iJRASET
International Journal For Research in
Applied Science and Engineering Technology

INTERNATIONAL JOURNAL FOR RESEARCH

IN APPLIED SCIENCE & ENGINEERING TECHNOLOGY

Volume: 4 Issue: VIII Month of publication: August 2016

DOI:

Volume 4 Issue VIII, August 2016
ISSN: 2321-9653
International Journal for Research in Applied Science & Engineering Technology (IJRASET)

Corporate Governance and CSR: Their Interrelationship

Veenu Gupta
Assistant Professor at Panipat Institute of Engineering and Technology, Samalkha

Abstract: Corporate Responsibility has come a long way since Milton Friedman pronounced " …there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profit so long as its stays within the rule of the game , which is to say, engages in open and free competition without deception or fraud". The inclusion of CSR under Clause 135 of the Competition Act, 2013 has defined the construct of CSR in India by suggesting that it is a set of actions of a company that benefits the society at large leading to sustainable development.

Corporate governance refers to mechanisms, processes and relations by which corporations are controlled and directed. It essentially involves balancing the interests of the many stakeholders in a company – like shareholders, management, customers, suppliers, financiers, government and the community. This paper seeks to explore the interrelationships between CG and CSR. This study seeks to explain how one can say them "Two sides of a coin". This study is descriptive in nature. This study makes a contribution. It suggests that there is a salient two-way relationship and increasing overlap between CG and CSR. While much previous literature has researched CG and CSR independently, this paper makes the case for considering them jointly and systematically.

Practitioner/Policy Implications: first, to seek the interrelationship between CG and CSR. Secondly, to briefly discuss some case study on CG and CSR.

Keywords: Corporate Governance, Corporate Social Responsibility (CSR), Sustainanble Development

I. INTRODUCTION

Corporate governance refers to mechanisms, processes and relations by which corporations are controlled and directed. It essentially involves balancing the interests of the many stakeholders in a company – like shareholders, management, customers, suppliers, financiers, government and the community. Corporations have traditionally been conceived as self-centered, profit-maximizing entities constituting the central tenets of capitalism and free market philosophies. Until recently, the connections between capitalism, economic growth, and self-interested corporation have largely gone unquestioned in policy circles. However, recent and monumental corporate scandals and failures have redirected attention to issues of good governance, ethics, trust, and accountability, heightening the debate on topics of corporate governance (CG) and the ethics of economic conduct. Accordingly, at no time in history have the role and power of the corporation been accorded more popular attention and concern, with the pure profit maximization axiom increasingly called into question. While shareholder value maximization is still a major goal for corporations worldwide, the rise in social activism and the emergence of new expectations have indeed caused other aspects of corporate performance to be examined alongside financial results. As firms grow in size and influence, they are no longer expected to be mere contributors to the global economy, but rather to reconcile and skillfully balance multiple bottom lines and manage the interests of multiple stake- holders. There is some recent evidence to suggest that organizations are generally more inclined today to broaden the basis of their performance evaluation from a short-term financial focus to include long-term social, environmental, and economic impacts and value added. This is where the concepts of CG and corporate social responsibility CSR) enter the picture. Under the umbrella of CG, companies are encouraged to promote ethics, fairness, transparency, and accountability in all their dealings. They are expected to continue generating profits while maintaining the highest standards of governance internally. A firm's decisions should also be aligned with the interests of different players within and outside the company. Hence, businesses have to also keep their activities attuned to society's ethical, legal, and communal aspirations. This falls in the realm of CSR, which has attracted increasing attention in recent years in relation to how companies approach their interactions with their various stakeholders – from providing quality products and services, to undertaking charitable activities. Much of the previous literature has researched and discussed CG and CSR independently, as being unrelated accountability models, whose guidelines, reporting standards, and oversight mechanisms have evolved separately. However, we feel that CG and CSR are strongly and intricately connected, and that previous literature has fallen short in capturing the nature and essence of this relationship. This paper will explore this relationship

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ISSN: 2321-9653
International Journal for Research in Applied Science & Engineering Technology (IJRASET)

in depth by reviewing the literature and highlighting how this CG–CSR relationship has been posited.

