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WHITE BLACK LEGAL is an open access, peer-reviewed and refereed journal providededicated to express views on topical legal issues, thereby generating a cross current of ideas on emerging matters. This platform shall also ignite the initiative and desire of young law students to contribute in the field of law. The erudite response of legal luminaries shall be solicited to enable readers to explore challenges that lie before law makers, lawyers and the society at large, in the event of the ever changing social, economic and technological scenario.

With this thought, we hereby present to you

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THE IMPACT OF CORPORATE GOVERNANCE ON FINANCIAL PERFORMANCE AND STABILITY OF A FIRM

AUTHORED BY - BAHGESH GUPTA & SARTHAK BHATNAGAR

Abstract

In the era of Globalization, Corporate Governance is essential for the success of businesses while upholding the interest of its stakeholders. The aim of this is to delve into the complexity and significance of Corporate Governance and evaluate how the robust compliance of it can impact Financial Performance and Stability of a firm. The purpose of the paper is to understand how a robust Corporate Governance can balance the interests of its stakeholders ensuring increased Fairness, Accountability and Transparency. Apart from showcasing the historical development and significance of Corporate Governance the paper highlights the several theories of which explains the interaction of stakeholder and how robust governance practices increases the financial performance and stability of a firm. The paper also draws comparison of examples of Poor and Sound Governance to highlight how good governance increases the life of a business. The paper critically analyses the impact of Corporate Governance in Financial Sector and concluded with the need of strong Corporate Governance for long term performance of organisation.

(1) INTRODUCTION

A group of people or a legitimate organization that comes together to do business and generate revenue is called a corporation. Since the business is always in need of finance and investments, the owner lowers the company's shares to generate money and engage the public. A CEO is usually chosen by successful companies to manage the company's operations. The owner wants to make a profit, while the management wants a specific amount of money from the business. Because of this structure, the owner's and management's goals and visions become more at odds, making corporate governance (CG) essential.

Corporate governance gives the companies direction and control. It is based on the Fairness, Accountability, and Transparency (FAT) philosophy. It outlines the efforts an organisation takes to improve its relationships and exchanges with a variety of stakeholders, such as workers, shareholders, investors, the public, regulatory bodies, and commercial partners. Adherence to the norms, guidelines, and operational framework is necessary to maintain equilibrium between the interests of all stakeholders involved.

Another aspect of Corporate Governance is the increased Financial Performance and Stability of the business. This paper aims to delve into this aspect of Corporate Governance. The paper has been divided into five parts, the first paper provides an overview of Corporate Governance and its theoretical framework. The second part highlights the regulatory framework of Corporate Governance in India. The third and fourth part examine the interplay of Corporate Governance and Financial Performance and financial stability of a firm respectively along with examples of businesses. The fifth part critically analyse the impact of Corporate Governance of Financial Performance and financial stability of a firm. The paper end if a conclusion of a need of robust regulation for the compliance of Corporate Governance.

(2) CORPORATE GOVERNANCE: AN OVERVIEW

The process of accomplishing a goal or carrying out an action is referred to as governance. The Latin word "gubernare" and the Greek phrase "kybernan," which meant "to guide," "direct," or "steer," are the sources of the English word "government." Over the past three decades, the term "Corporate Governance" has evolved into a distinct academic field of study. The fall of corporate giants in the United States and their scandals, the rise in institutional investor activity and awareness of investments, the trend towards privatisation over the past 20 years, and the idea of conglomerates through mergers and acquisitions since the 1980s served as the impetus for the scholarly interest in Corporate Governance in the new millennium.[1]

[1] Rajesh Patel, *Fundamental Theories and Interfaces of CG: Survey from literature,* 23 IIFT 13-27 (2021).

(3) THEORIES OF CORPORATE GOVERNANCE

The different theories of Corporate Governance help explain the various relationships among company stakeholders. These theories also mention different duties and their functioning. Read below the prominent ones.

