control, second is the fragmented ownership, and third is the divided functions and interests. So, locus of control is shareholders do not have a direct control on what the running of the organization. The running of the responsibilities of the running of the organization is in the hands of the directors, the managers and the employees, the boards managers and the employees.

Fragmented ownership, as there are many shareholders who are investing in their money in the organization for buying their shares, so and there are many shareholders the ownership is also fragmented. Nobody can claim to the very great extend, this is only my organization, it belongs to many, and that is why this is fragmented ownership. Divided functions and interest, the shareholders do not have much of responsibility towards the running of the organization. And the rights to the organization are based on the shares that they have invested in, and the say that they may have with the decision-making of the organization to certain extend and then that is put in the form of a paper that they need to preserve. But for the running of the organization did not have as such any true responsibility. The shareholders are oriented towards profit and the managers are more oriented towards the growth of the organization.

(Refer Slide Time: 14:07)

Based on these peculiarities of the corporate ownership, what arise are the rights and duties of the firm in the firm, and the shareholder firm shareholder relationships means, if the shareholders interest shareholders rights are mainly directed towards the stock that they are holding in the organization. Then what are the corresponding rights of the shareholders and the duties of the managers.

Let us see this rights and duties. The rights of the shareholders are number one, they have to right to sell their stock; they have the right to vote in a general meeting. The right to, they have the right to certain information about the company, because managers are expected to work in the best interest of the shareholders they have the right to sue the managers or the alleged party for any miss conduct. And they have certain residual rights in terms of liquidation of the corporation.

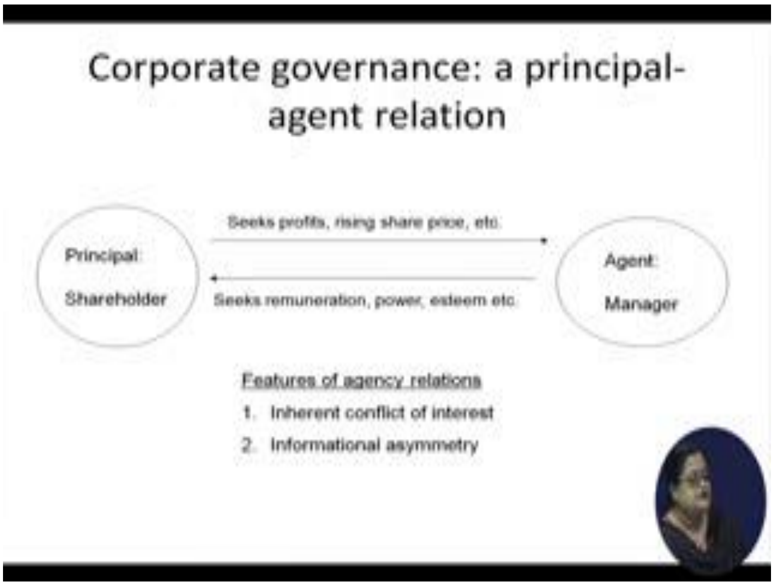
The duties of the managers are, the primary duty of the manager is to act in the benefit of the organization. Second the duty of care and skill. They are expected to be the experts in the field they are expected to have the knowledge and experience in the field, which will help them to manage the day-to-day operations and the future operations of the organization in a proper way and take care of any risk that the organization may be facing. And the duty of diligence the duty of diligence means they have the duty for active engagement in the company's affairs. So, they should be deeply involved in the affairs of the company and take in interest in how the organization is functioning and how it was reaching its objective, so that which objective which is required for the growth and survival of the organization. These are the duties of the managers.

(Refer Slide Time: 17:18)

We can understand from here, these roles of the rights of the shareholders, where they are more moved by the motivation to see that they are interested being served by the organization and the organization is making profit and also or corporate is functioning based in their own self interest. And the duties of the managers is to take care the organization is growing and to take active interest into the day-to-day functioning of the organization and smooth running of the organization. What it comes up is an relationship which we called principal agency relationship, which we will be discussing in details now. Due to this principal agency relationship sometimes conflict of be interest may happen between the shareholders and the mangers of the organization.