II. LITERATURE REVIEW

A. Corporate Governance Literature

This paper will focus on an important and in no way simplistic definition of CG as "the system by which companies are directed and controlled". The control aspect of CG encompasses the notions of compliance, accountability, and transparency, and how managers exert their functions through compliance with the existing laws and regulations and codes of conduct. The importance of CG lies in its quest at continuously refining the laws, regulations , and contracts that govern companies' operations, and ensuring that shareholder rights are safeguarded, stakeholder and manager interests are reconciled, and that a transparent environment is maintained wherein each party is able to assume its responsibilities and contribute to the corporation's growth and value creation.

Corporate Responsibility has come a long way since Milton Friedman pronounced " …there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profit so long as its stays within the rule of the game , which is to say, engages in open and free competition without deception or fraud".

Governance thus sets the tone for the organization, defining how power is exerted and how decisions are reached. A narrow view of CG portrays it as an enforced system of laws and of financial accounting, where socio-environmental considerations are accorded a low priority. There is, however, a broader CG conception, emphasizing every business' responsibilities toward the different stakeholders that provide it with the necessary resources for its survival, competitiveness, and success. As such, managers are primarily accountable toward stockholders whose wealth and fortunes are at stake. But they are also responsible toward employees, suppliers, customers, and communities whose investments in the company are equally significant in other important respects. Thus, within this broader conception, the interests of all stakeholders are accorded due regard and consideration and posited as constraints on managerial action and shareholder rights. Other focal elements or ingredients of good governance include corporate leadership and strategy setting. These aspects involve defining roles and responsibilities, orienting management toward a long-term vision of corporate performance, setting proper resource allocation plans, contributing know-how, expertise, and external information, performing various watchdog functions, and leading the firm's stakeholders in the desired direction. The leadership and control aspects of CG are thus not mutually exclusive; rather, they go hand in hand, and they both define the extent of power accorded to various stakeholders, including executives, managers, employees, and, to a lesser extent, external constituencies and actors. Leaders in this respect should exercise their flair in taking their companies forward, while according due regard to their responsibilities to shareholders and stakeholders. Corporate Governance is also intimately concerned with honesty and transparency, which are increasingly expected of the public both in corporate dealings and disclosure. Investor confidence and market efficiency depend on the disclosure of accurate information about corporate performance. To be of value in global capital markets, disclosed information should be clear, consistent, and comparable (OECD, 1999). Moreover, transparency and disclosure of information between managers and employees are essential to earn employee trust and commitment. These factors ensure an accurate and timely reporting of activities, thus providing the necessary underpinning that would facilitate the application of sound governance mechanisms (Cadbury, 2000). While the above focuses primarily on internal governance mechanisms and principles, a holistic view of CG needs to also account of external governance mechanisms, including the takeover market and the legal system. Admitting that the legal system is a universally important CG mechanism, providing for the protection of investor rights and enforcement of rules, the market for corporate control becomes salient when there is enough incentive for outside parties to seek control of the firm or, in other words, when internal control mechanisms fail to a large degree. Given the dynamic interrelationships among various CG mechanisms, external aspects invariably deserve consideration to provide a contextualized understanding of firm-specific internal CG dimensions. In summary, CG thus generally revolves around a set of universal attributes, including ensuring accountability to shareholders and other stakeholders (Keasy and Wright, 1997), creating mechanisms to control managerial behavior (Tricker,1994),ensuring that companies are run according to the laws and answerable to all stakeholders (Dunlop, 1998), ensuring that reporting systems are structured in such a way that good governance is facilitated (Kendall, 1999), crafting an effective leadership/strategic management process that incorporates stakeholder value as well as shareholder value (Tricker, 1994; Kendall, 1999), and enhancing accountability and corporate performance (Keasy and Wright, 1997). Leadership, direction, control, transparency, and accountability attributes thus lie at the heart of sound and effective CG. A variation of these core attributes is articulated in turn in the OECD Principles (1999), listed and described in Table 1. These principles, originally adopted by the 30 member countries of the OECD in 1999, have become a reference tool for countries all over the world (Jesover and Kirkpatrick, 2005), providing an international benchmark for CG, and specific guidance for policy makers, regulators, and market participants in improving the legal, institutional, and regulatory framework that underpins CG. These principles have exhibited a good level of adaptability in varying legal, economic, and cultural contexts, and they have served as the basis for various reform initiatives by governments and the private sector in different countries (Jesover and Kirkpatrick, 2005).