- **Agency theory**

The agency hypothesis states that, as the name suggests, the owner of the firm hires the management or director to oversee daily operations in the owner's and the company's best interests. The problem arises when someone in such role prioritises maintaining his base wage and serving his personal interests above striving to grow the business and increase revenue. The agent is in control of the decisions taken and how the business is run.[2] The agency theory is a conception of corporate governance that co-relates the relationship of the higher authority of the company, who are owners of the company, which includes shareholders, stakeholders, and also the board of the company, directors, etc., with the people who are being hired by the company as agents, who do have responsibilities to work upon the governance part, which would be best in the company interest. The company's agent has responsibilities to handle the functions of the business organizations, to work upon fair transactions by management and board, to handle the company's dealings, etc. The main goal of such agents is to work on the FAT principle of fairness, accountability, and transparency of the company.

There are some limitations for the same where an agent is working for the best interests of the company, but also instances where the personal interest of the agent is prioritized by them in place of the company interest. There may be some circumstances where the points of agents and board or management do contradict, like the company's best interest of an agent or the higher remuneration demanded by the agent. Another important part of the theory that is lacking is that such agents work on the interests for only a short-term period, in which the company considers the managers to be the engines of a company to hold such responsibility and prioritize the company's best interest.

PRINCIPLE ⇒HIRES ⇒ AGENT ⇒ WORK IN SELF INTEREST.

[2] Afshan Younas, *Review of CG Theories,* I7 EJMR 79-83 (2022).

- **Stewardship Theory**

The emphasis of these Corporate Governance ideas is on stewards, or business owners. It says that these executives prioritise the objectives of the organisation. Rather of approaching them with an individualistic attitude, they approach them from an organisational one. It guarantees these executives fulfil the objectives of the owner. They put in the work and make the choices for them. Employees are required to propagate the company's goodwill wherever they go as they are regarded as its ambassadors. These companies recruit professionals to fill important roles such as chairman or CEO. The internal members are joined by the company board. Better business success and knowledge are the results of it.[3]

SHAREHOLDERS ⇒ EMPOWER THE TRUST ⇒ STEWARD

STEWARD⇒ ORGANISATIONAL SUCCESS⇒ SHAREHOLDERS

- **Stakeholder Theory**

The stakeholders in the corporation are another focal point of these Corporate Governance theories. In addition to the owners, there are other stakeholders. Each one of these stakeholders is interested in the business. Their objectives may differ. According to this notion, the company needs to concentrate on each of these parties. It also states that the interests of these different parties are equal. They cannot all be superior to one another. For instance, several businesses practise corporate social responsibility. They promote and refer to their social events. In this way, a firm serves the interests of the environment and local communities. It fosters goodwill and gives the business a positive image.[4] The managers and the employees of the company are considered the engine of a company; if the engine is doing better, then only the machine will run smoothly. For a company, if the employees and managers are up to their job satisfaction and working environment, their work is being recognized by the superiors; hence, if they are motivated, then only the company will be able to conduct the day-to-day operations if the articles of association do allow the managerial staff and another employee to have the power of decision making and control over lower or ground-level work from which they can contribute to the company in their best interests. This will help the company to attain its organizational success and focus on future goals of the company. A stakeholder is a person does has an interest in the company; it can be a creditor,

[3] Masiye Banda, *CG: A Theoretical Review,* 17 EJBM 60-64 (2023).

[4] Haslinda Abdullah, *Fundamental and Ethics Theories of CG,* 4 MEFE 88-97 (2009).

