An Enquiry into the State of Corporate Governance in India: Evolution and Key Issues

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Abstract:

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 complies a history of the evolution of corporate governance reforms in India and through a survey of existing research, identifies issues that are peculiar to the Indian context and which are not being adequately addressed in the existing corporate governance framework. The purpose of the study is to state a chronological perspective of the corporate governance in India and to subsequently address the key issues. Therefore, start with an overview on the subject of the key problems of corporate governance in transition. The paper concludes by emphasizing the corporate governance enforcement gap and by identifying research issues that require further study.

Introduction

Corporate Governance in its most simplified iteration refers to the manner in which corporate bodies are managed and operated. The majority of the definitions articulated in the codes relate corporate governance to “control” – of the company, of corporate management, or of company conduct or managerial conduct. Perhaps the simplest and most common definition of this sort is that provided by the Cadbury Report (U.K.), which is frequently quoted or paraphrased: “Corporate governance is the system by which businesses are directed and controlled.” Corporate governance in the context of a modern corporation has become synonymous with the practices and processes used to direct and manage the affairs of a corporate body with the object of balancing the attainment of corporate objectives with the alignment of corporate behavior to the expectations of society and accountability to shareholders and other stakeholders. Corporate governance covers a large number of distinct concepts and phenomenon as we can see from the definition adopted by Organization for Economic Cooperation and Development (OECD) – “Corporate governance is the system by which businesses are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders and spells out the rules and procedures for making decisions in corporate affairs. By doing this, it also provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance”. A corporation is a congregation of various stakeholders, namely, customers, employees, investors, vendor partners, government and society. A corporation should be fair and transparent to its stakeholders in all its transactions. This has become imperative in today’s globalized business world where corporations need to access global pools of capital, need to attract and retain the best human capital from various parts of the world, need to partner with vendors on mega collaborations and need to live in harmony with the community. Unless a corporation embraces and demonstrates ethical conduct, it will not be able to succeed. Corporate governance is a key element in improving the economic efficiency of a firm. Good corporate governance also helps ensure that corporations take into account the interests of a wide range of constituencies, as well as of the communities within which they operate. Further, it ensures that their Boards are accountable to the shareholders.
Good governance means that processes and institutions produce results that meet the needs of society while making the best use of resources at their disposal. Good corporate governance (GCG) is a mandatory requirement in today’s corporate world by every stakeholder groups. Failure of giant corporate groups in last two-three decade strengthens the demand further. And surprisingly, in some of such failures, accounting as a discipline is held liable. Recently the terms “governance” and "good governance" are being increasingly used in development literature. Bad governance is being increasingly regarded as one of the root causes of all evil within our societies. Major donors and international financial institutions are increasingly basing their aid and loans on the condition that reforms that ensure "good governance" are undertaken. It is participatory, consensus oriented, accountable, transparent, responsive, effective and efficient, equitable and inclusive and follows the rule of law. It assures that corruption is minimized, the views of minorities are taken into account and that the voices of the most vulnerable in society are heard in decision-making. It is also responsive to the present and future needs of society. Corporate governance is a key element in improving the economic efficiency of a firm. Good corporate governance also helps ensure that corporations take into account the interests of a wide range of constituencies, as well as of the communities within which they operate. Further, it ensures that their Boards are accountable to the shareholders. This, in turn, helps assure that corporations operate for the benefit of society as a whole. While large profits can be made taking advantage of the asymmetry between stakeholders in the short run, balancing the interests of all stakeholders alone will ensure survival and growth in the long run. This includes, for instance, taking into account societal concerns about labor and the environment.
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 required a mandatory status in early 2000s through the introduction of Clause 49 of the Listing agreement, as all the companies (of certain size) listed on stock exchanges were required to comply with these norms. In late 2009, the Ministry of Corporate Affairs has released a set of voluntary guidelines for corporate governance, which address a myriad corporate governance issues.

Evolution of Corporate Governance in India
Corporate governance initiatives in India began in 1998 with the Desirable Code of Corporate Governance – a voluntary code published by the CII, and the first formal regulatory framework for listed companies specifically for corporate governance, established by the SEBI. The latter was made in February 2000, following the recommendations of the Kumarmangalam Birla Committee Report.

