Good Corporate Governance in India – Evolution and Challenges

Dr. Atul Bansal, Principal
C.Z. Patel College of Business and Management, Vallabh Vidyanagar, Anand (Gujarat)

Shital Bati,
Baroda Institute of Management Studies, Vadodara, Gujarat

ABSTRACT
Corporate governance, which is the system that helps firms control and direct operations, is in the spotlight as key parts of the governance framework such as audit and finance functions have failed to check the promoter-driven agendas. Corporate governance in India has undergone a paradigm shift by gradually becoming more conscience-driven due to interests of customers, employees, vendors and regulators. The Corporate Governance failures in developed countries have brought the subject to media attention, the issue has always been central to finance and economics. India has one of the best corporate governance laws but poor implementation together with socialistic policies of the pre reform era has affected corporate governance. Concentrated ownership of shares, pyramiding and tunneling of funds among group companies mark the Indian corporate landscape. Boards of directors have frequently been silent spectators with the DFI nominee directors unable or unwilling to carry out their monitoring functions. Since liberalization, however, serious efforts have been directed at overhauling the system with the SEBI instituting the Clause 49 of the Listing Agreements dealing with corporate governance. This Paper explain the corporate governance in India and the reforms how its boards of directors function, improve its enforcement mechanisms, redefine its corporate laws, and embrace corporate governance as a philosophy.

Key Words: Good Corporate governance, stability, control premium, manipulation, transparency, stakeholders, BIFR, SEBI, liberalization, residual powers, legal systems, deviations, Ownership Patterns.

1. Introduction

Corporate Governance comprises systems and processes, which ensure the efficient functioning of the firm in a transparent manner, for the benefit of all the stakeholders and people dependent on them. The focus is on the relationship between owners and the board of directing and controlling companies as legal entities in perpetuity. A company's ability to create wealth for its owners however depends on the role and freedom given to it by the society. Corporate Governance maintains the balance between the economic and social goals and between individual and community goals. The focus of corporate governance arises out of the large dependence of companies on financial markets as the prominent source of capital. Corporate governance meant different things to different people. Less than half the class believed that corporate governance meant leadership; several referred to Clause 49 as "imposed" by SEBI and several others were honest enough to proclaim their belief that business was all about money, control and power. The codes of ethics and business conduct of companies and their impact on the firms' businesses can be referred to for answers to some of the questions mentioned in the foregoing paragraphs. These codes of most companies are approved by their Boards, and should be clearly reflective of the "tone at the top".

The importance of the corporate governance of country is as follows- ." (1) According to the Organization for Economic Co-operation and Development ("OECD"), (2) "Corporate governance deals with the rights and responsibilities of a company's management, its board, shareholders and various stakeholders." (3) The spectacular collapses of Enron (4) and WorldCom (5) in the United States, (6) where shareholders lost a combined $245 billion, (7) and the collapse of Italian dairy giant Parmalat (8) in Europe, have transformed corporate governance from an afterthought to the cornerstone of any firm's or country's long-term success. (9) Corporate governance in a developing-country setting takes on additional importance. Good corporate governance is vital because of its role in attracting foreign investment. (10) The extent of foreign investment, in turn, shapes the prospects for economic growth for many developing countries. This Note presents an in-depth inquiry into corporate governance in one such developing country, India. While India's corporate-governance framework is advanced for a developing country, it still can be significantly improved. Part II discusses the importance of corporate governance for developing countries. (11) Part III provides a brief history of corporate governance in India. Part IV examines the current standards of corporate governance in

India. Finally, Part V recommends improvements to India's corporate-governance framework. (12) Investors primarily consider two variables before making investment decisions--the rate of return on invested capital and the risk associated with the investment. (13) In recent years, the "attractiveness of developing nations" as a destination for foreign capital has increased, partly because of the high likelihood of obtaining robust returns and partly because of the decreasing "attractiveness of developed nations." (14) The lure of achieving a high rate of return, however, does not, by itself, guarantee foreign investment; the attendant risk (15) weighs equally in an investor's decision-making calculus. (16) Good corporate-governance practices reduce this risk by ensuring transparency, accountability, and enforceability in the marketplace.