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supplier, partner, or a normal person too. Such persons do have different organizational goals but do have a relationship with a company upon which their interests lie. If the stakeholder of the company or any person who is connected to the company directly or indirectly does hold the reputation and maintain the goodwill of the company. The employees or the managers who do have relations with them or who engage with them regularly should be taking steps to maintain good relations and interaction with them to secure good governance and also to maintain the goodwill of the company

- **Resource Dependency Theory**

In this case, the directors are considered assets of the business. They are considered a way to provide a company a competitive edge over other businesses in the same field. Here, directors are required to have strong social and external contacts in addition to having highly regarded talents. The board members and the directors are considered the main authorities of the company and have most of the responsibility for the resources to run the company smoothly. Such persons with power and responsibility make good efforts for the company to bring useful resources like suppliers, buyers, creditors, buyers, dealers, skilled employees, and most importantly, the capital funding of the company to conduct its operations. The company is not self-sufficient to run internally; they do have to rely upon external factors to operate smoothly, make interactions, make deals, do contracts, and maintain relations with the resources of the company.

DIRECTORS ⇒ BRING IN RESOURCES ⇒ ORGANISATIONAL SUCCESS

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(4) CORPORATE GOVERNANCE NORMS IN INDIA

Reforming Corporate Governance is crucial for India, as the country moves towards an economic governance structure that is more responsible and transparent. In 1991, the Indian economy faced the fiscal crisis which led to the liberalisation and privatisation. Finance was needed by Indian businesses to grow and expand. India’s demand for Corporate Governance changes was sparked by the country’s desire for international investment. Since then, SEBI has consistently placed a high focus on effective governance in the capital market.[5]

[5] Sanjit Sarkar, *Regulatory Framework for CG in India: Critical Analysis,* 11 IJCRT 537- 552 (2023).

In 1999, SEBI took "Clause 49" from the code of governance created by the "Confederation of Indian Industry", an independent group that collaborates with the government on policy matters. Reforms aimed at enhancing corporate, social, and environmental disclosures were implemented in India. "The National Voluntary Guidelines on Social, Environmental, and Economic Responsibilities of Business" were released in 2011 by the "Ministry of Corporate Affairs". To improve the calibre of disclosures, the standards mandate that listed businesses produce Business Responsibility Reports.[6] "The Companies Act, 2013" supersedes the Companies Act, 1956, with the objective of enhancing minority shareholder rights and streamlining laws via improved Corporate Governance standards. According to the most recent modification, which was made in 2014, clause 49 covers the following, fair treatment of shareholders, protection of their rights, appropriate and timely disclosures, certification of financial statements by the chief financial officer, increased board accountability, and standards for avoiding insider trading.[7]

(5) CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE

A company's financial success is greatly influenced by Corporate Governance, which sets up procedures and structures that balance the interests of shareholders, the board, and management. Long-term sustainability and improved firm reputation are the outcomes of good Corporate Governance. It creates a connection between the firm and its stakeholders, which leads to the latter starting to believe in the latter and show support for it, as was the case with Unilever and the Tata Group. However, the demise of Satyam Computer Services and Enron might serve as a useful illustration of what occurs when Corporate Governance is inadequate. In addition to the firm closing, other negative outcomes included job losses for employees and a loss of trust from investors.[8]

[6] "Al Maqtari, F.A., Al-Hattami, H.M., Al-Nuzaili, K.M. and Al-Bukhrani, M.A., CG in India: A systematic review and synthesis for future research, 7 Cogent Business & Management (2020)."
[7] D. R. Jalwani, *CG framework in India: An overview,* 3 AJMC 102-107 (2022).
[8] "Al-Ahdal, W.M., Alsamhi, M.H., Tabash, M.I. and Farhan, N.H., *The impact of CG on the financial performance of Indian and GCC listed firms: An empirical investigation*, 51 RESEARCH IN INTERNATIONAL BUSINESS AND FINANCE, 51, p.101083 (2020)."

Therefore, it is essential to sustain excellent Corporate Governance via interacting with stakeholders, upholding transparency, and engaging in CSR initiatives. Effective CG can improve financial returns in several keyways:

(a) **Reducing agency costs and conflicts of interest**: The goal of Corporate Governance is to make sure that management behave in the shareholders best interests as opposed to their own. This lowers agency expenses, which may have a detrimental effect on profitability. This is facilitated by systems like as performance-based CEO remuneration and independent board scrutiny.