TABLE 1: Basic Principles of Corporate Governance

OECD principles	Description
Protection of shareholders' rights	Entails the protection of shareholders and maintaining investor confidence at all times in way of ensuring the continuous inflow of needed capital
Equitable treatment of shareholders	Entails the equitable treatment of all equity investors, including minority shareholders.
Protection of stakeholders' rights	Entails the skillful consideration and balancing of the interests of all stakeholders, including employees, customers, partners, and the local community
Accurate disclosure of information	Entails the accurate and timely disclosure of clear, consistent, and comparable information in good times and bad times
Diligent exercise of board responsibilities	Board elections should be totally free from political interference and board members should exercise their responsibilities diligently and independently

OECD, Organization for Economic Cooperation and Development (1999).

B. Corporate Social Responsibility Literature

CSR on the other hand is a concept that has attracted world- wide attention and acquired a new resonance in the global economy (Jamali, 2006). Heightened interest in CSR in recent years has stemmed from the advent of globalization and international trade, which have reflected in increased business complexity and new demands for enhanced transparency and corporate citizenship. Moreover, while governments have traditionally assumed sole responsibility for the improvement of the living conditions of the population, society's needs have exceeded the capabilities of governments to fulfill them (Jamali, 2006). In this context, the spot-light is turning to focus on the role of business in society, and companies are seeking to differentiate themselves through engagement in what is referred to as CSR. The World Business Council for Sustainable Development (WBCSD) defines CSR as the commitment of business to contribute to sustainable economic development, working with employees, their families and the local communities (WBCSD, 2001). More generally, CSR is a set of policies, practices, and programs that are integrated throughout business operations and decision-making processes, and intended to ensure the company maximizes the positive impacts of its operations on society (Business for Social Responsibility, 2003). The most common conceptualizations of CSR are those of Carroll (1979) and Lantos (2001). Carroll (1979; 1991) differentiated between four types of CSR, namely, economic (jobs, wages, services), legal (legal compliance and playing by the rules of the game), ethical (being moral and doing what is just, right, and fair) and discretionary (optional philanthropic contributions), while Lantos (2001) collapsed these categories into three: ethical, altruistic, and strategic. According to Lantos (2001), ethical CSR is morally mandatory and goes beyond fulfilling a firm's economic and legal obligations, to its responsibility to avoid harm or social injuries, even in cases where the business does not directly benefit. Altruistic CSR, according to Lantos (2001), is humanitarian/ philanthropic CSR, which involves genuine optional caring, irrespective of whether the firm will reap financial benefits or not. Examples include efforts to alleviate public problems (e.g., poverty, illiteracy) in an attempt to enhance society's welfare and improve the quality of life. Strategic CSR on the other hand is strategic philanthropy aimed at achieving strategic business goals while also promoting societal welfare (Jamali, 2007). The company strives to identify activities and deeds that are believed to be good for business as well as for society (Quester and Thompson, 2001). Many scholars also conceive of CSR as encompassing two dimensions: internal and external. On the internal level, companies revise their in-house priorities and accord due diligence to their responsibility to internal stakeholders, addressing issues relating to skills and education, workplace safety, working conditions, human rights, equity considerations, equal opportunity, health and safety, and labor rights.

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With respect to the external dimension of CSR-which admittedly receives more attention in the literature (Deakin and Hobbs, 2007) – priority shifts to the need for corporations to assume their duties as citizens, and accord due diligence to their external-economic and social-stakeholders and the natural environment. The environmental component addresses primarily the impacts of processes, products, and service on the environment, biodiversity, and human health, while the social bottom line incorporates community issues, social justice, public problems, and public controversies. Addressing these two CSR dimensions often implies difficult adjustments and willingness to consider multiple bottom lines. It also often requires good communication of CSR objectives and actions, new standards, control and performance metrics, and the successful integration of CSR into the culture of the organization.