Good Governance provides stability and growth to the company, builds confidence among investors, reduces perceived risks and consequently reduces the cost of capital. Good governance practices ensure stability and long – term sustenance of relationship with the stakeholders. Good corporate governance also lowers of the cost of capital by reducing risk and creates higher firm valuation once again boosting real investments. There is a variation of a factor of 8 in the "control premium" (transaction price of shares in block transfers signifying control transfer less the ordinary share price) between countries with the highest level of equity rights protection and those with the lowest. Effective corporate governance mechanisms ensure better resource allocation and management raising the return to capital. The return on assets (ROA) is about twice as high in the countries with the highest level of equity rights protection as in countries with the lowest protection. Good corporate governance can significantly reduce the risk of nation-wide financial crises. There is a strong inverse relationship between the qualities of corporate governance and currency depreciation. Indeed poor transparency and corporate governance norms are believed to be the key reasons behind the Asian Crisis of 1997. Such financial crises have massive economic and social costs and can set a country several years back in its path to development. Finally, good corporate governance can remove mistrust between different stakeholders, reduce legal costs and improve social and labor relationships and external Economies like environmental protection. Making sure that the managers actually act on behalf of the owners of the company – the stockholders – and pass on the profits to them are the key issues in corporate governance. Limited liability and dispersed ownership – essential features that the joint-stock company form of organization thrives on – inevitably lead to a distance and inefficient monitoring of management by the actual owners of the business. Managers enjoy actual control of business and may not serve in the best interests of the shareholders. These potential problems of corporate governance are universal. In addition, the Indian financial sector is marked with a relatively unsophisticated equity market vulnerable to manipulation and with rudimentary analyst activity; a dominance of family firms; a history of managing agency system; and a generally high level of corruption. All these features make corporate governance a particularly important issue in India.

2. Corporate Governance in India – a background

The history of the development of Indian corporate laws has been marked by interesting contrasts. At independence, India inherited one of the world's poorest economies but one which had a factory sector accounting for a tenth of the national product; four functioning stock markets (predating the Tokyo Stock Exchange) with clearly defined rules governing listing, trading and settlements; a well-developed equity culture if only among the urban rich; and a banking system replete with well-developed lending norms and recovery procedures.24 In terms of corporate laws and financial system, therefore, India emerged far better endowed than most other colonies. The 1956 Companies Act as well as other laws governing the functioning of joint-stock companies and protecting the investors' rights built on this foundation.

The beginning of corporate developments in India were marked by the managing agency system that contributed to the birth of dispersed equity ownership but also gave rise to the practice of management enjoying control rights disproportionately greater than their stock ownership. The turn towards socialism in the decades after independence marked by the 1951 Industries (Development and Regulation) Act as well as the 1956 Industrial Policy Resolution put in place a regime and culture of licensing, protection and widespread red-tape that bred corruption and stilted the growth of the corporate sector. The situation grew from bad to worse in the following decades and corruption, nepotism and inefficiency became the hallmarks of the Indian corporate sector. Exorbitant tax rates encouraged creative accounting practices and complicated emolument structures to beat the system.

In the absence of a developed stock market, the three all-India development finance institutions (DFIs)– the Industrial Finance Corporation of India, the Industrial Development Bank of India and the Industrial Credit and Investment Corporation of India – together with the state financial corporations became the main providers of long-term credit to companies. Along with the government owned mutual fund, the Unit Trust of India, they also held large blocks of shares in the companies they lent to and invariably had representations in their boards. In this respect, the corporate governance system resembled the bank-based German model where these institutions could have played a big role in keeping their clients on the right track. Unfortunately, they were themselves evaluated on the quantity rather than quality of their lending and thus had little incentive for either proper credit appraisal or effective follow-up and monitoring. Their nominee directors routinely served as rubber-stamps of the management of the day. With their support, promoters of businesses in India could actually enjoy managerial control with very little equity investment of their own. Borrowers therefore routinely recouped their investment in a short period and then had little incentive to either repay the loans or run the business. Frequently they bled the company with impunity, siphoning off funds with the DFI nominee directors mute spectators in their boards.

