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Corporate Governance in India

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Abstract

Corporate Governance in India has seen a paradigm shift and has been posing new set of challenges to the top echelons of management in various organizations includingorganizations from the financial sector. The increasing stringencies and tighter regulatory mechanism have been the compelling reasons for the companies to have stronger focus and orientation on smooth implementation of the corporate governance code in India. The paradigm shift in the manner in which business is conducted across the world in the digital era, warrants a synchronization of the regulatory mechanisms to tackle frauds & to safeguard the interests of various stakeholders. Aclear understanding of the various changing dimensions and perspectives optimally backed by the collective will power of the corporate world as well as the government will ensure the accomplishment of shareholders' objectives by the various organizations
Keywords: Corporate Governance, Corporate governance code, Audit committee

Objectives of Study

- To understand the development of corporate governance.
- To understand the concept of corporate governance.
- To gain insight in the formation of laws and enforcement agency rules in consequent of corporate governance failures cases.
- To highlight the changes made in corporate governance framework.

INTRODUCTION

In a Board Culture of Corporate Governance, business author Gabrielle O'Donovan defines corporate governance as "An internal system encompassing policies, processes and people, which serves the needs of shareholders and other stakeholders, by directing and controlling management activities with good business savvy, objectivity, accountability and integrity". Sound corporate governance is reliant on external marketplace commitment and legislation, plus a healthy board culture which safeguards policies and processes.

Corporate Governance is the set of processes, customs, policies, laws, and institutions affecting the way a corporation (or company) is directed, administered or controlled. Corporate governance also includes the relationships among the many stakeholders involved and the goals for which the corporation is governed. In simpler terms it means the extent to which companies are run in an open & honest manner.

Corporate governance has three key constituents namely: the Shareholders, the Board of Directors & the Management. Other stakeholders include employees, customers, creditors, suppliers, regulators, and the community at large. The concept of corporate governance identifies their roles & responsibilities as well as their rights in the context of the company. It emphasises accountability, transparency & fairness in the management of a company by its Board, so as to achieve sustained prosperity for all the stakeholders.

Corporate governance in India gained prominence in the wake of liberalization during the 1990s and was introduced, by the industry association Confederation of Indian Industry (CII), as a voluntary measure to be adopted by Indian companies. It soon acquired a mandatory status in early 2000s through the introduction of Clause 49 of the Listing Agreement, as all companies (of a certain size) listed on stock exchanges were required to comply with these norms. In late 2009, the Ministry of Corporate Affairs released a set of voluntary guidelines for corporate governance, which addressed a myriad corporate governance issues.

In view of reforms in the area of corporate governance, The Companies Bill, 2009 was referred to the Parliamentary Standing Committee on Finance, which submitted its report on 31 August 2010 and was withdrawn after the introduction of the Companies Bill, 2011. After the approval of companies bill 2011 by the lok sabha on 18 December 2012 as the Companies bill 2012 and then by Rajya Sabha too on 8 August 2013, the final president's assent on 29 August 2013 is now known as Companies Act 2013 which includes some mandatory and non mandatory requirments to be fulfilled by listed companies (amended form).

The Anglo-Saxon model of governance, on which the corporate governance framework introduced in India is primarily based on, has certain limitations in terms of its applicability in the Indian environment. For instance, the central governance issue in the US or UK is essentially that of disciplining management that has ceased to be effectively accountable to the owners who are dispersed shareholders.

However, in contrast to these countries, the main issue of corporate governance in India is that of disciplining the dominant shareholder, who is the principal block-holder, and of protecting the interests of the minority shareholders and other stakeholders. This issue and the complexity arising from the application of alien corporate governance model in the Indian corporate and business environment is further compounded by the weak enforcement of corporate governance regulations through the Indian legal system.

Currently, corporate governance reforms in India are at a crossroads; while corporate governance codes have been drafted with a deep understanding of the governance standards around the world, there is still a need to focus on developing more appropriate solutions that would evolve from within and therefore address the India-specific challenges more efficiently.

This paper suggests the need for robust research in the field of corporate governance research that would support policy formulation in order to make the next generation of corporate governance reforms more effective for the Indian conditions.