C. Links between CG and CSR

In light of the overview presented above, there is a discernable overlap between CG and CSR. More specifically, when considering the broader conception of CG, it is clear that good governance entails responsibility and due regard to the wishes of all key stakeholders and ensuring companies are answerable to all stakeholders. There is thus a clear overlap between this conception of CG and the stakeholder conception of CSR that considers business as responsible vis-à-vis a complex web of interrelated stakeholders that sustain and add value to the firm. Conversely, various CSR scholars emphasize the need to uphold the highest standards of governance internally, particularly in discussions of the internal dimension of CSR. These preliminary links are highlighted in Table 2. Other links can also be detected. Both CG and CSR call on companies to assume their fiduciary and moral responsibilities toward stakeholders. This act of accountability is crucial for a business to gain and retain the trust of its financial investors and other stakeholders. Both concepts thus draw vigor from the same sources, namely transparency, accountability, and honesty. Marsiglia and Falautano similarly suggest that good CG and CSR initiatives are gradually advancing from a philanthropic variant of corporate capitalism to authentic strategies intended to regain the trust of clients and society at large. While CG implies "**being held** accountable for," CSR means "taking account of" and both mechanisms are increasingly used by firms to regulate their operations. Windsor and Preston argue that, within the framework of legitimacy theory, CG and CSR are intricately related notions defining the interaction between an organization and its internal and external socio-political environment, with both increasingly considered as complementary fundamental pre-requisites for sustainable growth within a globalizing business environment. Both disciplines are also perceived to confer important long-lasting benefits and to ensure the endurance of the business. With respect to CG, it is observed that good governance mechanisms reconcile the interests of owners, managers, and all those dependent on the corporation, allowing corporations to secure long-term capital, retain the confidence of financiers, and to use the obtained capital proficiently. From the above discussion it is clearly seen that CG is significantly correlated with both stock returns and firm value.

TABLE 2: Preliminary Links between Corporate Governance (CG) and Corporate Social Responsibility (CSR)

Corporate governance	CSR
Broader CG conception: Entails due regard to all stakeholders and ensuring that firms are answerable to all their key stakeholders	Stakeholder approach to CSR: Corporations are the crux of a complex web of stakeholder relationships and have an obligation or responsibility to these different stakeholders
Narrow CG conception: Ensuring accountability, compliance, and transparency	Internal dimension of CSR: Corporations should accord due diligence to their responsibility to internal stakeholders addressing issues relating to skills and education, workplace safety, working conditions, human rights, equity/equal opportunity, and labor rights

Good CG generally enhances firm competitiveness and results in superior financial performance. CSR in turn increases the trustworthiness of a firm and strengthens relationships with core stakeholders who may lead to decreased transaction costs and increased attractiveness in the eyes of investors. While the business case for CSR remains controversial, a bulk of accumulating evidence suggests that CSR can result in lower environmental costs, enhanced innovation capability, improved recruitment,

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increased employee satisfaction, and positive perceptions of the firm. Admittedly, short-term costs may be incurred when designing good CG and CSR initiatives, but there are also several indicators pointing to positive win-win outcomes for businesses that are seriously committed to both.

D. Relational TRI-Model

While we have witnessed significant advances in research relating to each of these respective paradigms, and few recent formulations hinting to their cross-connections, some lingering questions persist, pertaining to their interrelationships, namely, are CG and CSR independent or interdependent functions? Are they mutually exclusive or mutually coexistent and increasingly convergent? A potential convergence is alluded to in a paper by Elkington (2006), where there is a mention of a progressive overlap between the CG agenda and the CSR and sustainable development agendas. This paper claims that “it is timely to review the increasingly complex cross-connects between the rapidly mutating governance agenda and the burgeoning world of CSR, social entrepreneurship and sustainable development.” In heeding this call, we present here are view of several models which have posited a relationship between CG and CSR, namely: (1) CG as a pillar for CSR, (2) CSR as an attribute of CG, and (3) CG and CSR as coexisting components of the same continuum.

Model # 1: CG as a Pillar of CSR: This depiction of CG as a pillar of CSR requires an effective CG system to be in place as a foundation for solid and integrated CSR activities. This is clearly illustrated in the postulation of Hancock (2005) who focuses that investor and senior management attention should be focused on these four core pillars, strategic governance, human capital, stakeholder capital, and the environment, which together help account for about 80 per cent of a company’s true value and future value- creating capacity. In other words, consistent with are source-based perspective, the model argues that value creation, even in relation to CSR, is contingent on leveraging human, stakeholder, and environmental capital through good strategic governance. CG is thus considered according to this model as one of CSR’s basic building blocks.

Model # 2: CSR as a Dimension of CG: Another model encountered in the literature is the one presented by Ho (2005), who considers CSR as an attribute or dimension of CG, thus widening the scope of CG, and incorporating non- financial risks into the risk mitigation dimension of CG activities. As illustrated in Figure 2, this conception of CG includes conventional dimensions or attributes (e.g., board structure, strategic leadership, social responsibilities, and capital structure and market relations), as well as CSR. This is consistent with the writings of other authors, who also consider CSR as an integral part of CG. Ho (2005) proposes through this framework to gauge CG more holistically by considering a range of relevant attributes, including CSR.