This sordid but increasingly familiar process usually continued till the company's net worth was completely eroded. This stage would come after the company has defaulted on its loan obligations for a while, but this would be the stage where India's bankruptcy reorganization system driven by the 1985 Sick Industrial Companies Act (SICA) would consider it "sick" and refer it to the Board for Industrial and Financial Reconstruction (BIFR). As soon as a company is registered with the BIFR it wins immediate protection from the creditors' claims for at least four years. Between 1987 and 1992 BIFR took well over two years on an average to reach a decision, after which period the delay has roughly doubled. Very few companies have emerged successfully from the BIFR and even for those that needed to be liquidated, the legal process takes over 10 years on average, by which time the assets of the company are practically worthless. Protection of creditors' rights has therefore existed only on paper in India. Given this situation, it is hardly surprising that banks, flush with depositors' funds routinely decide to lend only to blue chip companies and park their funds in government securities. Financial disclosure norms in India have traditionally been superior to most Asian countries though fell short of those in the USA and other advanced countries. Noncompliance with disclosure norms and even the failure of auditor's reports to conform to the law attract nominal fines with hardly any punitive action. The Institute of Chartered Accountants in India has not been known to take action against erring auditors. While the Companies Act provides clear instructions for maintaining and updating share registers, in reality minority shareholders have often suffered from irregularities in share transfers and registrations – deliberate or unintentional. Sometimes non-voting preferential shares have been used by promoters to channel funds and deprive minority shareholders of their dues. Minority shareholders have sometimes been defrauded by the management undertaking clandestine side deals with the acquirers in the relatively scarce event of corporate takeovers and mergers. Boards of directors have been largely ineffective in India in monitoring the actions of management. They are routinely packed with friends and allies of the promoters and managers, in flagrant violation of the spirit of corporate law. The nominee directors from the DFIs, who could and should have played a particularly important role, have usually been incompetent or unwilling to step up to the act. Consequently, the boards of directors have largely functioned as rubber stamps of the management. For most of the post-Independence era the Indian equity markets were not liquid or sophisticated enough to exert effective control over the companies. Listing requirements of exchanges enforced some transparency, but non-compliance was neither rare nor acted upon. All in all therefore, minority shareholders and creditors in India remained effectively unprotected in spite of a plethora of laws in the books.

3. Changes since liberalization

The years since liberalization have witnessed wide-ranging changes in both laws and regulations driving corporate governance as well as general consciousness about it. Perhaps the single most important development in the field of corporate governance and investor protection in India has been the establishment of the Securities and Exchange Board of India (SEBI) in 1992 and its gradual empowerment since then. Established primarily to regulate and monitor stock trading, it has played a crucial role in establishing the basic minimum ground rules of corporate conduct in the country. Concerns about corporate governance in India were, however, largely triggered by a spate of crises in the early 90's – the Harshad Mehta stock market scam of 1992 followed by incidents of companies allotting preferential shares to their promoters at deeply discounted prices as well as those of companies simply disappearing with investors' money. These concerns about corporate governance stemming from the corporate scandals as well as opening up to the forces of competition and globalization gave rise to several investigations into the ways to fix the corporate governance situation in India. One of the first among such endeavors was the CII Code for Desirable Corporate Governance developed by a committee chaired by Rahul Bajaj. The committee was formed in 1996 and submitted its code in April 1998. Later SEBI constituted two committees to look into the issue of corporate governance – the first chaired by Kumar Mangalam Birla that submitted its report in early 2000 and the second by Narayana Murthy three years later. Table 1 provides a comparative view of the recommendations of these important efforts at improving corporate governance in India. The SEBI committee recommendations have had the maximum impact on changing the corporate governance situation in India. The Advisory Group on Corporate Governance of RBI's Standing Committee on International Financial Standards and Codes also submitted its own recommendations in 2001.