Literature Review

A comprehensive study by Chakrabarti, Megginson, and Yadav has traced the evolution of the Indian corporate governance system and examined how this system has both supported and held back India's ascent to the top ranks of the world's economies. The authors of the study have found that while on paper, the framework of the country's legal system provides some of the best investor protection in the world; enforcement is a major problem in view of the slow functioning of the over-burdened courts and the widespread prevalence of corruption.

Furthermore, ownership of enterprises remains concentrated in a few hands, and family business groups continue to be the dominant business model.

Gupta and Parua attempted to find out the degree of compliance of the Corporate Governance (CG) codes by private sector Indian companies listed in the Bombay Stock Exchange (BSE). Data regarding 1245 companies for the year 2004-2005 was taken for the study from the CG reports (which are included in the Annual Reports) of these companies and 21 codes (of which 19 are mandatory and 2 non-mandatory) were selected for study.

The compliance rate of the CG codes was first tested individually for each company. Further, the mean compliance rate (taking into account all the companies under the study) and the variation among the companies from the mean compliance rate were also tested. It was observed that more than 70 per cent of the sample companies comply with 80 per cent or more of the codes. As regards the code-wise compliance rate, the compliance rate is greater than 80 per cent in respect of 17 codes.

The enforcement of the corporate governance reforms in India has been analyzed by Khanna, who has attempted to find an answer to the paradox of foreign institutional investors (FIIs) increasing their presence and interest in the Indian stock markets when reforms were enacted but not immediately enforced. Khanna has argued that given the high returns available in India, FIIs may

have thought that the need for enforcement was not pressing initially (as the chance of insider diversion may not be high at that time), but could become so during the next few years when the market eventually matured.

An important empirical study by Dharmapala and Khanna acknowledged the importance of enforcement in corporate governance reform and studied the impact of the introduction of Section 23E to the Securities Contracts (Regulation) Act, 1956 in 2004, which imposed large penalties of Rs. 25 crore for non-compliance with the Listing Agreement (that also includes Clause 49) containing the corporate governance norms. Using a sample of over 4000 firms during the period 1998-2006, this study revealed a "large and statistically significant positive effect (amounting to over 10% of firm value) of the Clause 49 reforms in combination with the 2004 sanctions." Since Clause 49 did not apply to all listed firms, the researchers could analyse the response of 'treatment' groups (firms subject to Clause 49) and compare the same with a 'control' groups (firms not subject to Clause 49). The study shows a positive correlation between the introduction of stringent enforcement norms and the market value of the companies Jayanth Varma has argued that the corporate governance problems in India are very different from those found in the Anglo-Saxon world and would need a different model for corporate governance, which has a significant external focus. The governance issue in the US or the UK is essentially that of disciplining the management that has ceased to be effectively accountable to the owners.

Khanna and Palepu have concluded that it did not appear that concentrated ownership in India was entirely associated with the ills that the literature has ascribed to it in emerging markets. On the other hand, they felt that if the concentrated owners are not exclusively, or even primarily, engaged in rent-seeking and entry-deterring behaviour concentrated ownership may not be inimical to competition.

In the backdrop of the key role played by the dominant shareholder or the promoter, in the Indian context, Varrotil makes the case that the source for strengthening Indian corporate governance lies within, and the emulation of other systems of corporate governance, or even adopting best practices that may have been successful elsewhere, would only lead to further incongruity with the traditional business systems and practices that are prevalent in India.

Evolution of Corporate Governance in India

A) Chronological Perspective:

Corporate governance is perhaps one of the most important differentiators of a business that has impact on the profitability, growth and even sustainability of business. It is a multi-level and multi-tiered process that is distilled from an organization's culture, its policies, values and ethics, especially of the people running the business and the way it deals with various stakeholders.

Creating value that is not only profitable to the business but sustainable in the long-term interests of all stakeholders necessarily means that businesses have to run—and be seen to be run—with a high degree of ethical conduct and good governance where compliance is not only in letter but also in spirit.

B) Historical Perspective:

At the time of Independence in 1947, India had functioning stock markets, an active manufacturing sector, a fairly developed banking sector, and also a comparatively well- developed British-derived convention of corporate practices. From 1947 through 1991, the Indian Government pursued markedly socialist policies when the State nationalized most banks and became the principal provider of both debt and equity capital for private firms.

