

## A Study on Mechanisms and Key Issues of Corporate Governance Practices in India



### Management

**KEYWORDS :** Corporate Excellence, CG Mechanism, India, Stakeholder Value.

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### ABSTRACT

*The paper portrays an existing Codes of Corporate Governance (CG) in India which has become a buzz word in corporate sector. It has emerged as a means of corporate excellence and driving force for attaining greater performance, maximizing the stakeholder's wealth and corporate values. CG problems in India are very different from that of the US or the UK. Lack of adequate governance of Indian corporate has been cited in popular press, in academic debates and in some committee reports as one of the primary reasons for under-performance of companies and the growing disinterest of the small investor in corporate financing. The paper uses secondary data for analyzing the adaptability of CG codes in the Indian context which were collected through various published and unpublished reports, websites, journals, magazines, etc. The paper reveals that India has a good CG mechanism and disclosure practices on par with world counterparts.*

### INTRODUCTION:

In recent years, corporate governance has attained significance all over the world because of the integration & globalization of financial markets and a surge of corporate scandals such as World Com, Enron and others. The combined GDP of BRIC countries (Brazil, Russia, India and China), have emerged as an influential economic power in the global economy, is likely to be higher than that of developed countries.<sup>1</sup> Amongst the BRIC economies, India has the potential to grow the fastest over the next 30-50 years (Wilson & Purushothaman, 2003). Foreign investments in India come directly and through secondary markets. The cumulative foreign direct investment (FDI) to India until August, 2010 was US \$137,960 million (RBI Bulletin, 2010).<sup>2</sup> In Indian Capital Market, foreign institutional investors have made substantial investments of \$4.78 billion in November 2010 alone and a total investment of \$ 38 billion until March 2011.<sup>3</sup>

Foreign institutional investors are insisting that Indian Companies follow international best practices with an emphasis on corporate governance. As per McKinsey Survey 2002, investors were willing to pay a premium upto 25% for a well governed company (Barton, Coombes, & Wong, 2004). The scandals related to the Indian markets (Goswami, 2002), the global financial crisis of 2008 and the more recent corporate fraud at Satyam has raised a lot of concerns about governance practices in India. As a result, there has been an increasing effort around corporate governance structures and apparatus by both regulators and corporations.

### CONCEPT OF CORPORATE GOVERNANCE:

Corporate governance is "the system by which companies are directed and controlled" (Cadbury Committee, 1992). It involves a set of relationships between a company's management, its board, its shareholders and other stakeholders; it deals with prevention or mitigation of the conflict of interests of stakeholders (Goergen, Marc. 2012). The way of mitigating or preventing these conflicts of interests include the processes, customs, policies, laws, and institutions which have impact on the way a company is controlled.<sup>4</sup>

Corporate governance is concerned with ways of bringing the interests of investors and manager into line and ensuring that firms are run for the benefit of investors F. Mayer (1997). CG includes the relationships among the many stakeholders involved and the goals for which the corporation is governed (Tricker, Adrian, 2009).<sup>5</sup> In contemporary business corporations, the main external stakeholder groups are shareholders, debt holders, trade creditors, suppliers, customers and communities affected by the corporation's activities. Internal stakeholders are the board of directors, executives, and other

employees. It guarantees that an enterprise is directed and controlled in a responsible, professional, and transparent manner with the purpose of safeguarding its long-term success. It is intended to increase the confidence of shareholders and capital-market investors.<sup>6</sup>

### OBJECTIVES OF THE STUDY:

The objectives of this research paper are to put emphasis on:

1. To study the scenario of Corporate Governance worldwide as well as in India.
2. To discuss about the mechanisms of Corporate Governance India
3. To converse on the driving forces of corporate governance in India
4. To recommend the ways through which issues of CG can be resolved in India.

### CORPORATE GOVERNANCE IN THE WORLD SCENARIO:

Corporate Governance refers to the tool to achieve corporate excellence and a driving force for accomplishing much better performance, maximizing the stakeholder's wealth and corporate value. It has become a motto in the world corporate sector. It shapes the efficiency of firms, the stability of employment, the fortunes of suppliers and distributors, the portfolios of pensioners and retirees, the endowments of orphanages and hospitals, the claims of the rich and the poor (Peter Alexis Gourevitch and James J. Shinn, 2005).