FIGURE 1: Four Key Pillars of Corporate Social Responsibility (CSR) (Adapted from Hancock, 2005)

Strategic Governance • Strategic scanning capability • Agility/adaptation • Performance indicators/monitoring • Traditional governance concerns • International “best practice”

Human Capital • Labor relations • Recruitment / retention strategies • Employee motivation • Innovation capacity • Knowledge development

Stakeholder Capital • Regulators and policy makers • Local communities / NGOs • Customer relationships • Alliance partners

Environment • Brand equity • Cost/risk reduction • Market share growth • Process efficiencies • Customer loyalty • Innovation effect

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ISSN: 2321-9653
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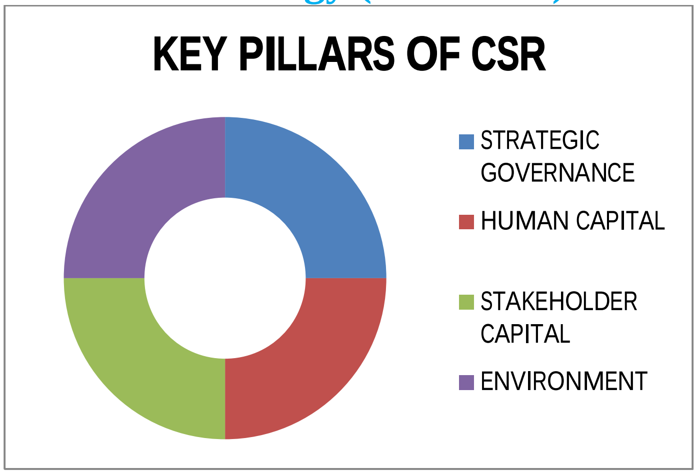

According to this model, being responsible externally to the society at large and internally to employees should be embedded in CG formulations and structures. This model provides evidence that higher commitments to CSR are strongly and positively related to the qualifications and terms of directors, boards that exercise strong stewardship and strategic leadership roles, and the management of capital market pressures, and that these various attributes combined constitute the hallmarks of good CG.

Model # 3: **CG and CSR as Part of a Continuum**: Bhimani and Soonawalla (2005) portray CG and CSR as complementary constituents of the same corporate accountability continuum. They consider that poor CG and misleading financial statements are one side of the corporate coin- the other side being poor CSR. Their corporate responsibilities continuum (Figure 3) is intended as an integrative framework, designed to reconcile conformance and performance reporting issues that should be articulated in a comprehensively integrated manner rather than disparately. The continuum reflects varying degrees of compliance with laws and legally enforceable standards, with stress placed on corporate conformance on the left end of the continuum and attention shifting to corporate performance on the right end, where codes/standards are extremely difficult to apply and oversight mechanisms are much less evident. Implied in this model is the idea that CG has been the predominant focus of attention in research and practice, but this is starting to be counterbalanced by some interest in CSR and CSR reporting, which, while still not mandatory, is portrayed as increasingly desired. The model presented here is also a good reminder of the nuances increasingly noted in the literature between legally binding requirements increasingly embodied in governance mechanisms requiring compliance and conformance, and self-regulatory stakeholder and CSR initiatives, which are evidence of voluntary corporate social performance. It is evident that even today, CG and compliance with continuously evolving legal requirements continue to draw more attention than voluntary CSR performance.

Fig 2: CSR as a Dimension of CG

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Fig 2: CSR as a Dimension of CG