The government agencies that provided capital to private firms were evaluated on the basis of the amount of capital invested rather than on their returns on investment. Competition, especially foreign competition, was suppressed. Private providers of debt and equity capital faced serious obstacles in exercising oversight over managers due to long delays in judicial proceedings and difficulty in enforcing claims in bankruptcy. Public equity offerings could be made only at government-set prices. Public companies in India were only required to comply with limited governance and disclosure standards enumerated in the Companies Act of 1956, the Listing Agreement, and the accounting standards set forth by the Institute of Chartered Accountants of India (ICAI).

Faced with a fiscal crisis in 1991, the Indian Government responded by enacting a series of reforms aimed at general economic liberalization. The Securities and Exchange Board of India (SEBI)—India's securities market regulator—was formed in 1992, and by the mid 1990s, the Indian economy was growing steadily, and Indian firm

had begun to seek equity capital to finance expansion into the market spaces created by liberalization and the growth of outsourcing.

The need for capital, amongst other things, led to corporate governance reform and many major corporate governance initiatives were launched in India since the mid-1990s; most of these initiatives were focused on improving the governance climate in corporate India, which, at that time, was somewhat rudimentary.

Codifying Good Governance Norms

Confederation of Indian Industry:

The first major initiative was undertaken by The Confederation of Indian Industry (CII), India's largest industry and business Association, which came up with the first voluntary code of corporate governance in 1998.More than a year before the onset of the East Asian crisis, the CII had set up a committee to examine corporate governance issues, and to recommend a voluntary code of best practices. Drawing heavily from the Anglo-Saxon Model of Corporate Governance, CII drew up a voluntary Corporate Governance Code.

Securities and Exchange Board of India: Consequently, the second major corporate governance initiative in the country was undertaken by SEBI. In early 1999, it set up a committee under Kumar Mangalam Birla to promote and raise the standards ofgood corporate governance. The Birla Committee placed emphasis on independent directors and made specific recommendations regarding board representation, audit committee, shareholders grievances committee, accounting standards and financial reporting, disclosure to the shareholders as mandatory provisions under clause 49.

Government of India's Initiative:

The Naresh Chandra committee was appointed in August 2002 by the Department of Company Affairs (DCA) under the Ministry of Finance and Company Affairs, to examine various corporate governance issues. The Committee submitted its report in December 2002. It made recommendations in terms of two key aspects of corporate governance: financial and non-financial disclosures, and independent auditing and board oversight of management.

Narayan Murthy Committee:

The fourth initiative on corporate governance in India was in the form of the recommendations of the Narayana Murthy Committee. This committee was set up by SEBI under the chairmanship of Mr. N.R. Narayana Murthy, in order to review Clause 49, and to suggest measures to improve corporate governance standards. Revised Clause 49 of the Equity Listing Agreement consists of mandatory as well as non- mandatory provisions.

Mandatory Provisions zconsists of the following:

Composition of Board and its procedure - frequency of meeting, number of independent directors, code of conduct for Board of directors and senior management;

Audit Committee, its composition, and role

Provision relating to Subsidiary Companies

Disclosure to Audit committee, Board and the Shareholders

Non mandatory Provisions consists of the following:

- Constitution of Remuneration Committee
- Despatch of Half-yearly results
- Training of Board members
- Peer evaluation of Board members
- Whistle Blower policy

Ministry of Corporate Affairs:

In parallel, the review and redrafting of the Companies Act, 1956 was taken up by the Ministry of Corporate Affairs (MCA) on the basis of a detailed consultative process .and the Government constituted an Expert Committee on Company Law under the Chairmanship of Dr. J.J. Irani on 2 December 2004 to offer advice on a new Companies Bill.

Satyam Computer Services Scandal (Case Study)

In January 2009, the Indian corporate community was rocked by a massive accounting scandal involving Satyam Computer Services (Satyam), one of India's largest information technology companies.

The rise of Satyam

1987: Satyam Computers Pvt. Ltd. born.

1991: -June: first fortune 500 clients

-August: Converted into public Ltd Co.

1994: The big break- Allies with Dun and Bradstreet Corp.

