A Study of Corporate Governance Practices in India

Pooja Malik Jain

Asst. Prof., Deptt. of Commerce, S. A. Jain College, Ambala City – Haryana (India)

Abstract – Corporate governance (CG) has emerged as a very important ideal. The reason is, today companies are substantially contributing to the overall growth and development, particularly in emerging economies such as India and a healthy investment environment is vital. To overcome the limitations of the partnership form of business, mainly on account of the limited availability of capital, the corporate form of business has gained widespread acceptability, succeeded gradually and expanded worldwide. However, not all companies are managed successfully. There has been a spree of corporate frauds worldwide, e.g., Enron in the United States (US) and more recently in India, Satyam Computers. The latter had accounting and auditing flaws apart from lack of accountability and oversight by Independent Directors at Board meetings. There was no whistle-blowing in case of Satyam Computers unlike Enron. The Satyam Computers revelation was an outcome of a takeover attempt. It eroded the wealth of shareholders.

From this fraud it is evident that we need to review the enforcement of CG practices. The role of the Ministry of Corporate Affairs (MCA) as one of the stakeholders in case of Satyam Computers has been commendable especially in appointing reputed members on the Board immediately after the fraud, in order to restore confidence among investors, customers, employees and to revive the company. This initiative by the government also encouraged the stock markets to some extent.

---------------------------♦---------------------------

INTRODUCTION

'Corporate' means a body having the nature of, or acting by means of a corporation. The term 'Governance' is derived from the word Gubernate, means to rule or steer. Even though the term governance is from political science, these days it is also debated under public administration. In common parlance, CG means protecting interests of shareholders but not at the cost of other stakeholders. However, there are varied opinions about the terms 'Management', 'Governance' and 'Administration'. The term 'Management' in the context of CG means "executing strategic as well as all other decisions taken by the Board'. The Chief Executive Officer (CEO) is entrusted with the responsibility of managing the day-to-day affairs of business in consonance with the decisions of the Board. Moreover, in management, there is a hierarchy, where the CEO (being senior executive with managerial roles and responsibilities, is also a part of the Board) is on the top of the managerial pyramid, delegating authority and responsibility for management functions downwards while demanding accountability upwards. The term 'Management' is mostly referred for businesses with the profit motive. As explained by Carver, Governance is a subcategory of ownership, not a branch of management; the Board is owner-representative. The authority of ownership can be passed into the organization via the Board The term 'Governance' denotes a controlling or ruling function, which is the sole responsibility of the Board of Directors. The accountability of 'Governance Function' is higher than the accountability of 'Management Function'. The reason is, management is accountable to the Board while the Board is accountable to the management for taking timely decisions as these decisions are to be executed by the management. Simultaneously, the Board is also responsible to equity shareholders for implications of the decisions so made. The term 'Administration' means compliance with specific rules and procedures. The term 'Administration' is also used in the context of non-profit businesses.

In general CG reforms have significantly focused on the relationship between the management and the Board particularly on separating these two functions for effective management and hence may lead to greater transparency. The Board members usually may not get enough time and the management has to manage the day-to-day affairs. So the role of CG becomes more pertinent. Further, the reforms cover the implications of risk-return relationship between management and shareholders to some extent. However, limited focus has been given to the implications of risk-return relationship between the Board and shareholders.

In India, corporations emerged from the managing agency system. In this system the terms, ‘Managing Agent’ and ‘Managing Agency’ were used for individuals and business firms that entered into a legal contract with joint stock companies to manage the affairs of the latter. The managing agencies were established by the business families. These business families took to the managing agency system for two reasons: (i) managing agency system provided a quick turnover on capital and (ii) a small sum of capital to be spread over a large number of ventures. Overall, the managing agencies facilitated actions such as establishment and management of companies, and executing finance functions, when the capital markets and credit system were underdeveloped.

Since most managing agencies were established as partnerships involving members of a single family, this relationship between the agency and the business family established the foundation for the family-controlled conglomerates that have dominated the Indian economy since independence. In this model corporate control led from the individual to the joint stock company and a parent or apex company. Profits were generated not due to productivity or innovations but on account of market imperfections, price fluctuations, wars, famines and artificial scarcities. Profit-making in this fashion highlighted the ad hoc-nature of business. The laissez-faire capitalism, which facilitated industrial development to some extent in the western countries, did not work out in India's colonial context. Moreover, managing agents deprived shareholders of their basic rights and ignored their voice in managing affairs of the firms. So, the process of industrialization failed to generate wealth either in the form of wages or dividends, for the concerned stakeholders.