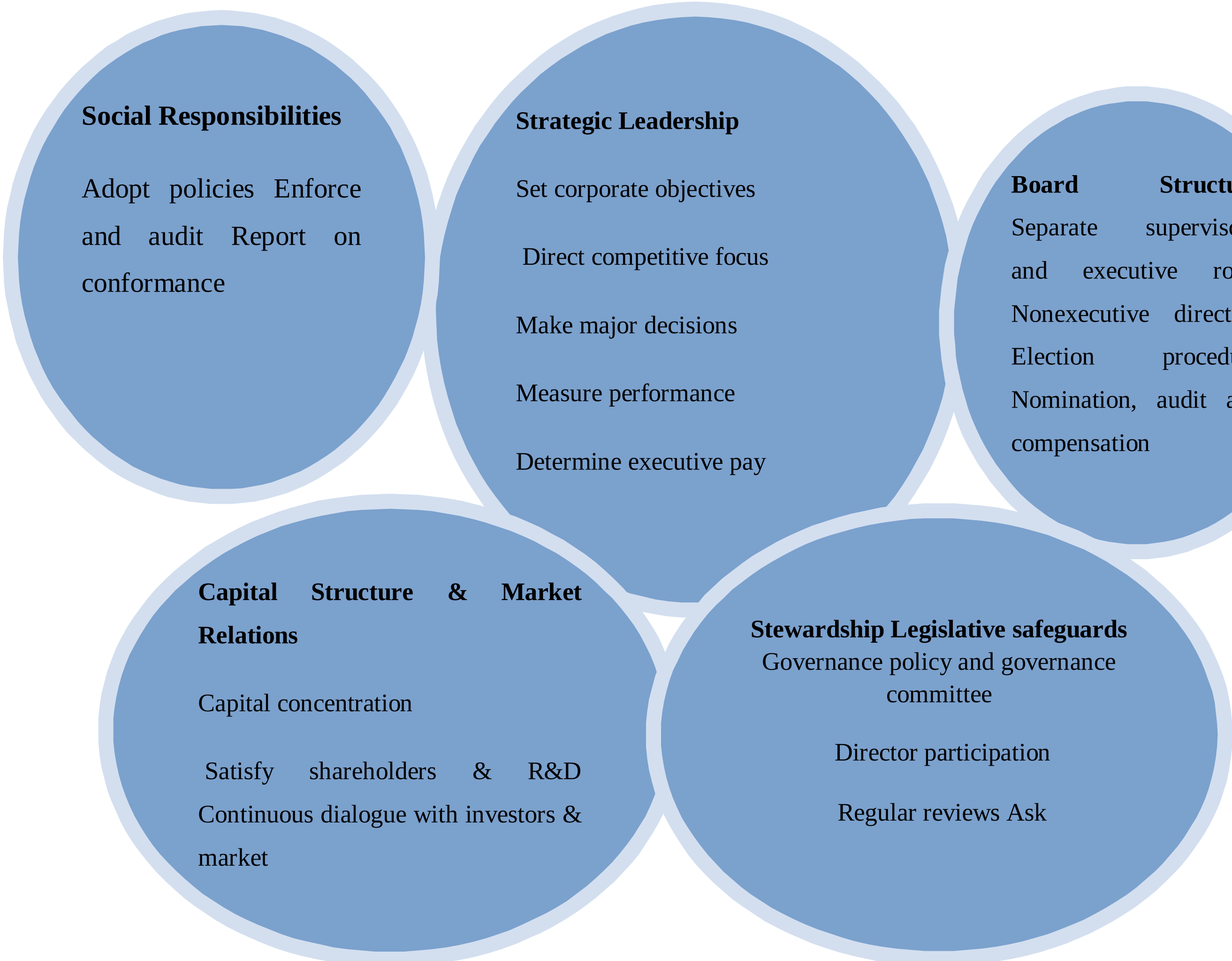
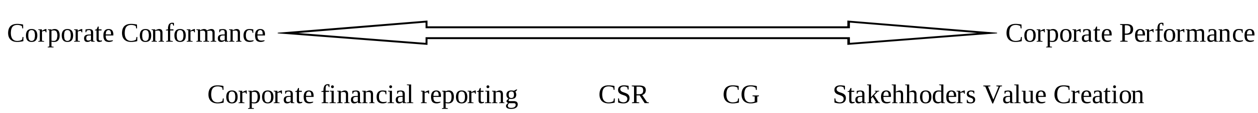


FIGURE 3: The Corporate Responsibilities Continuum (Bhimani and Soonawalla, 2005)



Nevertheless, the continuum serves the purpose of delineating the basic building blocks of corporate accountability, with CG and compliance on the left-hand side constituting the basic corner stone and the remaining items being gradually integrated in an attempt to strengthen overall accountability on a global basis. From the above discussion it is cleared that CG is dependent upon CSR and CSR depends on CG, both are interdependent. A company has to go through both if they want to be succeeding in their corporate future. So we can achieve our objective to find how CG and CSR are interdependent. Now, we will discuss some case studies relating to both of these.