2000: Declared one of the 100 most pioneering technology Companies by world Economic forum

-Dataquest IT Man of the year award

2002: -CNBC's Asian Business Leader

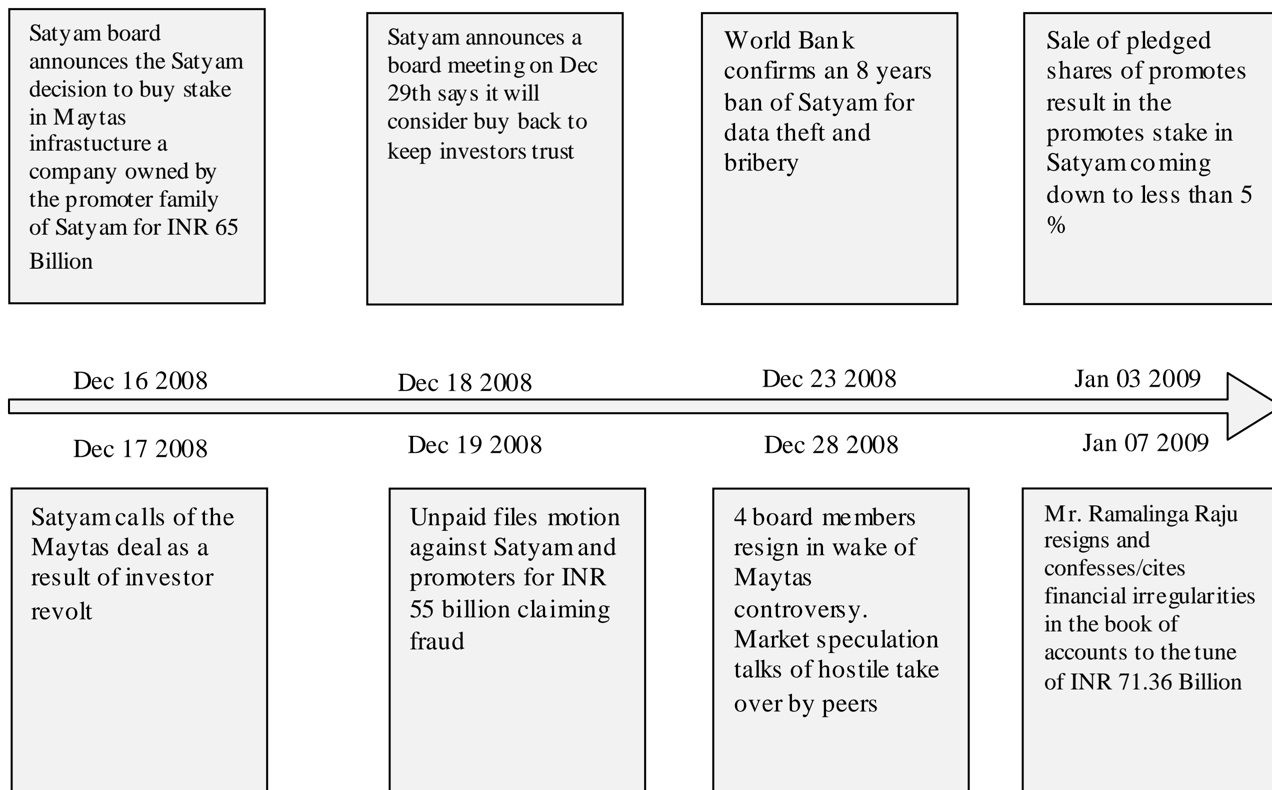
-Corporate citizen of the year award

Satyam proved it

"World is not only just going through economic crisis but also ethical crisis with the Corporate frauds, Accounting scandals, Mismanagement, Bribes and many more."

The Satyam scandall prompted quick action by the Indian government, including the arrest of several insiders and auditors of Satyam, investigations by the MCA and SEBI, and substitution of the company's directors with government nominees.

What Happends



The Disastrous Revelation

A. The black day: 7th January, 2009
B. Accounting fraud of over 7800 crore rupees
C. From past 7 years accounting books were cooked:
D. Profits were inflated
E. Understated liability and overstated debts
F. Accrued interest (Non Existing)
G. The gaps in the balance sheet are due to the inflated profits
H. Biggest single day fall for a stock in stock market (Jan 6th) 77%
I. BSE sensex fell by 749.05 i.e. 7.25%
J. NSE fell by 192.40 points i.e. 6.18%

The Companies Act 2013 and Its Impact on Corporate Governance

As a consequence of various corporate scams, India's ranking in the CLSA Corporate Governance Watch 2010 slid from third to seventh in Asia.

