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Corporate Governance Practices in India: An Evaluation

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ABSTRACT

Corporate Governance (CG) is increasingly becoming important in India since its codification by Confederation of Indian Industries (CII) in 1998. Establishment of different committees on CG by the regulator has contributed to the first phase of CG reforms. Subsequently, CG regulations became mandatory (since 1.1.2006) through the Listing Agreement i.e., Clause 49. Clause 49 also comprises non-mandatory provisions. However, CG has not yielded desired results as apparent from different scandals. Few years back Satyam Computers scandal has eroded wealth of many shareholders. Such an event has raised doubts to the extant and prospective investors. It engendered new recommendations of CG in second phase of CG reforms. Recently, entry of Foreign Direct Investment (FDI) in retail and aviation sectors by the Government of India will require more effective and efficient implementation of CG to win investors. Here an attempt has been made to study mandatory CG practices as per Clause 49.

KEYWORDS: First Phase of CG reforms, Second Phase of CG reforms, tunnelling, expropriation.

Conceptual Background

Spree of corporate frauds in west has mooted the idea to conceptualize CG in India. According to the Securities and Exchange Board of India (SEBI), CG is "the way in which companies run themselves, in particular the way in which they are accountable to those who have a vested interest in their performance, especially their shareholders." So the interests of equity shareholders is overriding than interests of other stakeholders. In congruence with this view, according to Kumar Mangalam Birla Committee Report on Corporate Governance, 2002 "the fundamental objective of corporate governance is the enhancement of shareholder value, keeping in view the interests of other stakeholders". In short, suppliers of finance should get adequate return on their investments (Shleifer & Vishny 1997). Among suppliers of finance, equity shareholders being residual claimants require special attention because others (assured returns) can protect their claims through legal mechanisms whereas returns to equity shareholders are not warranted.

First Phase of CG Reforms

First phase of CG reforms refers to period from the year 1997 to 2007. Gradual improvements or initiatives taken to protect interests of equity shareholders and general public at large are termed as CG reforms. It includes initiatives by National task Force of CII (1997), chaired by Rahul Bajaj and developed A Code of Desirable Corporate Governance in 1998. Further, the SEBI appointed Kumarmangalam Birla Committee in 1998 to raise standards of CG. On the basis of recommendations of Kumarmangalam Birla Committee, SEBI enacted Clause 49 in the Listing Agreement in the year 2000, to be adhered by selective companies. Department of Company Affairs, Government of India appointed Naresh Chandra Committee to incorporate desired changes in CG on the lines of developments of Sarbanes–Oxleys Act, 2002 in United States (US). Narayan Murthy Committee was set up by SEBI in 2003 to further review status of CG norms and their effectiveness. In 2004, J. J. Irani Committee set up by Government suggested changes in Companies Act, 1956 to revamp provisions of CG. With the background of these all CG recommendations, Clause 49 was revised a handful of times. As an institutional measure, Government of India, Ministry of Corporate Affairs (MCA) established National Foundation for Corporate Governance in 2004. In 2007, Government devised Corporate Governance Guidelines for Public Sector Enterprises where Government companies are expected to adhere to these guidelines in addition to compliance with Clause 49.

Second Phase of CG Reforms

Second phase of CG reforms refer to CG initiatives from the year 2008 to till date. After Satyam scam in the year 2008-09, MCA took many initiatives apart from effectively managing affairs of corrupted Satyam to inculcate confidence in the economy (stock exchanges), thereby enabling investors to restore their confidence. Such initiatives include developing Corporate Governance Voluntary Guidelines, 2009, Corporate Social Responsibility Voluntary Guidelines, 2009, Corporate Governance Recommendations for Voluntary Adoption by CII, 2009, National Voluntary Guidelines on Social, Environmental and Economic Responsibility of Business, 2011. The Institute of Company Secretaries of India has also suggested recommendations to Strengthen Corporate Governance Framework post Satyam fiasco. After several attempts, continuous efforts of Government has made it possible to bring new company law i.e., Companies Bill, 2011 and final draft is placed before the Cabinet. Companies Bill, 2011 incorporates many provisions of Clause 49, apart from much needed other provisions; one such is class action suits. According to new provisions of the said Bill, now MCA will monitor CG enforcements as SEBI used to do it earlier. Despite of these reforms, Government has announced that it will soon finalise National Policy on Corporate Governance on the basis of recommendations suggested by Adi Godrej Panel on Corporate Governance.

Regulation

Enactment of CG regulations has been done through listing agreement i.e., Clause 49 for listed companies having paid-up equity share capital worth Rs. 3 Crore or net worth Rs. 25 Crore. The effective date of implementation of the said clause has been from beginning of the fourth quarter of the financial year 2005-06 i.e., from 1.1.2006.

Objectives

Objectives of the study are to impart conceptual understanding of CG, to highlight primacy of protection of interests of equity shareholders, to know status of different CG reforms, to evaluate mandatory CG practices and to know relevant implications.

Research Method

Sampling Plan

Purposive and random sampling techniques were used for the sample. The sample companies are pertaining to different sectors comprising S&P CNX NIFTY Index.