REVIEW OF THE LITERATURE:

This study presents a review of the studies pertinent to mandatory, non-mandatory and other Corporate Governance (CG) practices. The area of CG became a fertile field of research after the Cadbury Committee Report in the United Kingdom (UK) in 1992. In emerging markets, CG has not been studied as intensively as in developed markets. Outside the United States (US), i.e., in Japan and Germany, limited research has been carried out on CG. Since economic reforms, CG has gained momentum in India. Gopal has contended that establishment of various committees on CG initiated the adoption of CG practices in India. Good CG addresses the need for disclosure, transparency and professionalism by managers, shareholders, foreign institutional investors and financial institutions. According to Balgobin, the number of scholarly and peer-reviewed articles on CG has gone up from 207 and 434. Agarwal stated that companies in India have opportunities as well as threats worldwide due to entry of global companies. There is a growing realization that good CG is a must not only for credibility and trust but also as a part of strategic management for the prosperity and sustainability of business. According to Stijn and Fan, enormous research work is being done on CG in Asia, excluding Japan but most of the work is based on the literature available on CG from the western countries particularly, US. Khanna and Palepu analyzed the CG practices of an Indian firm i.e., Infosys Technologies and they argued that the globalization of product and talent markets have affected CG of firms. Influence of such individual firms as the role model of good CG may be a positive externality on the rest of the Indian firms and may accelerate convergence of CG. Kimber *et al.,* analyzed CG in four Asia Pacific countries viz., Australia, China, India and Singapore. The said countries have significant diversity in terms of social, cultural, economic developments and approaches to CG. One common feature found is the high concentration of ownership by national governments and families, and such concentration had peculiar effects on the stock market and protection to minority shareholders.

Varma feels that the Anglo-Saxon (Anglo-American) Model of CG is not particularly suitable to the Indian context. As all CG models survived and the economies prospered, the CG models of Japan and Germany are equally good. Evolving arguments evidently do not settle the question as to which model of CG is more efficient.

Recent research has shown that historically, political pressures are as important in the evolution of CG models, as the economic ones. Balasubramanian advocated that our own ancient texts have laid down sound principles of CG which are relevant in the present context too. However, in India, policy-makers are adopting the Western models of CG, policies, and regulations without checking their feasibility in the Indian context. So, the suitability of CG norms may not be so expeditious in emerging markets. To provide adequate investor protection for enforcement of CG rules in India, key concerns are overburdened courts and significant corruption though, on paper India provides the highest levels of investor protection in the world. CG in India does not compare unfavorably with, and in many respects represents a major improvement over the CG models of, the other major emerging economies notably Brazil, Russia and China. No CG model is proven to be effective in all circumstances. Even the Anglo-Saxon Model has its own flaws which are apparent from the corporate scandals of prominent companies viz., Enron and WorldCom. Gilson suggests the possible emergence of a globally accepted CG model, relatively uniform in functions despite persisting formal differences. The Indian corporate sector offers both the best and worst kind of CG models. CG in Indian Boards is apparently driven by its collective conscious and not by stakeholder' demands or market forces.

RESEARCH METHODOLOGY:

Gompers *et al.,* have uncovered a strong relationship between CG and firm performance. Phani *at el.,* found that in the Indian context, the influence of insiders' ownership on the performance of the firm is sporadic in nature. The association of insider ownership with performance could be considered as temporary aberrations and would disappear in a short time span. The study by Mujumdar and Chhiber revealed a significant negative relationship in India between the levels of debt in the capital structure of the firm and performance. They argued that both short-term and long-term lending institutions are government-owned and it could be the reason behind this relationship. They advocated that CG mechanisms in the west would not work in the Indian context unless the supply of loan capital is privatized. Singh studied the ownership pattern of 14 major Indian companies and revealed that promoter-shareholders are dominant owners, owning 33 per cent to 85 per cent of the total share capital. The 'Principal-agent' relationship is thus considerably diluted in this model, as the interest of promoters substantially converges with retail shareholders. Morck *et al.,* observed a positive relationship between Board ownership, ranging up to 5 per cent and firm performance but a negative relationship for the 5 per cent to 25 per cent ownership range, indicating that as ownership stakes rises, management entrenchment outweighs convergence of interest, and the positive influence of management ownership re-appears only beyond the 25 per cent ownership range. According to Agrawal and Knoeber, higher insider ownership was positively related to performance. Murphy and Core *et al.,* (2001) as well as Holderness found that the relationship between inside ownership and performance is mixed.47 Khanna and Palepu have detected a positive linear relationship between insider ownership and performance of the firm in a single year, where both accounting and market based performance measures were used. Van *et al.,* found that equity ownership of management Board and supervisory Board does not affect performance.