The Companies Act, 2013 makes comprehensive provisions concerning corporate governance in the country. The Act is partially made effective w.e.f. 12th September, 2013, by way of implementing 98 sections. The Act is expected to be fully operational by April 2014. Some of the salient features of the companies act, 2013 are as under:

Disclosure of Promoters' holding (Section 93): Every listed company shall file a return in the prescribed form with the registrar with respect to change in the number of shares held by promoters and top ten shareholders of such company, within fifteen days of such change.

Voting by Electronic Means (Section 108): The central government may describe the class or classes of companies and manner in which a member may exercise his right to vote by the electronic means.

National financial reporting authority (Section 132):

The Central Government may constitute a National Financial Reporting Authority to provide for matters relating to accounting and auditing standards.

Corporate Social Responsibility (Section 135):

A. Every company having net worth of rupees five hundred crore or more, or turnover of rupees one thousand crore or more or a net profit of rupees five crore, out of which at least one director shall be an independent director.
B. The Board's report shall disclose the companies of the corporate social responsibility committee.
C. The board of every company shall make every endeavour to ensure that the company spends, in every financial year, at least two per cent of the average net profits of the company made during the three immediately preceding financial years, in pursuance of its corporate social responsibility.

Audit and Auditors:

Appointment and Rotation (Section 139) : Every company shall, at the first annual general meeting, appoint an individual or a firm an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting and the manner and procedure,selection of auditors by the members of the company at such meeting shall be such as may be prescribed. Before such appointment is made, written consent of the auditor to such appointment and a certificate from him stating that the appointment,if made, shall be in the accordance with the conditions as may be prescribes,shall be obtained from the auditors.

Appointment and Qualifications of Director:

Independent Director (Section 149)

Every listed company6 shall have at least one third of the total no. of directors as independent directors and the central government may prescribe the minimum no. of director in case of any class or classes of public companies.

Definition of independent Director

An independent director in relation to a company, means a director other than a managing director or a whole-time director or a nominee director.

Audit Committee:

A. The board of directors of every listed company and such other class or classes of companies, as may be prescribed,shall constitute an audit committee.
B. The audit committee shall consist of minimum of three director with independent directors forming a majority . majority of members of audit committee including its chairperson shall be persons with ability to read and understand the financial statements.
C. Every audit committee of a company existing immediately before the commencment of this act shall, within one year of such commencement, be reconstituted in accordance with sub section (2).

Nomination and Remuneration committee (Section 178):

A. The board of directors of every listed company and such other class or classes of companies, as may be prescribed shall continue the nomination and remuneration consisting of three or more non-executive directors out of which not less than one half shall be independent directors.
B. The nomination and remuneration committee shall determine committee shall formulate the criteria for determining qualifications, positive attributes and independence of a director and recommend to the Board a policy, relating to the remuneration for the directors, key managerial personnel and other employees.

Prohibition on forward trading (section 194):

A. No directors of a company or any of its key managerial personnel shall buy the company or in its holdings, subsidiary or associate company.
B. If a director or any key managerial personnel of the company contravenes the above provision ,such director or key personnel shall be punishable with imprisonment for a term which mat extend to 2 years or with fine shall not be less than one lakh rupees but which may extend to five lakh rupees ,or with both.

10) Insider trading (Section 195):

No person including any director or key managerial personnel of a company shall enter into insider trading: provided that nothing contained in this sub-section shall apply to any communication required in the ordinary course of business or profession or employment or under any law

Challenges for corporate governance in India:

- There is a gap between corporate governance standards in the public sector and the private sector. PSUs are subjected to varying levels of government interference in their routine functioning, undermining their autonomy. Further, restrictive and outdated labor laws in India make laying off employees and closing businesses difficult.
- In public sector units (PSUs), members of the board and the Chairman are usually appointed by the concerned ministry and very often PSUs are led by bureaucrats rather than professional managers. Therefore, PSU boards can rarely act in the manner of an empowered board as envisaged in corporate governance codes. This makes several provisions of corporate governance codes merely a compliance exercise.
- Much of global corporate governance norms focus on boards and their committees, independent directors and managing CEO succession. In the Indian business culture, boards are not as empowered as in several western economies and since the board is subordinate to the shareholders, the will of the majority shareholders prevails.
- Multinational companies (MNCs) in India are perceived to have a better record of corporate governance compliance in its prescribed form. However, in the ultimate analysis, it is the writ of the large shareholder (the parent company) which runs the Indian unit that holds sway, even if it is at variance with the wishes of the minority shareholders.

