

# International Journal of Research in Human Resource Management

E-ISSN: 2663-3361  
P-ISSN: 2663-3213  
IJRHRM 2019; 1(2): 23-25  
Received: 17-05-2019  
Accepted: 20-06-2019

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## The effect of corporate governess on the performance of an organization

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### Abstract

This study examined whether corporate governance has impact on organizational performance in Financial Institutions as research problem. This research was carried out with objective to measure association between Corporate Governance and Financial Institution's Performance in Batticaloa district. Conceptual framework has been developed to measure linkages between Corporate Governance and Financial Institution's Performance. Board Size, Corporate Governance Mechanism, Communication Strategies, and Code of Conduct are considered as the measurement variables of Corporate Governance which was derived from Changezi & Saeed (2013) and Customer Satisfaction, Employee Commitment and Corporate Reputation are considered as the measurement variable of Organizational Performance which was derived from Bayoud (2012) and Carton (2004). Moreover, it also found that there is a strong positive relationship between Corporate Governance and Organizational Performance. Corporate Governance significantly impacts Organizational Performance of Financial Institutions. These findings would be useful to consider more on Corporate Governance practices to avoid the Corporate Collapses and to achieve successful Organizational Performance.

**Keywords:** Corporate governance, organizational performance

### Introduction

Corporate administration is the arrangement of tenets, practices and procedures by which a firm is coordinated and controlled. Corporate administration basically includes adjusting the interests of an organization's numerous partners, for example, investors, the board, clients, providers, agents, government and the network. Since corporate administration likewise gives the structure to achieving an organization's destinations, it envelops for all intents and purposes each circle of the board, from activity designs and inside controls to execution estimation and corporate divulgence. Administration alludes explicitly to the arrangement of guidelines, controls, approaches and goals set up to direct corporate conduct. Intermediary counselors and investors are vital partners who in a roundabout way influence administration, however these are not instances of administration itself. The top managerial staff is essential in administration, and it can have significant implications for value valuation.

### Corporate governance and the board of directors

The top managerial staff is the essential direct partner impacting corporate administration. Executives are chosen by investors or selected by other board individuals, and they speak to investors of the organization. The board is entrusted with settling on imperative choices, for example, corporate officer arrangements, official pay and profit strategy. In a few occurrences, board commitments extend past money related streamlining, when investor goals require certain social or natural worries to be organized.

Barricades are regularly made of inside and autonomous individuals. Insiders are significant investors, organizers and administrators. Autonomous chiefs don't share the ties of the insiders, however they are picked in view of their experience overseeing or coordinating other vast organizations. Independents are viewed as supportive for administration since they weaken the centralization of intensity and help adjust investor enthusiasm with those of the insiders.

### Good and bad governance

Bad corporate governance can cast doubt on a company's reliability, integrity or obligation to shareholders - which can have implications on the firm's financial health.

Tolerance or support of illegal activities can create scandals like the one that rocked Volkswagen AG in 2015, when it was revealed that the firm had rigged engine emissions tests in America and Europe. Volkswagen saw its stock shed nearly half its value in the days following the start of the scandal, and its global sales in the first full month following the news fell 4.5%.

Companies that do not cooperate sufficiently with auditors or do not select auditors with the appropriate scale can publish spurious or noncompliant financial results. Bad executive compensation packages fail to create optimal incentive for corporate officers. Poorly structured boards make it too difficult for shareholders to oust ineffective incumbents. Corporate governance became a pressing issue following the 2002 introduction of the Sarbanes-Oxley Act in the United States, which was ushered in to restore public confidence in companies and markets after accounting fraud bankrupted high-profile companies such as Enron and WorldCom.

Good corporate governance creates a transparent set of rules and controls in which shareholders, directors and officers have aligned incentives. Most companies strive to have a high level of corporate governance. For many shareholders, it is not enough for a company to merely be profitable; it also needs to demonstrate good corporate citizenship through environmental awareness, ethical behavior and sound corporate governance practices.

Cadbury (1992) <sup>[1]</sup> defined corporate governance as “the system by which companies are directed and controlled. Corporate governance is mainly considered with board of directors’ duties and responsibilities and relationship with the stakeholders to meet the success of company. The Organization for Economic Co-operation Development Principles of Corporate Governance (1999) states that “Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. It also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined”. Thus definition of corporate governance can be concluded that mechanisms developed into the company by which companies are directed to increase long term value of stakeholders and ultimately improving the performance of companies. There are varieties of definition of organizational performance in the literature. In general, Carton (2004) <sup>[2]</sup> states that “the concept of organizational performance is based upon the idea that an organization is the voluntary association of productive assets, including human, physical, and capital resources for the purpose of achieving a shared purpose”. The collapse of companies has highlighted to study about corporate governance practices and its impact on organizational performance. Therefore, the purpose of study was to examine impact of corporate governance on organizational performance in financial institutions in Batticaloa district. Reason for selecting financial institutions is that there are many expansions of financial institutions and also it is one of growing sector in Batticaloa. It is important to study corporate governance system and its relationship with organizational performance in Batticaloa. Rare research has been conducted regarding this topic so this study is important and relevant in order to fill the knowledge gap to find out to what extent corporate governance impacts on organizational performance.