Zeitun and Gang found that there was a positive impact of managerial ownership on a firm's performance in Jordan. Another study by McConnell and Servaes studied the relationship between Tobin's Q and ownership, in which a significantly positive relationship was found. Ming-Yuan Chen found that association of the family in management of the firm determines the option of ownership stakes in Taiwan. It was also found that entrenchment effect engulfs incentive (interest) effect at a higher level of ownership. According to Short and Keasey, a non-linear relationship existed between managerial ownership and firm performance for UK companies due to possible *effects of alignment* and *entrenchment*. However, the exact relationship between a firm's managerial ownership and performance is still ambiguous. The relationship is either positive or non-existent. This justifies the need for further research.

According to Chaganti and Damanpour, there exits limited research about the impact of institutional ownership on firm performance as it is assumed that there is no significant relationship between the two. Capital structure and Return on Equity were found to be considerably related to the amount of shareholding by institutional investors. The stakes also impact firms' Return on Assets, and Price-Earnings Ratio in varying degrees. It was observed that ownership structure had no substantial impact on total stock return. Another study found the institutional ownership to be negatively related with growth but positively related with profitability. Public ownership did not show any significant relationship with any of the performance variables. Financial Institutions' ownership showed significant and positive relation with assets creation. However, Roy found that the stake of financial institutions had a negative relationship with profitability. Chhibber and Majumdar found that three types of state ownership exist in India: firstly, firms where the government has less than 26 per cent shareholding; secondly, where the government owns more than 26 per cent; and lastly, where state is the majority shareholder with more than 50 per cent share. The study revealed that firms which do not have state as the majority shareholder performed better. But, another study by Ahuja and Majumdar, involving 68 state-owned firms revealed that the firms on average were less effective in employing their resources. In India, Kumar studied more than 2,000 publicly traded enterprises and found that foreign shareholding does not influence the performance of the firm significantly, contrary to the other studies. He also found that the extent of ownership by financial institutions positively influences a firm's performance. However, no significant difference was found in managerial ownership and firms' performance across group and stand-alone firms. According to Pant and Pattanayak, ownership in India is concentrated in the hands of family members and their relatives. The findings suggested that when insider ownership increased from 0 percent to 20 per cent, firm value also increased and as the stake increased further from 20 per cent, the entrenchment effect came into play so the performance deteriorated; further, when the ownership extended beyond 49 per cent, there was a convergence of interest with the firm and again the performance improved. According to Hambrick and Jackson, outside director holdings were actually associated with corporate performance changes subsequent to such holdings.

OBJECTIVES OF THE STUDY:

1. To ascertain the extent of compliance with mandatory provisions of Clause 49 of Listing Agreement.

2. To examine the status of non-mandatory and exemplary CG practices.

3. To ascertain barriers to CG reforms in India.

HYPOTHESES:

In order to achieve the above objectives of the study, we propose to test relevant hypotheses, some of which are presented as follows.

H0 : There exists no compliance with mandatory provisions of CG with respect to composition of Board of Directors in a majority of the companies.

H0 : There exists no compliance with mandatory provisions of CG with respect to Audit Committee in a majority of the companies.

H0 : There exists no compliance with mandatory provisions of CG with respect to CEO/CFO Certification in a majority of the companies.

H0 : There exists no compliance with mandatory provisions of CG with respect to Compliance (as certified) in a majority of the companies.

H0 : A majority of companies adheres to non-mandatory provisions of CG with respect to the Remuneration Committee.

H0 : A majority of companies follows exemplary CG practices.

H0 : In a majority of companies the size of the Board is appropriate.

H0 : The CG approach emphasizes the primacy of equity shareholders in a majority of companies.