- Family businesses and business groups as a category are perhaps the most complex for analysing corporate governance abuses that take place. The position as regards family domination of Indian businesses has not changed; on the contrary, over the years, families have become progressively more entrenched in the Indian business milieu. As per a recent study by the global financial major Credit Suisse, India ranks higher than most Asian economies in terms of the number of family businesses and the market capitalization of Indian family businesses as a share of the nominal gross domestic product (GDP) has risen from 9 per cent in 2001 to 46 per cent in 2010.

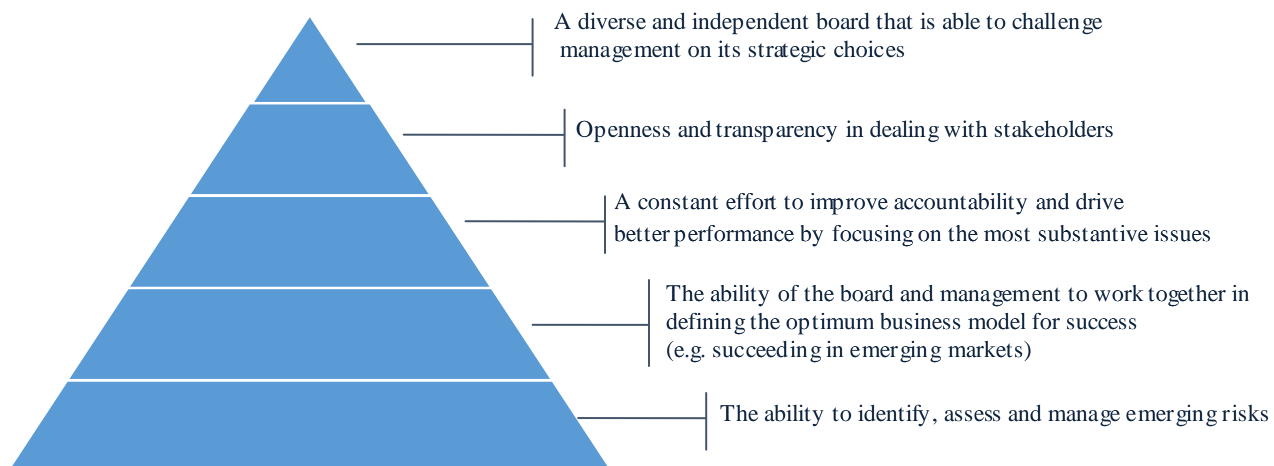
- Promoter control: There exists an additional complexity on account Of the 'promoter control' in Indian companies. Promoters (who may not be holding controlling shares) usually exercise significant influence on matters involving their companies, even though such companies are listed on stock exchanges and hence have public shareholders.

Conclusion & Suggestions

In order to be successful, CG needs to be based on sound theory rather than popular perception or results of spontaneous discussions with the concerned parties. They also need to be tested empirically and linked to concrete performance indicators. Businesses adapting better corporate governance practices should be rewarded by high profitability.

The loop holes in the provisions have to be removed. And the companies should not be let to escape by taking advantage of the limitations of the clause 49 of the listing agreement. The function of the audit committee has be expanded to include oversight of risk management control systems to create an environment for the adherence to the practices of good corporate governance.

Effective Governance can be explained with the help of following diagram:



Suggestions

- There should be a new method for the appointment of Independent Director. Market regulator SEBI can be a part of appointment process of independent director.
- Independent directors- selection criteria must be transparent; also process of appointment of BOD must be reconsidered.
- The regulation and scrutiny of the audit profession in India could benefit from some objective of introspection.
- There should be a rise in investor activism in India.
- It is important to focus on not just Quantity or profits but on the sustainability of business models.

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