Corporate scams and frauds that came to light have brought about a change and necessitated substantial external regulations apart from internal controls and regulations. For the last two decades, a series of events have placed corporate governance issues as of supreme importance both for international business community and international financial institutions. Business failures and frauds in the USA, several scandals in Russia and Asian crisis (1997) have brought corporate governance issues to the forefront in developing countries and transition economies.

The consequent distrust predictably resulted in the virtual collapse of external capital to firms, reveals that corporate mis-governance can shake the very foundations of a society. Asian financial crisis also demonstrated that even strong economies lacking transparent control, responsible corporate boards and shareholder rights could collapse due to the dilution of investors' confidence. As a result, over the years, various countries in the world have adopted corporate governance reforms as the shown below:

Table 1: World Scenario: CG Reforms Adoption

Year of CG Reforms Adoption	Name of the county
1992	United Kingdom
1997	USA, Japan, The Netherlands
1998	India, Belgium, Germany, Italy, Thailand
2001	China, Czech Republic, Malta, Peru, Singapore, Sweden
2002	Austria, Cyprus, Kenya, Pakistan, Poland, Russia, Switzerland, Taiwan
2003	Finland, Lithuania, Macedonia, New Zealand, Turkey, Latin America
2004	Argentina, Bangladesh, Iceland, Norway, Slovenia, OECD
2006	Estonia, Lebanon, Luxemburg, Nigeria, Sri Lanka, Thailand
2007	Bulgaria

Source: Jill Solomon (2007)

Corporate governance apparatus gained universal concentration due to the frauds and deficiencies involved in the corporate sector in the US and UK in this situation. Among corporate failures in US, Collapse of Enron was famous and in UK, Maxwell failure (1991), Barings Bank (1995), etc. were prominent. To find out the root causes of corporate failure and distress in UK, several committees were appointed and appropriate solutions for improving the CG practices.

Table 2: CG Committee in UK

Year of CG Committee Appointment	Name of CG Committee in UK
1992	Cadbury Committee
1995	Greenbury Committee
1998	Hampel Committee
1999	Turnbull Committee
2003	Higgs Committee
2003	Tyson Committee
2003	Smith Committee
2003	Redraft of combined code

Apart from all these movements, World Bank, OECD (Organization for Economic Co-operation and Development) and McKinsey Survey on CG, 2002 also played vital role to improve CG practices worldwide.

**CORPORATE GOVERNANCE IN THE CONTEXT OF INDIA:**

The CG problems in every country are unique and this is because of the path dependence (Bebchuk and Roe, 1999). Bhasa (2003) traces and analyses the history of Indian business models from 19th century to the present day.

In India, corporate governance had its beginning in the early 1990s. The emergence of CG in India is the result of a wave of scandals in corporate and stock markets, unlike corporate failures in the other parts of the world. The number of committees and commissions has been appointed for improving CG practices in India. Though in India, there haven't been such immense corporate failures such as Enron, Maxwell etc., it has resolved intelligently to incorporate better governance practices in the corporate sector. India was one of the economically poorest countries in the world at the time of independence in 1947. Because of structured efforts of economists and planners, it developed a well designed economic system with lot of planning and regulations for future development.

The Companies Act, 1956 and establishment of Financial Institutions (like the IFCI, IDBI, ICICI, etc.) is the milestone in the Indian history. FIs were launched to provide funds to meet long-term financial needs of industrial sector in India. All these developments paved the way for the overall industrial development of the country. India has well designed corporate laws and financial system to make stronger the industrial base on sound lines. At the commencement, Indian corporate development

was noticed by the managing agency system which paved the way for equity ownership and gratification of unequal ownership controls in the organization. As a result, over a period of time the ethical values of corporate were diluted due to uncontrolled malpractice. Due to economic liberalization in India, corporate governance gained great momentum and importance in the country. Department of Company Affairs, Institute of Company Secretaries and Trade Associations (like CII, FICCI, etc), Capital Market Regulator, SEBI and the companies such as the ICICI took the lead in discussing it and recommending CG implementation. CG movement in India began in 1997 with a voluntary code framed by the Confederation of Indian Industry (CII).