Codifying Governance Norms
Drawing heavily from the Anglo-Saxon model of Corporate Governance, CII drew up a voluntary Corporate Governance Code. The first draft of the code was prepared by April 1997, and the final document titled Desirable Corporate Governance: A Code was publicly released in April 1998. The code was voluntary, contained detailed provisions and focused on listed companies. This initiative by CII flowed from public concerns regarding the protection of investor interest, especially the small investor; the promotion of transparency within business and industry; the need to move towards international standards in terms of disclosure of information by the corporate sector and, through all of this, to develop a high level of public confidence in business and industry.

Although the CII code was welcomed with much fanfare and even adopted by a few progressive companies, it was “felt that under conditions a statutory rather than a voluntary code would be for more purposive and meaningful, at least in respect of essential features of corporate governance.” 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 of good corporate governance.

Kumar Mangalam Birla Committee
The Birla Committee specially placed emphasis on independent directors in discussing board recommendations and made specific recommendations regarding board representation and independence. The Committee also recognized the importance of audit committee and made many specific recommendations regarding the function and constitution of board audit committees. In 2000 the SEBI board accepted and rectified the key recommendations of the Birla Committee, which were incorporated into Clause 49 of the Listing Agreement of the Stock Exchange.

Naresh Chandra Committee
On 21 August 2002, the Department of Company Affairs (DCA) under the Ministry of Finance and Company Affairs appointed this High Level Committee to examine various corporate governance issues. Among others, this Committee has been entrusted to analyze and recommend changes, if necessary, in diverse areas such as:

- the statutory auditor-company relationship, so as to further strengthen the professional nature of this interface;
- the need, if any, for rotation of statutory audit firms or partners;
- the procedure for appointment of auditors and determination of audit fees;

1 From the preface to the “Report of the Committee Appointed by the SEBI on Corporate governance under the chairmanship of Shri Kumar Mangalam Birla” (Birla Committee Report).
restrictions, if necessary, on non-audit fees;
• independence of auditing functions;
• measures required to ensure that the management and companies actually present ‘true and fair’ statement of the financial affairs of companies;
• the need to consider measures such as certification of accounts and financial statements by the management and directors;
• the necessity of having a transparent system of random scrutiny of audited accounts;
• adequacy of regulation of chartered accountants, company secretaries and other similar statutory oversight functionaries;
• advantages, if any, of setting up an independent regulator similar to the Public Company Accounting Oversight Board in the SOX Act, and if so, its constitution; and
• the role of independent directors, and how their independence and effectiveness can be ensured.

Narayana Murthy Committee
The fourth initiative on corporate governance in India is in the form of the recommendations of the Narayana Murthy Committee. This committee was set up by SEBI under the chairmanship of Mr. Narayana Murthy, in order to review Clause 49, and to suggest measures. Some of the major recommendations of the committee primarily related to audit committees, audit reports, independent directors, related parties transactions, risk management, directorships and director compensation, code of conduct and financial disclosures.

In its present form, Clause 49 called ‘Corporate Governance’ contains eight sections dealing with the Board of directors, Audit Committee, Remuneration of Directors, Board Procedures, Management, Shareholders, report on Corporate Governance, and Compliance, respectively. Firms that do not comply with Clause 49 can be de-listed and charged with financial penalties.

India’s corporate governance reform efforts did not cease after the implementation of Clause 49. 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. On the recommendations of the Irani Committee the Government of India introduced the Companies Bill, 2008, in the Indian Parliament, which sought to enable the corporate sector in India to operate in a regulatory environment characterized by best international practices that foster entrepreneurship and investment. However, due to the dissolution of the Fourteenth Lok Sabha, the Companies Bill, 2008 lapsed.

In January 2009, the Indian Corporate Community was rocked by a massive account scandal involving Satyam Computer Services (Satyam), one of the India’s largest information Technology companies.

The company’s founder and chairman, B. Ramalinga Raju, confessed $1.47 billion fraud on its balance sheet, which he had and his brother, Satyam’s Managing Director, had disguised from the company’s Board, senior managers and auditors for several years. The Satyam Scandal prompted quick action by the Indian Government. Including the arrest of several insiders and auditors of Satyam, investigation by the MCA and SEBI, and substitution of the company’s directors with government

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2 Securities and exchange board of india, Report of the SEBI Committee on Corporate governance (February 2003) ; see, Narayana Murthy Committee Report,at para.1.6.1;”Recent events worldwide, primarily in the United States, have renewed the emphasis on corporate governance. These events have highlighted the need for ethical governance and management, and for the need to look beyond mere systems and procedures.”