(b) **Increasing accountability and openness**: Transparency is emphasised by strong Corporate Governance, which includes risk assessments, financial reporting, audits, and the sharing of pertinent firm information with shareholders. This responsibility contributes to the confidence and trust of investors.

(c) **Managing risks effectively**: By identifying issues early and taking action to reduce downside risks before they worsen, an emphasis on monitoring and controls around risk management safeguards the value of the organisation. Long-term financial stability is aided by this risk governance.

(d) **Increasing judgement**: When it comes to important choices about transactions, investments, and strategic direction, management may benefit greatly from the advice of independent, knowledgeable directors who possess a strong financial background. This superior decision-making results in more prudent resource and capital deployment.[9] To put it simply, Corporate Governance fosters an atmosphere that allows management to optimise the business's financial and operational success. It offers the structure and foundations for pursuing opportunities that create value while reducing risks that might have a negative impact on financial returns. Businesses that implement best practices in Corporate Governance will be in a better position to provide their shareholders with long-term, sustainable value.

[9] *Ibid.*

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(6) IMPACT OF CORPORATE GOVERNANCE ON FINANCIAL STABILITY

An organization's financial stability benefits from CG. An organization's capacity to manage itself responsibly and transparently can result in improved financial performance and stability when it has strong governance policies in place. An organisation with sound CG has a defined structure and responsibility. This facilitates the process of making thoughtful, well-informed decisions that may support long-term financial security. It also aids in properly managing risks, avoiding fraud, and guaranteeing adherence to legal requirements.

Only the combination of these three fundamental pillars which are effective regulation and oversight, market discipline, and strong internal leadership inside the organization can lead to financial stability. These three components serve as the cornerstone of a sound financial system. Strong leadership is essential for preventing financial system instability at the company level. The foundation of it all is sound company governance, which calls for qualified and seasoned directors and management. They ought to be operating under a well-defined and rational strategy and business plan. Other essential components of effective leadership are accountability and responsibility.[10]

Conversely, insufficient CG may result in unstable financial conditions. A company may experience financial issues because of unethical behaviour, poor risk management, and a lack of transparency. These factors can undermine investor trust. To put it briefly, robust CG enhances prudent management, capital accessibility, investor confidence, and risk minimisation, all of which are favourable effects on an organization's financial stability.

EXAMPLES OF CORPORATE GOVERNANCE

- Good Corporate Governance

The TATA Group in India, is the largest, established and most trusted company which is known for its dedication of carrying out the Corporate Social Responsibility and its morality while conducting the business. Under the abled leadership of Ratan Tata, the company has reached a new height. The Tata Group is an epitome of robust CG Model, the corporation has always made

[10] Wajdi Affes, *The impact of CG on financial Performance: a cross-sector,* 20 INT'L J. DIS. GOV. 374-394 (2023).

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sure that the interest of stakeholders and management should be on same line. The involvement of stakeholders can be said to be the priority of the company. The company ensures that stakeholders are aware of its decisions leading to the Transparency in Business. Further, the significant portion earning of the group goes to CSR programs which further inbuilt the trust of stakeholders.[11]

- **INFOSYS LTD.**

Infosys is a multinational IT company which provide information technology services, consultation services and outsourcing services globally. Infosys is considered as second largest IT company in India over 100 billion market capitalisations in the year 2021. The most important factor for such a success and goodwill of a company the good corporate governance standards which were established by the board of members which do provide systematic compliance and composition between the management and the board of members which initially helps the company to maintain transparency, accountability and fairness in all aspects of the company where it is seen the protection of interest of all stakeholders in long term. Let us take an example of transparency of decisions and to express their point of views, most of the board of members 7 out of 10 directors are independent members of the board. These members do take part in audit, investor grievance issues, finance and most important the risk management decisions of the company independently and with fairness and transparency. The company's goal is to prioritise the fairness, transparency and accountability principles as to manage the risk taking all points and circumstances into company's board and management consideration. It is not like the company do not get into flaw yes, the company do account to many issues but with the equal cooperation of the board and the management the members are able to resolve those issues and able to maintain the India's best governance company.