III. SOME CASE STUDIES ON CG AND CSR

The collapse of the Rana Plaza factory in Bangladesh exposed the unsafe working conditions that garment workers endure across the developing world. The tragedy also revealed the inconsistencies of some companies with respect to corporate social responsibility (CSR). Take the case of Walmart. A month after the disaster, it refused to sign on to the safety measures adopted by more than a dozen European firms. Those companies, including H&M, Carrefour and Marks & Spencer, backed a plan in which they agreed to have rigorous, independent inspections of the factories they contract with in Bangladesh and to help pay for

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ISSN: 2321-9653
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improvements in building safety. Gap, too, has been particularly vocal in its opposition to the initiative. The world's third-largest apparel company says it supports much of the plan, but has suggested a change to it that would significantly restrict any legal liability for a company that violated it. (Gap did not use workshops in Rana Plaza. Walmart has said that no authorized Walmart production occurred there, but one of the factory's workshops, Ether Tex, listed the retailer as a customer on its website.)

Walmart and Gap, along with other retailers and the main retail federations, are forging their own plan to promote safety in Bangladesh's apparel industry. This effort will seek to "develop and implement a new program to improve fire and safety regulations in the garment factories of Bangladesh," according to the Bipartisan Policy Center, the nonprofit group that is spearheading the plan.

Despite their high-profile -- and widely criticized -- resistance to the originally proposed safety measures, Walmart and Gap would no doubt be quick to cite their initiatives in other areas: Gap is often considered an industry leader in CSR, and both companies have proclaimed themselves as champions of efforts promoting women.

Two years ago, Walmart launched its Global Women's Economic Empowerment Initiative, which doubled the money the firm spends on women-owned businesses and provides women around the world with job training and access to education. Gap has instituted PACE (Personal Advancement & Career Enhancement), a program to help female garment workers in developing countries advance beyond entry-level positions.

To some, the companies' rejection of the European plan -- while also touting these kinds of social programs -- appears contradictory, even hypocritical. A cynical view might be that when firms trumpet their efforts to produce organic foods, sell fair-trade T-shirts or just make the world a better place, they are diverting attention away from the more unseemly elements of their business strategies -- such as polluting the air, manufacturing goods in unsafe factories or exploiting workers with low wages.

"You can look at the ways in which companies selectively engage with certain CSR issues as being hypocritical, sure, but at the end of the day, as a company, you can't put money into everything," says Americus Reed, professor of marketing at Wharton. "Rational decisions are being made. It's not a conspiracy or manipulation."

Judging a company's CSR record as an investor, customer or prospective employee requires both skepticism and understanding, he notes. Resources are scarce, and companies make CSR decisions as part of a complex business process. "For people who see companies doing one thing with their right hand and doing another thing with the left, the question is: What is your more moral calculus? Does the good outweigh the bad? It's not realistic to expect perfection. What we should be looking for is a company that has good values and takes a long-term perspective over the pursuit of short-term profit."- This is an example of CSR

IV. CASE STUDY ON CORPORATE GOVERNANCE

The issue of corporate governance in the private sector is a reality and it's time they live up to that," says Sachin Pilot, minister of corporate affairs. The 62-year old law that governs companies is on the cusp of being replaced by new rules, which the government says will usher in many good practices. The big picture shows intent, but it's the small details, which will unravel in the coming year, that will show the government's seriousness to follow through.

A. Disclose More Information

Information is a currency, and the new bill looks to put more of it in the public domain, particularly related to unlisted and privately-held companies. This set has reporting requirements that are much more lenient than their listed peers, which make up about 1% of the 1.06 million companies registered with the MCA. Lately, several transactions of private companies that, directly or indirectly, intersected with public interest—coal block allotments, business interests of BJP president Nitin Gadkari, real estate dealings of Congress Party president's son-in-law Robert Vadra with DLF—have made a case for this set of companies to put out more information. The proposed law wants companies to give financial statements that consolidate the numbers of all their subsidiaries, including associates (at least 20% stake) and joint ventures. It also wants them to put out their cash-flow statement, which is the place to find how much of a company's cash came from operations and how much from external financing. Such disclosures will give a more holistic picture of an entity's business interests. Thanks to capital market regulator Securities Exchange Board of India, listed companies already present consolidated accounts, up to an extent, and cash-flow statement. Even they would have to make adjustments.

Companies that previously reported consolidated annual numbers as per IFRS (International Financial Reporting Standards), which was permitted by Sebi, would now need to consider the need to again report consolidated numbers as per Indian accounting principles," says Jamil Khatri, global head of KPMG's accounting advisory services, who wants companies to do so on a quarterly basis. Other changes proposed include seeking shareholder approval when a related party (a director of the company, or its holding

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company or subsidiary) acquires assets from the company for a non-cash consideration.