@ Clause 49 of the Listing Agreement contains the guidelines on corporate governance for all Listed Companies and applies to all Listed Companies, except for very small companies (that is, those that have a paid up capital of less than Rs.30 million and a net worth of less than Rs.250 million throughout their history).
nominees. Shortly after the news of scandal broke, the CII began examining the corporate governance issues arising out of Satyam scandal and in late 2009; the CII task force listed a series of voluntary reforms. CII also advocated caution against over regulating. The report is structured according to the different elements of corporate governance:

- **The Board of Directors**
  - Non-executive and independent directors
  - Committees of the board
  - Significant related party transactions

- **Auditors**
  - Independence of Auditors
  - Rotation of Audit Partners

- **Regulatory Agencies**
  - Legal and regulatory standards
  - Effective and credible enforcement

- **External Institutions**
  - Institutional investors
  - The Press

In addition to the CII, a number of other corporate groups have joined the corporate governance dialogue. The national association of software and services Companies (NASSCOM) also formed corporate governance and Ethics Committee chaired by N. R. Narayana Murthy. The Committee issued its recommendations in mid-2010 focusing on the stakeholders in the company. Additionally, the Institute of Company Secretaries of India (ICSI) has also put forth a series of corporate governance recommendations.

The revised Bill, namely, the Companies Bill,2011**3 was introduced in the Lok Sabha on 14th December 2011; however the same was withdrawn by the Government on 22nd December and sent back for consideration by the Standing Committee on Finance. The Bill has 470 clauses and 7 schedules as against 658 Sections and 15 schedules in the existing Companies Act, 1956. The entire bill has been divided into 29 chapters. The Bill provides for self-regulatory process and stringent compliance regime. On 4th October 2012, looking to better serve the interest of all stakeholders, the government the government approved amendments to Companies Bill, 2011, including changes related spending on Corporate Social Responsibility (CSR) activities. The revised Companies Bill, which is expected to be introduced in the winter session of Parliament, has limited numbers of companies an auditor can serve to 20. It has also brought in more clarity on criminal liabilities of auditors.4

**Key Issues**

The Organization for Economic Co-operation and Development (OECD) has defined Corporate Governance as the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the Board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides a mechanism through which the company objectives are set, the means of attaining those objectives defined, and the process of monitoring performance delineated. With the OECD definition of Corporate Governance serving as the basis to understand the interaction among different participants in the company being rated. The following diagram depicts the typical participants in a corporation, and the interrelationship between them.

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4 As reported in http://arlicles.economictimes.com/2012-10-04/news/34260244
The corporate governance literature in the US and the UK focuses on the role of the Board as a bridge between the owners and the management (see for example; Cadbury, 1992; Salmon, 1993; Ward, 1997). In an environment in which ownership and management have become widely separated, the owners are unable to exercise effective control over the management or the Board. Turning to the Indian scene, one finds increasing concern about improving the performance of the Board. This is doubtless an important issue, but a close analysis of the ground reality in India would force one to conclude that the Board is not really central to the corporate governance malaise in India.

The central problem in Indian corporate governance is not a conflict between management and owners as in the US and the UK, but a conflict between the dominant shareholders and the minority shareholders. The Board cannot even in theory resolve this conflict. One can in principle visualize an effective Board which can discipline the management. At least in theory, management exercises only such powers as are delegated to it by the Board. But, how can one, even in theory, envisage a Board that can discipline the dominant shareholders from whom the Board derives all its powers? Some of the most glaring abuses of corporate governance in India have been defended on the principle of “shareholder democracy” since they have been sanctioned by resolutions of the general body of shareholders. The Board is indeed powerless to prevent such abuses. It is indeed self evident that the remedies against these abuses can lie only outside the company itself.