- **Example of Bad Corporate Governance**

Enron Corporation was well knowing American energy, commodities, and services conglomerate, however in 2007, it has to close its gates forever due to their deception in accounting. The collapse of corporation started in 2000 itself, when the company suffered huge financial loss. The deception was carried out by the management of the corporation with the intent to cover the financial losses

[11] Ekta Selarka, *CG Practice in India (*May 2018), https://www.mse.ac.in/wp-content/uploads/2018/08/Working-Paper-173.pdf.

from the investors. Apart from this the company went on using the loopholes to carry out the crime. Further, Satyam Scam in India is well known example of bad governance.[12]

- **Yes, bank crisis 2020**

Yes, bank is one of the largest private sector bank in India founded in the year 2003 by Rana Kapoor. In the year 2017 RBI discovered bad loans and other lending. In the year 2018 RBI ordered the CEO Rana to step down. With time the chairman of the bank and two other independent directors step down from the board and management of the bank. In the same year CEO Rana sold all his stake from the bank. The reasons for such crises happened because of heavy loan on the bank and the bank was even lending the money to companies that are unable to pay back the money containing to very high risk and with the spread of such news, large amount of withdrawals were happening eventually created a balance sheet burden on the company that the management and the board are unable to cope up with resulting in moratorium on the bank as the bank has failed reasoning as bad corporate governance by the board and management without having fairness in taking decisions like taking money and lending money. Not able to cope up with the balance of funds in the bank. The management as well as board were unable to manage the risk as there was no proper decision making by the concerned persons. The resignation of independent directors and the CEO selling his all stake and try to escape the situation shows how fair and transparent the decisions were.

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(7) MANAGEMENT AND BOARD ROLE IN GOOD CORPORATE GOVERNANCE

- Promotion of ethical culture in managerial role – the ethical culture in a business organisation is above the legal requirements that can be termed as conduct of the management which eventually affect the smooth running of the organisation. It is responsible for the level of trust between the customers, stakeholders, creditors etc of the company and the management of the company at the ground level, with good corporate governance at the management level leads to a bond of trust.
- Transparency of communication – transparency of the company is the proof that the

[12] *Ibid.*

company may have issues within but do not try to hide the facts from the rest of the public or people who relate to the company directly or indirectly but do try to find the solution for the same. Such steps do help to maintain the level of trust between the management of the company as well as the board to take quick and necessary decisions.

- Clarification of roles and responsibilities of the board and directors- when the board members and directors who are the top authorities of the company do clearly know what responsibilities they have for the company. This will help to have certainty between the members and will help to avoid the chaos and complexity between the board and directors which may arise. Such clarified roles and responsibilities are an example of good governance which can apply to all sort of organisations.
- Evaluation of policies on regular basis – every company do make policies for the betterment of the society and company itself but they most of the time do not evaluate or update the policies with time and the polices become outdated. Here both management of the company and the board of the company do have role to play, both can notify about the foundation of policies to each and can work together by framing of new policies or updating the current ones. This will help the relation between both and will eventually lead to company doing its best practices with the transforming world and advancing technology.