Approximately 30 large-scale listed companies accounting for over 25% of India's market capitalization voluntarily adopted the CII code in next 3 years. Securities & Exchange Board of India (SEBI) - India's capital market regulator, gain entry and set up a committee headed by Kumar Mangalam Birla to mandate international standards of corporate governance for the listed companies by 1999. From 1 April 2001, over 140 listed companies accounting for almost 80 per cent of market capitalization started following a mandatory code which was in line with some of the best international practices. By April 2003, every listed company adopted the SEBI code of Corporate Governance. Gollakota and Gupta (2006) divided the evolution of corporate governance in India into four phases and identified the value system associated with business enterprises during those periods. They are given below:

Table 3: Description of Phase

Phase	Description of phase
I	Pre-independence (until 1947): Eco-centrism and family ownership
II	The License Raj (1947 – 1981): Social altruism and public enterprises
III	Knowledge of Professionalism (1981 – 1991): Social justice & professional ownership
IV	Liberalization (1991 onwards): Eco-centrism and foreign ownership

The governance of most of the industrial and business organizations in India was based on unethical business practices. State-owned organizations occupy a dominant position in the country's economy and being monopolistic; force the consumers to pay the costs of their corporate misgovernance. Organizations in the private sector, except for a few exceptions also indulge in all possible unethical practices to cheat their customers on the one hand and deny the benefits to them on the other. The scandals in a large number of private corporations during the last one decade clearly indicate the nature and extent of corporate misgovernance that exist in the private sector.

**DRIVING FORCES OF CORPORATE GOVERNANCE:**

CG scenario in India has been changing fast since the mid-1990s, and it gained pace after the enactment of Sarbanes-Oxley-Type Measures and legal changes to improve the enforceability of the creditors' rights. India should have the quality of regulatory institutions to sustain its impressive current growth rates in the future (Chakraborti et al, 2008). A good CG is a reflection of quality management with highest caliber understanding the role, which a good CG plays in maintaining checks and balances within the organization, while increasing transparency and preventing corporate abuse and mismanagement.

CG provides a mechanism, which improves the efficiency, transparency and accountability of the corporate and builds the confidence of the stakeholders. CG systems also describe the structure of rights and responsibilities among the parties that have a stake in the firm (Augilera & Jackson, 2003). But the kind of responsibility and structure of the firm varies from region to region and country to country indulging the emerging economies which provide unique opportunities and challenges for governance practices and research. As pointed out already, little research in this area has taken place in these countries. In this context, an effort is made here to identify the driving forces for CG in India. There are a number of causes for the emergence of corporate governance in India, apart from the ethically ambiguo-

ous business practices and scams in the market environment. There are certain major driving forces, which have resulted in the emergence of CG in India and these include:

1. Globalization
2. Unethical business practice & security scams
3. Privatization
4. Ownership / Capital Structure
5. Institutional Investors
6. Board characteristics & firm performance
7. Executive compensation
8. Nature & emergence of Indian CG system

After a detailed analysis, it can be concluded that in Indian system, certain driving forces take more important role for better CG practices required for the effective and efficient management of corporate sectors.

#### **MECHANISMS OF CORPORATE GOVERNANCE:**

In India, there are six mechanisms to ensure successful corporate governance:

##### **Companies Act:**

In India, companies are regulated by the Companies Act, 1956, as amended up to date. The Companies Act is one of the biggest legislations with 658 sections and 14 schedules. The arms of the Act are quite long and touch every aspect of a company's insistence. But to ensure corporate governance, the Act awards legal rights to the shareholders to:

- Vote on every resolution placed before an annual general meeting.
- Elect directors who are responsible for specifying objectives & laying down policies.
- Determine remuneration of Directors and CEO and removal of directors.
- ☐ Take active part in the annual general meetings.