Corporate governance is a mechanism, which the shareholder has to ensure it is a process by which the shareholders seeks to ensure that their corporation is run according to their intentions. It includes processes of goal definition, supervision, control and sanctioning of the ways in which the organization is functioning. It has two senses; in the narrow sense, it includes two actors only the shareholders and the management of the corporation as two main actors; in the broad sense, it includes all actors who contribute to the achievement of the stakeholder goals, inside and outside the corporation.

(Refer Slide Time: 20:12)



When we talking of the principal agent relationship, the features inherent features of the agency relationships are inherent conflict of interest as we have already discussed the interest of the principal that is the shareholder is seeking profit, raising share prices etcetera. And they expect the manager to function with that goal in mind to see that the profits are increased and share prices rises high.

The agents because they are the person, who are toiling hard to get the organization function effectively, they in return demand from the shareholders, remuneration, power esteem. So, the interest of the shareholder and the manager may be of conflicting nature. Because the shareholder if they want to increase the profit then they may look into lower salaries given to the employees in the organization and to the managers, and thus increase the profit margin. But the agent, the managers and the employees meanwhile want more salary remuneration for the work that they are doing. So, there could be conflicts of interest.

Information asymmetric, as the managers, the directors are the people who are there inside the organization, and they are working day-to-day at organization, and facing the problems of the organization, and trying to solve it. They have the first hand knowledge of how the organization is functioning, and how it is going to perform in future also. This information, they have access to because there the people within the organization. And these information may not be reaching the greater pool of shareholders who are there outside the organization and who have put their money in the organization on based on the trust like the managers within the organization will be properly taking care of their money investing that in a proper way and give us more return in terms of profits. But the true picture of how the organization is functioning at present or expected to function in future is not there with them. It is their only with the agent or the manager as an insider of the organization. So, this is called information asymmetric.

So, two main features of principal agency relationship are inherent conflict of interest, and informational asymmetric. These two features of the principal agency relationship may give raise to major ethical issues in the organization. And through the mechanism of corporate governance, the organization aims to take care of these issues, and try to see like the manages and shareholders are not acting their too much of conflict interest. And they are not using the information asymmetry to get some gains from themselves which are not reaching the majority of the shareholders and other also stakeholders. So, there is where the corporate governance comes to plea.

(Refer Slide Time: 25:42)

We will try to see the shareholder and other stakeholder relations in different framework of perfect governance globally. Ownership structure in the Anglo-American model, it is dispersed. In the Indian model, it is supposed highly concentrated. We say tendency to what dispersed ownership in Russia; it is concentrated either in the hands of owner and managers or wider circle of employees in joint stock corporations. Ownership identity, we will see also it is differing across different regions in terms of Anglo-American model, it is individuals pensions and mutual funds in capitalism, it is banks, corporations and state. In India, it is families, foreign investors, banks. In Russia, owner, managers, employees and state.

So, in Russia, we see like employees have major say in how the business is being run. Changes in ownership in America is frequent, because it is a structure is an dispersed model, in capitalism it is rare. In Russia also it is frequent, but decreasing intendancy. In India traditionally extremely rare, but recently also changing and so others. The goals of ownership if you see in America it is shareholder value and short-term profits. In India, it is long-term ownership growth of market shares, the board is controlled by. In America, it is executives and shareholders; in India it is owners and other insiders. In capitalism, it is shareholders and employees. And the key stakeholders, in Anglo-American model, it is the shareholder in capitalism it is owners and employees. In Russia, it is the owners and the stakes. In India, it is the owners, customers in overseas market. In Brazil also it is customers in overseas market and the owners.

So, what it is focusing to like the idea of corporate governance which we see as a mechanism of how the shareholder is exerting control on the functioning of the organizations, and how the management is functioning whether in the best interest of the shareholder does or not. The emphasis on it and the relative role of the shareholders varies from region to region, because the ownerships structure will determine how much power the shareholders are having with respect to the others stakeholders mentioned in controlling, in trying to gain control the corporate governance and having their prominent save in the running of the business.

So, this the chart that it is showing is trying to show the difference in the emphasis across different regions or different models of whether the individual shareholders are important or it is already like concentrated in the hands of inter locking pattern of ownership or group is responsible not individuals. So, they group has a more like say in the corporate governance, and the board is get in controlled by the managers, owners, managers, insides or the shareholders or the employees or the executives and shareholder. So, different structures arise from the nature of difference in how the corporate governance is viewed in different models.

Next, we will move forward to the ethical issues in the corporate governance in the next module.

Thank you.