B. Remodel Their Corporate Structure

The proposal with possibly the greatest import relates to how companies route their investments. In order to identify the ultimate beneficiary, the new legislation proposes to restrict the number of layers of investment companies to two. Take Chintamani Agrotech, where BJP president Nitin Gadkari served as director for a decade. Also, adds Jamil Khatri of KPMG: "The challenge is not to introduce new provisions, but implementation." As we wait for greater clarity, John Samuel Raja D breaks down the new legislation to show how things will change for companies—and, by extension, their stakeholders like investors, creditors, auditors and employees.

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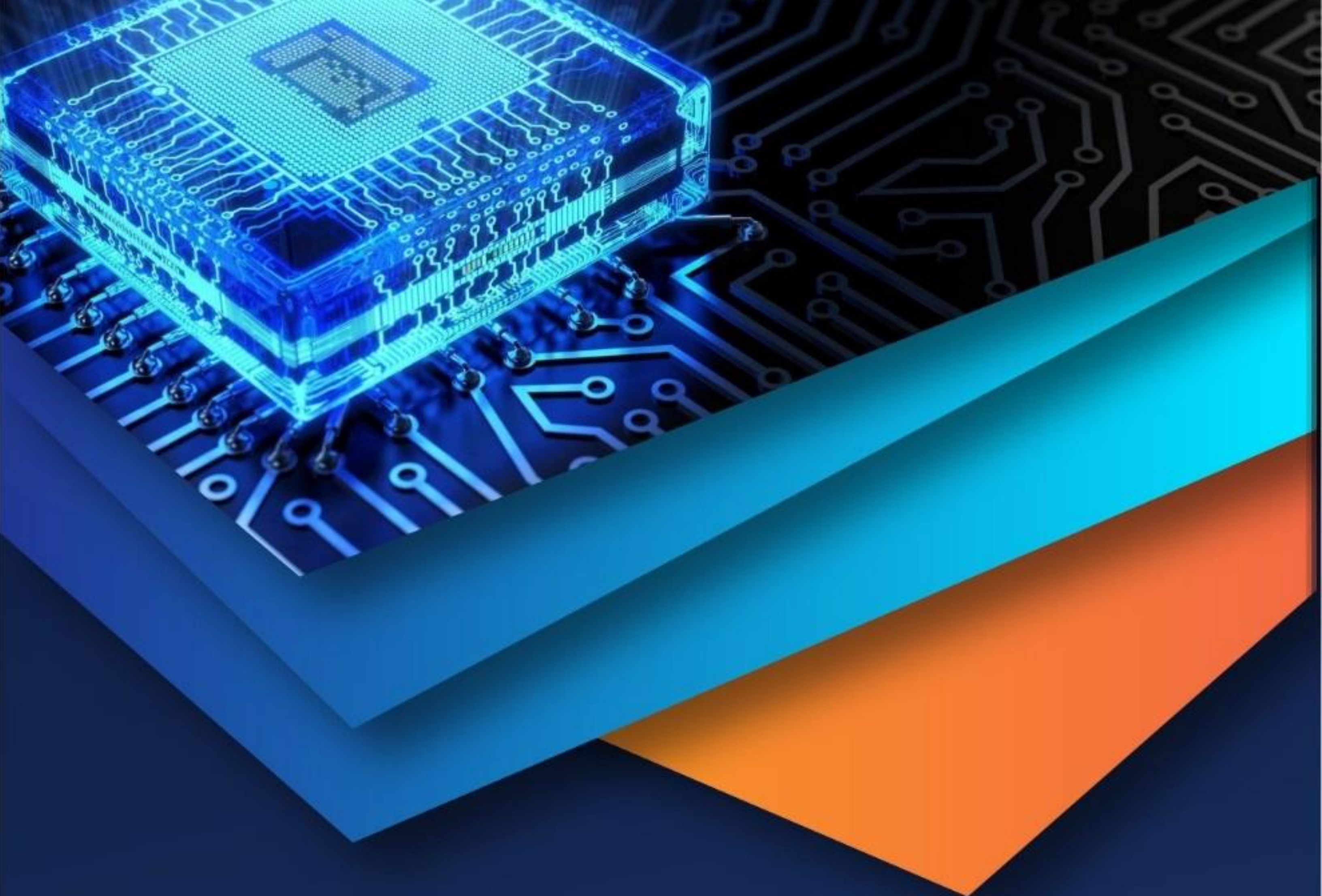

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