##### **Securities Law:**

The primary securities law in India is the SEBI Act. Since its setting up in 1992, the board has taken a number of initiatives towards investor protection. One such initiative is to mandate information disclosure both in prospectus and in annual accounts. While the Companies Act itself mandates certain standards of information disclosure, SEBI Act has added substantially to these requirements in an attempt to make these documents more meaningful.

##### **Discipline of Capital Market:**

Capital market itself has considerable impact on corporate governance. Here in lies the role the minority shareholders can play effectively. They can refuse to subscribe to the capital of a company in the primary market and in the secondary market; they can sell their shares, thus depressing the share prices. A depressed share price makes the company an attractive takeover target.

##### **Nominees on Company Boards:**

Development banks hold large blocks of shares in companies. These are equally big debt holders too. These nominees can effectively block resolutions, which may be detrimental to their interests.

Unfortunately, the role of nominee directors has been passive, as has been pointed out by several committees including the Bhagwati Committee on takeovers and the Omkar Goswami committee on corporate governance.

##### **Statutory Audit:**

Statutory audit is yet another mechanism directed to ensure

good corporate governance. Auditors are the conscious-keepers of shareholders, lenders and others who have financial stakes in companies. Auditing enhances the credibility of financial reports prepared by any enterprise. The auditing process ensures that financial statements are accurate and complete, thereby enhancing their reliability and usefulness for making investment decisions.

#### **CORPORATE GOVERNANCE ISSUES IN INDIA:**

The cornerstone of CG is the maximization of shareholders' wealth in a legal and ethical manner. In practice, there are number of issues faced in achieving it. While there is wider agreement on the need for good CG, the practice sometimes is altogether different. For instance, sometimes the promoters, even when they have contributed a small portion to the equity, manipulate situations to reach a commanding position and serve themselves, in total disregard of stakeholders' interest.

Also, sometimes there is lack of professional culture and commitment among non-executive directors and professional accountants. The regulatory authorities, at times, fail to detect violation of laws and do not make serious attempt to ensure compliance. The public interest groups, including the investors' and consumers' forums, are still not well organized in India and are not vocal about enforcement of the right to information. Lack of political will to enforce the law sometimes encourages the lawbreakers resulting in poor CG. In this respect, poor CG is a reflection of poor CG of the State. The other issues associated with the implementation of corporate governance in India are as under:

##### **Demand for information:**

A barrier to shareholders using good information is the cost of processing it, especially to a small shareholder. The traditional answer to this problem is the efficient market hypothesis (in finance, the efficient market hypothesis (EMH) asserts that financial markets are efficient), which suggests that the shareholder will free ride on the judgments of larger professional investors.

##### **Monitoring costs:**

In order to influence the directors, the shareholders must combine with others to form a significant voting group which can pose a real threat of carrying resolutions or appointing directors at a general meeting.

##### **Supply of accounting information:**

Financial accounts form a crucial link in enabling providers of finance to monitor directors. Imperfections in the financial reporting process will cause imperfections in the effectiveness of corporate governance. This should, ideally, be corrected by working of external auditing process.

#### **CONCLUSION:**

The emergence of CG has its own history in different parts of the world. In the present global environment, where economies are integrated with global market environment, it is imperative to develop a sound CG system. It is more so in emerging economies like India. The first major stimulus for CG reforms was the Southeast Asian crisis during 1997-98 followed by the Enron debacle in 2001, which necessitated the need for ensuring better CG practices. Though there are exceptions like Global Trust Bank and Satyam Computer, India did face miserable corporate failures as in the west such as Enron, Maxwell, WorldCom, etc.

In India, the initial drive for better CG and disclosure – perhaps as a result of the 1992 stock market scam and the fast emerging international competition as a consequence of liberalization of the economy that began in 1991 – came from the CII and the Department of Corporate Affairs. The CG system of India has to provide a fresh look to all the important industrial laws in India such as MRTF, FEMA, Companies Act, etc. The more important aspect of desirable CG is to boost the inflow of foreign capital to India. To streamline the process of inflow of foreign capital, CG has to ensure all sorts of ease to foreigners.

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