Most corporate governance abuses in India arise due to conflict between the majority and minority shareholders. The problem of the dominant shareholder arises in three large categories of Indian companies. First are the public sector units (PSUs) where the government is the dominant (in fact, majority) shareholder and the general public holds a minority stake (often as little as 20%). Second are the multinational companies (MNCs) where the foreign parent is the dominant (in most cases, majority) shareholder. Third are the Indian business groups where the promoters (together with their friends and relatives) are the dominant shareholders with large minority stakes, government owned financial institutions hold a comparable stake, and the balance is held by the general public. The governance problems posed by the dominant shareholders in these three categories of companies are slightly different.

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. The government as the majority shareholder takes these decisions through the concerned ministry with the help of the Public Enterprises Selection Board. The Board cannot fire the CEO nor can it vary his compensation package. As far as audit is concerned, again the dominant role is that of the Comptroller and Auditor General (CAG). There is very little that an Audit Committee could add to what the CAG does.
Multinational Companies (MNCs) in India are perceived to have a better record of corporate governance compliance in its prescribed form. Government regulations have required most MNCs in India to operate through subsidiaries which are not 100% owned by the parent. In the 70s, the government enacted a law limiting foreign ownership in most industries to 40% while allowing 51% in a few high technology areas. This law was liberalized in the 90s and now 51% is permitted in most industries while 74% or even 100% ownership is allowed in some cases. These regulations have created severe corporate governance problems in several key areas. Another corporate governance problem arises where the foreign parent has two subsidiaries in India in one of which it holds a higher stake (say 100%) while in the other it holds a smaller stake (say 51%). The manner in which the MNC structures its business in India between these two subsidiaries is riddled with problems as far as the minority shareholder is concerned. There have been allegations in some cases that the most profitable brands and businesses have been transferred from the long established 51% subsidiary to the newly formed 100% subsidiary at artificially low prices. This implies a large loss to the minority shareholders of the 51% subsidiary who have after all contributed to in equal measure to the investments that were made in the past to build up these businesses to their current dominant position.

Family Business Groups as a category are perhaps the most complex for analyzing corporate governance abuses that take place. In the Indian business groups, the concept of dominant shareholders is more amorphous for two reasons. First, the promoters’ shareholding is spread across several friends and relatives as well as corporate entities. It is sometimes difficult to establish the total effective holding of this group. Second, the aggregate holding of all these entities taken together is typically well below a majority stake. In many cases, the promoter may not even be the largest single shareholder. What makes the promoters the dominant shareholders is that a large chunk of the shares is held by state owned financial institutions which have historically played a passive role. So passive have they been that in the few cases where they did become involved in corporate governance issues, they were widely seen as acting at the behest of their political masters and not in pursuance of their financial interests. So long as the financial institutions play a passive role, the promoters are effectively dominant shareholders and are able to get general body approval for all their actions. This allows the promoters to play all the games that dominant shareholders play in PSUs and MNCs - structuring of businesses and transfer of assets between group companies, preferential allotments of shares to the dominant shareholder, payments for “services” to closely held group companies and so on.

Another important corporate governance issue is that of mergers and restructuring of companies in the same group. There have been several instances where the valuation of two group companies for the purpose of merger has been perceived to be biased in favour of one of the companies. It has been alleged that in many of these cases, the promoters had secretly built up large positions in this company as a cheap means of acquiring shares of the merged company. The amorphous nature of the promoter group makes it very difficult to verify these allegations. Mergers are subject to approval by shareholder bodies of both companies as well as judicial review. But shareholder democracy is an empty defense against the dominant shareholder.

Regulators face a number of difficulties in tackling the problem of corporate governance abuses by the dominant shareholders. In many cases, it is difficult to decide how far the regulator should go in interfering with the normal course of corporate functioning.

Conclusion
A significant feature of the corporate governance reforms in India has been its voluntary nature and the active role played by public limited companies in improving governance standards in India. CII, a non-government, not-for-profit industry-led and industry-managed organization dominated by large public listed firms had played an active role in the development of India’s corporate governance norms. What began as a voluntary effort soon acquired mandatory status through the adoption of Clause 49. In that
sense, the corporate governance norms in India appear to have completed two full cycles of oscillating between the voluntary and the mandatory approaches. Corporate governance reforms in India now stand at an interesting crossroads, and the future development of the next generation reforms and in their implementation during the current decade, will decide how long effective they are for Indian business.

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