Sample

Sample includes 34 companies which were members of the stock exchange i.e., S&P CNX NIFTY Index in the year 2007-08.

Sample Period

The year 2007-08 is considered as sample period.

Data Analysis

Data collected from the company's annual reports were analysed with the help of classification, tabulation, mean, per cent and grading system.

Evaluation of CG Practices

CG practices means compliance with mandatory provisions of CG as per Clause 49 of the Listing Agreement. Evaluation of CG practices is done through CG Index after classifying these practices according to broader headings as stipulated by the said clause. CG Index comprises total weights assigned to CG variables as presented in TABLE 1.

TABLE 1

CG INDEX FOR EVALUATING COMPLIANCE WITH MANDATORY PROVISIONS OF CLAUSE 49 OF THE LISTING AGREEMENT

Provisions	Clause	CG Index (Out of 100)
I. Board of Directors	49(I)	16

Composition of Board	49 (IA)	4
Non-Executive Directors' Compensation and Disclosures	49 (IB)	4
Other Provisions as to Board and Committees	49 (IC)	4
Code of Conduct	49 (ID)	4
II. Audit Committee	49 (II)	20
Qualified and Independent Audit Committee	49 (IIA)	4
Meeting of Audit Committee	49 (IIB)	4
Powers of Audit Committee	49 (IIC)	4
Role of Audit Committee	49 (IID)	4
Review of Information by Audit Committee	49 (IIE)	4
III. Subsidiary Companies	49 (III)*	-
IV. Disclosures	49 (IV)	24
Basis of Related Party Transactions	49 (IVA)	4
Disclosures of Accounting Treatment	49 (IVB)	4
Board Disclosures (Including Risk Management)	49 (IVC)	4
Proceeds from Public Issues, Rights Issues, Preferential Issues	49 (IVD)*	-
Remuneration of Directors	49 (IVE)	4
Management Discussion	49 (IVF)	4
Information to Shareholders	49 (IVG)	4
V. Chief Executive Officer (CEO)/Chief Financial Officer (CFO) Certification	49 (V)	20
VI. Report on Corporate Governance	49 (VI)	10
VII. Compliance (As Certified)	49 (VII)	10

*Clause 49 (III) and 49 (IVD) are excluded from computation of the CG Index as these Sub-Clauses are not applicable or no information has been provided by many companies in this regard.

Source: Adapted from www.nseindia.com

Findings

The following findings (TABLE 2) of the study are based on CG reports, a part of annual reports of companies.

TABLE 2
CG INDEX AND INTERPRETATION

Number of Companies (Total 34)	CG Index Obtained	Interpretation
24	100	Excellent
5	86-99	Very Good
5	71-85	Good
0	56-70	Average
0	46-55	Poor Average
0	Less than 45	Bad

Source: Gleaned from annual reports.

Explanation

1. Out of total 34 companies, 24 companies have obtained CG Index of 100, thereby indicating excellent CG practices and full compliance with CG norms.
2. Five companies show very good CG practices (CG Index 86-99), but not complying 100 per cent with CG norms i.e., Clause 49 requirements. The reasons for not achieving full companies include (i) all five companies were unable to adhere with composition of Board requirements; (ii) one company failed to hold adequate number of Audit Committee meetings.
3. Remaining five companies have exhibited good CG practices (CG Index 71-85), as apparent from CG Index. However, these five companies too failed to have full compliance with CG norms. The reasons being (i) all five companies have not shown certification of financial statements by CEO/CFO in their CG reports; (ii) one company failed to adhere with composition of Board requirements.
4. Among sample companies, mean CG Index was 96.2352, minimum CG Index was 80 and maximum CG Index was 100.
5. Out of the total 34 companies, 82.35% (28) companies fall within mean compliance level, implying very good level of CG practices.
6. Balance i.e., 17.65% (6) companies fall below mean level CG Index, doing good CG practices.

Conclusion

There exists compliance with mandatory CG practices by all companies. In case of few companies as mentioned above, degree of compliance is not satisfactory mainly in case of composition of Board and CEO/CFO Certification of financial statements. Further, number of Audit Committee meetings requires improvement.

Implications and Suggestions

For inadequate compliance of CEO/CFO certification, there are two possible reasons (i) inconsistency in CG reporting; (ii) lack of such compliance. Reporting of CG practices should be done carefully. Further, lack of compliance renders managers to shirk their responsibilities which omen possibilities of corporate frauds.

With respect to composition of Board, mainly proportion of Independent Directors requires significant improvements because Board of Directors is decision-making authority. Reasons could be hesitation of companies in bearing cost of CG or inadequate availability of Independent Directors.

Companies must have full compliance with respect to mandatory provisions of CG; otherwise it is violation of CG regulations. This requires regulatory attention and action if required, as compliance with CG norms is the fundamental and basic objective of CG. Denying access to capital market, stiff penalties for non-complying companies are some of the measures for regulator to ensure better implementation of CG norms.

Limitations of the Study

Data used in the study are for one year only. Further, sample size is limited and companies considered for study are large. CG norms are evaluated annually (not quarterly), so the results should be interpreted accordingly. The information available in annual reports was considered as if companies have practiced the same.

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