Central issues in Corporate Governance

The basic power structure of the joint-stock company form of business, in principle, is as follows. The numerous shareholders who contribute to the capital of the company are the actual owners of business. They elect a Board of Directors to monitor the running of the company on their behalf. The Board, in turn, appoints a team of managers who actually handle the day-to-day functioning of the company and report periodically to the Board. Thus mangers are the agents of shareholders and function with the objective of maximizing shareholders' wealth.

Even if this power pattern held in reality, it would still be a challenge for the Board to effectively monitor management. The central issue is the nature of the contract between shareholder representatives and managers telling the latter what to do with the funds contributed by the former. The main challenge comes from the fact that such contracts are necessarily "incomplete". It is not possible for the Board to fully instruct management on the desired course of action under every possible business situation. The list of possible situations is infinitely long. Consequently, no contract can be written between representatives of shareholders and the management that specifies the right course of action in every situation, so that the management can be held for violation of such a contract in the event it does something else under the circumstances. Because of this "incomplete contracts" situation, some "residual powers" over the funds of the company must be vested with either the financiers or the management. Clearly the former does not have the expertise or the inclination to run the business in the situations unspecified in the contract, so these residual powers must go to management. The efficient limits to these powers constitute much of the subject of corporate governance.

The reality is even more complicated and biased in favor of management. In real life, managers wield an enormous amount of power in joint-stock companies and the common shareholder has very little say in the way his or her money is used in the company. In companies with highly dispersed ownership, the manager (the CEO in the American setting, the Managing Director in British-style organizations) functions with negligible accountability. Most shareholders do not care to attend the General Meetings to elect or change the Board of Directors and often grant their "proxies" to the management. Even those that attend the meeting find it difficult to have a say in the selection of directors as only the management gets to propose a slate of directors for voting. On his part the CEO frequently packs the board with his friends and allies who rarely differ with him. Often the CEO himself is the Chairman of the Board of Directors as well. Consequently the supervisory role of the Board is often severely compromised and the management, who really has the keys to the business, can potentially use corporate resources to further their own self- interests rather than the interests of the shareholders.

The inefficacy of the Board of Directors in monitoring the activities of management is particularly marked in the Anglo-Saxon corporate structure where real monitoring is expected to come from financial markets. The underlying premise is that shareholders dissatisfied with a particular management would simply dispose of their shares in the company. As this would drive down the share price, the company would become a takeover target. If and when the acquisition actually happens, the acquiring company would get rid of the existing management. It is thus the fear of a takeover rather than shareholder action that is supposed to keep the management honest and on its toes. This mechanism, however, presupposes the existence of a deep and liquid stock market with considerable informational efficiency as well as a legal and financial system conducive to M&A activity. More often than not, these features do not exist in developing countries like India. An alternative corporate governance model is that provided by the bank-based economies like Germany where the main bank ("Hausbank" in Germany) lending to the company exerts considerable influence and carries out continuous project-level supervision of the management and the supervisory board has representatives of multiple stakeholders of the firm. Box 1 gives a brief comparison of the two systems.

4. Legal environment, Ownership Patterns and Corporate Governance

The legal system of a country plays a crucial role in creating an effective corporate governance mechanism in a country and protecting the rights of investors and creditors. The legal environment encompasses two important aspects – the protection offered in the laws and to what extent the laws are enforced in real life. Both these aspects play important roles in determining the nature of corporate governance in the country in question.

The primary difference between the legal systems in advanced countries and those in developing countries lies in enforcement rather than in the nature of laws- in books. Enforcement of laws play a much more important role than the quality of the laws on books in determining events like CEO turnover and developing security markets by eliminating insider trading.12 In an environment marked by weak enforcement of property rights and contracts, entrepreneurs and managers find it difficult to signal their commitment to the potential investors, leading to limited external financing and ownership concentration. This particularly hurts the development of new firms and the small and medium enterprises (SMEs). In such a situation many of the standard methods of corporate governance – market for corporate controls, board activity, proxy fights and executive compensation – lose their effectiveness. Large block-holding emerges as the most important corporate governance mechanism with some potential roles for bank monitoring, shareholder activism, employee monitoring and social control.