### Key principles of corporate governance

There are different fundamental elements of good corporate governance that influence the performance of any organization. Some key elements that can be regarded as appropriate in achieving effective corporate governance are: trustworthiness, honesty, sincerity, performance orientation, mutual interest, and commitment to the organization. Few generally accepted rules and principal for effective corporate governance are as following:

1. Its organization’s obligation to respect the rights of shareholders and facilitate shareholders in getting their rights.
2. Organizations should be aware that they have legal and lawful duties for all stakeholders.
3. Organization has vital obligation to provide effective and understandable information to the shareholders and all participations of annual general meeting.
4. Board of directors has responsibility to check and perform proper scrutiny of management’s performance. Another responsibility is to state visibly and clearly the duty and tasks of management and board of the organization in order to get full confidence of the shareholders towards organization. Despite of these key principals elaborated by the researchers, the most powerful principals of corporate governance, which followed by almost all countries through the universe, were built by OECD 1999 (reviewed and revised on 2004) based on four core pillars as follow:

**1. The Rights of Shareholders:** The rules emphasize that shareholders have secure ownership, the right to full disclosure of information, voting rights, participation in decisions concerning fundamental corporate changes such as the sale or modification of corporate assets including mergers and new share issues. Markets for corporate control should be efficient and transparent and shareholders should consider the costs and benefits of exercising their voting rights.

**2. The Equitable Treatment of Shareholders:** All shareholders of the same class should be treated equally, including minority and foreign shareholders and should have the opportunity to obtain effective redress for violation of their rights. It emphasizes the protection of minority and foreign shareholders rights with full disclosure of material information. It ensures the setting up of systems that keep insiders, including managers and directors, from taking advantage of their roles, insider trading is prohibited and members of the board and managers should be required to disclose any material interest in transactions.

**3. The Role of Stakeholders in Corporate Governance:** In addition to the shareholders, the OECD also recognizes the right of stakeholders. Employees are usually the important stakeholders that determine how companies perform and take decisions. Thus the corporate governance framework must ensure that the right of stakeholders are protected and respected by law. Stakeholders participating in the corporate governance process should have access to relevant information. The framework also encourages active cooperation between corporations and stakeholders in creating wealth, jobs and sustainable financial and sound enterprises.

**4. Timely and accurate disclosure and transparency:** The OECD principles ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership and governance of the company including board of directors and their remuneration. The guidelines also specify that annual audits should be performed by independent auditors in accordance with high quality standards of accounting, financial and non-financial disclosure. Channels for disseminating information should provide fair, timely and cost efficient access to relevant information by users.

**5. The responsibilities of the board:** The OECD guidelines lay in detail the functions of the board in protecting the company, its shareholders as well as its stakeholders. The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company, shareholders and stakeholders. These include concerns about corporate strategy, risk, executive compensation and performance, as well as accounting and reporting systems. Board members should act on a fully informed basis, in good faith, with due diligence and in the best interest of the company and its shareholders. The board should also ensure compliance with applicable laws and take into account the interests of the stakeholders. Finally the board should be able to make objective judgment on corporate affairs, independent from management Concept of Corporate and Corporate Strategy In its simplest form a corporation is defined as an organization having its own legal entity separate from its owners thereby having its own rights, responsibilities and obligations. They operate for a profit motive, capitalizing on their expertise, resources and networks. Its owners usually are very high in number (general public, group of investors, consortiums) and they pool their investments in the form of shares, which are traded at stock exchange. It is chartered and regulated by the government. By law, accounts are audited by independent external auditors; the company is subjected to the statutory and financial laws of the land and those of relevant regulatory authorities. While corporate strategy is a strategy for guiding a firm's entry and exit from different businesses, for determining how a parent company adds value to and manages its portfolio of businesses, and for creating value through diversification (Perace and Robinson, 2009) <sup>[3]</sup>. Corporate governance issues are of great concern in the world today because of its influences on the effectiveness and relevance of an organization's strategy. Organizations are more than ever, under increased pressure to be proactive in reforming various aspects of corporate governance to protect stakeholders' interests. A weak corporate governance results in weak organizational strategy, which seriously compromises the strategic positioning and success of an organization (Onuoha *et al.*, 2013) <sup>[4]</sup>. Sooner or later, every large corporation runs into trouble; poor strategic decisions are made that harm performance. The long-term strategic success of the corporation rests on cutting the frequency of such failures both large and small and on correcting them quickly and at low cost when they occur. Mistakes can depreciate brand equity, demoralize the company, and cause good people to leave. Strategic failures waste precious resources, and make it more difficult to find financing and support in capital markets in the future.

Corporate mistakes are typically seen as failures of strategy. Observers, analysts, and executives study the strategic direction followed by the company and question why it failed to produce results

Once the governance-strategy link (corporate governance and corporate strategy) is recognized, new possibilities open up for senior managers and boards to incorporate governance issues directly into corporate planning. By asking the right questions about where the corporation will be in a few years, and what pressures it will face, boards and managers can refine the system of controls that guide decision-making so that mistakes are less likely. By strengthening governance, corporations can strengthen their strategies and their ability to compete. Failures in strategy occur either because of mistakes by top executives that are not quickly corrected, or because of generalized problems within the company that make the entire company ineffective in responding to market signals. These failures, in turn, are supposed to be corrected by the corporate governance system (Drew, *et al.*, 2006) <sup>[5]</sup>.

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