(8) Impact of Corporate Governance on Financial Performance and Stability

CG has a major impact on the health and stability of an organization's finances. An important factor in long-term performance is excellent CG, even if this may not be clear from financial reporting. Large-scale financial disasters brought on by inadequate governance emphasize how important it is to have strong governance structures. Serious financial problems are often the result of negligent management. For example, insufficient risk management and inaccurate accounting practices were factors in the "Infrastructure Leasing & Accounting Services (IL&FS) 2018 collapse. This failure hurt investors and the Non-Banking Financial Company (NBFC) sector."[13] Other examples include the "Punjab and Maharashtra Co-operative (PMC) Bank crisis in 2019, the Yes Bank crisis in 2020, and the Lakshmi Vilas Bank (LVB) and DBS Bank India Ltd." merger in 2022. These institutions failed due to inadequate governance, risk, and compliance (GRC)

[13] Dr. Kembai Srinivasa Rao, *Discrenible gaps in CG in the financial sector,* TOI, Aug 8, 2024.

protocols, even if their boards were competent. Conflicts of interest in decision-making also exposed governance flaws.[14] For instance, Yes Bank adopted aggressive lending practices without doing a sufficient risk assessment, leading to a high volume of non-performing loans and a liquidity issue. Since these organisations couldn't maintain financial stability despite the restrictions, there was a loss of confidence.

(9) THE ROLE OF PROPER CORPORATE GOVERNANCE IN FINANCIAL STABILITY

In addition to improving financial stability, good CG ensures responsibility, openness, and fairness in management. Aiming to balance shareholder interests with those of the board and management is the goal of CG. CG, risk management, and compliance all of which are a part of the GRC framework benefit stakeholders. But how effectively it is executed will determine how successful it is. Several financial institutions' failures may be traced back to their incapacity to have an appropriate risk appetite, as demonstrated by their Internal Capital Adequacy Assessment Policy (ICAAP).[15]

Due to deficiencies in CG, there has been a surge in shareholder activism asking for stronger standards. SEBI has made electronic voting mandatory for shareholders to improve governance. This enhances governance and increases shareholder power. Financial organisations can manage risks, adhere to rules, and expand sustainably with the support of effective CG. It entails configuring internal monitoring programs with remedial actions. To identify and address aberrations, institutions should prioritise governance and match performance measures with self-regulatory parameters.

The government and regulatory agencies have tightened governance requirements in reaction to governance breakdowns. To address noncompliance and lower risks, the RBI has put in place fines and limitations. For instance, big NBFCs are now included in the Prompt Corrective Action (PCA) framework according to their financial performance. The PCA framework tackles deficiencies in

[14] "Puneeta Goel, *Implication of CG on financial performance: an analytical review of governance and social reporting reforms in india,* 2 ASIAN J. SUSTAINABILITY AND SOCIAL RESPONSIBILITY (2018)."
[15] David G. Mayes, Liisa Halme & Aarno Liuksila, *CG and Financial Stability,* IMPROVING BANKING SUPERVISION (2001).

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important areas of performance; yet it is more difficult to identify governance errors.

Due to concerns over governance, the RBI recently ordered Paytm Payments Bank Ltd (PPBL) to cease accepting new clients and placed limitations on certain actions carried out by IIFL Finance Ltd and JM Financial Products Limited. The RBI's dedication to compliance and financial stability is demonstrated by these measures. Strict criteria have also been established by SEBI for listed businesses, prohibiting those with governance failings from handling fresh debt issuance. This emphasises how crucial it is to follow governance guidelines.

In the financial industry, governance shortcomings continue despite these actions. 211 instances of non-compliance were noted in 2022–2023; as a result, ₹40.4 crores in fines were assessed. These problems highlight the necessity for financial organisations to put governance and compliance ahead of their immediate objectives.

(10) CONCLUSION

To attain the financial stability, the institution must implement the practices best in management of risk, compliance and CG. As analysed above the recent collapse of numerous financial institutions conveys the need to adhere and align the internal standards with risk tolerance and institutional strength. The collapse of Yes Bank is a evident example of it. The necessity of GRC Compliance is more than ever, by fortifying the GRC framework, the industries will progress towards a sustainable business model. To do this, a culture of fair governance, appropriate intervention, and learning from mistakes made in the past must be established among the workforces. In the end, stable and successful financial performance are greatly impacted by sound CG. The institutions must develop resilience, win back trust, and succeed over the long run by emphasising moral leadership, open communication, and efficient risk management.

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