Conclusions

With the recent spate of corporate scandals and the subsequent interest in corporate governance, a plethora of corporate governance norms and standards have sprouted around the globe. But developing countries have not fallen behind either. In the last few years the thinking on the topic in India has gradually crystallized into the development of norms for listed companies. The problem for private companies, that form a vast majority of Indian corporate entities, remains largely unaddressed. The agency problem is likely to be less marked there as ownership and control are generally not separated. Minority shareholder exploitation, however, can very well be an important issue in many cases.

Development of norms and guidelines are an important first step in a serious effort to improve corporate governance. The bigger challenge in India, however, lies in the proper implementation of those rules at the ground level. More and more it appears that outside agencies like analysts and stock markets (particularly foreign markets for companies making GDR issues) have the most influence on the actions of managers in the leading companies of the country. But their influence is restricted to the few top (albeit largest) companies. More needs to be done to ensure adequate corporate governance in the average Indian company. Even the most prudent norms can be hoodwinked in a system plagued with widespread corruption. Nevertheless, with industry organizations and chambers of commerce themselves pushing for an improved corporate governance system, the future of corporate governance in India promises to be distinctly better than the past.

5. Good Practices for Compliance

Where, there is a local code on corporate governance, enterprises should follow a “comply or explain” rule whereby they disclose the extent to which they followed the local code’s recommendations and explain any deviations. Where there is no local code on corporate governance, companies should follow recognized international good practices.
The use of “comply or explain” mechanisms in many countries allows investors and other stakeholders greater access to information about the corporation and is to be encouraged. In relation to this “comply or explain” rule, some countries now require companies with foreign listings to disclose the extent to which the local governance practices differ from the foreign listing standards.
The enterprise should disclose awards or accolades for its good corporate governance practices.
It is recognized that there is an increase in the number of corporate governance accolades, awards, ratings, rankings and even corporate governance stock market indexes where constituents are selected on the basis of exhibiting good practices in corporate governance. Especially where such awards or recognitions come from major rating agencies, stock exchanges or other significant financial institutions, disclosure would prove useful since it provides independent evidence of the state of a company's corporate governance.

References

Bertrand, M., P. Mehta, and S. Mullainathan. 2002. “Ferreting out Tunneling: An Application to Indian Business Groups.” Quarterly Journal of Economics 117(1):121–48.
Chhibber, P.K., and S.K. Majumdar(1999), Foreign Ownership and Profitability: Property Rights, Control, and the Performance of Firms in Indian Industry, Journal of Law and Economics, 42,209-238.
Das, A. and S. Ghosh, 2004. Corporate Governance in Banking System: An Empirical Investigation, Economic and Political Weekly, March 20, 2004, pp. 1263-1266.

Goswami, Omkar, 2002, “Corporate Governance in India,” Taking Action Against Corruption in Asia and the Pacific (Manila: Asian Development Bank), Chapter 9.

Reddy, Y.V., 2002. Public sector banks and the governance challenge - the Indian experience, BIS Review 25/2002, Bank for International Settlements, Basle.

Sarkar, J. and S. Sarkar (2000), Large Shareholder Activism in Corporate Governance in Developing Countries: Evidence from India, International Review of Finance, 1, 161-194.

World Bank, 2004. Report on the Observance of Standards and Codes (ROSC), Corporate Governance Country Assessment: India, ROSC, World Bank-IMF, Washington DC.

CACG (2003). Corporate Governance Principles for Annual Reporting in the Commonwealth. Commonwealth Association of Corporate Governance.

(2004). Principles of Corporate Governance (2004 Edition). Organization for Economic Co-operation and Development.

IASB (2005). Framework for the Preparation and Presentation of Financial Statements. International Accounting Standards Board.