TERMS AND CONCEPTS:

(a) CG

CG means a set of practices that safeguards the interest of the wider set of stakeholders including employees, creditors, customers and shareholders in particular. Since for most of the stakeholders, the company has contractual obligations, the interest of stakeholders is indirectly protected by their legal rights. Moreover creditors have superior claims on earnings and assets in the event of liquidation compared to equity shareholders. Therefore equity claimants should be provided adequate returns for bearing maximum risk after meeting the claims of creditors and preference shareholders. Yet, providing excessive returns to equity claimants at the cost of stakeholders is also not a good CG practice. There are possibilities that while upholding the interest of equity shareholders, stakeholders' interest may be jeopardized. For instance, earning good profits and distributing high dividend to equity shareholders does not guarantee ethical practices, environment protection, and timely payment of dues to other stakeholders and corporate social responsibility. So companies have to ensure that neither shareholders nor other stakeholders' interest is impaired. The Board of Directors has to ensure this by carrying out their fiduciary duty; in particular the role of CEO and Independent Directors is very significant in achieving this objective.

(b) CG PRACTICES

The expression means compliance with mandatory as well as non-mandatory provisions of CG as per Clause 49 of the Listing Agreement and exemplary CG practices followed by listed companies for compliance, transparency, value creation and excellence.

ANALYSIS:

It was decided to use secondary data of companies that featured in the Standard and Poor's (S&P) CNX NIFTY Index at the end of the years 2005-06, 2006-07 and 2007-08. Companies featuring in the Index represented diverse industries and sectors. However, while most of the companies selected for study are from the manufacturing sector, some of them are from service and allied sectors. The Nifty Index comprises equity shares of fifty companies. Twelve companies presently featuring, were not listed at the National Stock Exchange in all the three years as mentioned above. These companies were excluded from the sample in order to provide a comparable basis for the study and also to discern trends in Corporate Governance (CG). Further, claims made by Satyam Computers Services Ltd. about its CG practices raised suspicion in the light of subsequent revelations, so it too was not considered. Out of the remaining thirty-seven companies, publically disclosed information was not available in the case of three companies, viz., National Aluminium Company Limited, Punjab National Bank and State Bank of India (SBI). In the wake of non-availability of data, it was further decided to send a registered letter to these above-mentioned three companies requesting their annual report.

SBI stated that it has complied with provisions of the Listing Agreement except where provisions are not in conformity with SBI Act, 1955 and the directives issued by Reserve Bank of India (RBI) or Government of India. It is further stated that mandatory requirements of clause such as composition of Board, composition of Audit Committee and compensation of Non-Executive Directors are not binding on the bank as separate provisions of the SBI Act, 1955, SBI general regulations and RBI guidelines deal with the same. So, on these grounds SBI was not considered. Eventually, the sample for the study comprised thirty-four companies.

SIGNIFICANCE OF THE STUDY:

The corporate form of business has played an underpinning role in the growth and development of economies, more so for emerging India. Companies, large and small, serve as engines of economic growth. Sometimes their capitalization exceeds the GDP of countries. To illustrate, the market capitalization of Exxon Mobil, for the year 2006 was US $469 Billion, which is greater than the GDP of 76 countries in a group that has Philippines at the top with a GDP of US $443 Billion, and Paraguay at the bottom with a GDP of US $31 Billion. Companies in India, particularly business conglomerates, have played a prominent role in the nations's development. However despite such splendid contributions, governance of such companies has emerged as a new challenge more so on account of their large size, competitive markets and cross border business. India has been proactive in enacting CG reforms, immediately after the spree of US corporate frauds. In fact, though India enacted commendable reforms, effective and efficient enforcement of the reforms is a matter of concern. Despite various CG reforms in India, there is considerable scope for improvement. If one of the top among the four information technology firms in India, i.e., Satyam which was also in the Nifty could deceive investors, then investors would be mistrustful of other companies. Such corporate frauds discourage equity investments at least in the short term, which India has experienced in the aftermath of the Satyam scam. Stock markets plummet, thereby causing immense loss of wealth to investors. Even though we have strict and mandatory codes of CG, such frauds continue. Sometimes, the nature of frauds is also distinct in India compared to Anglo-Saxon countries. “Vanishing acts” of companies and individual stock-market related frauds are common. Frauds involving directors of companies indulging in tunnelling or misappropriations of corporate resources also occur frequently.

This further necessitates specific research focusing on frauds in corporate. One of the possibilities is that CG is largely followed in letter but not in spirit. Seeing Satyam's case, the worrisome issue of CG in India seems to be sham compliance of Listing agreement. Sometimes CG is followed in letter as well as in spirit but not comprehensively, i.e., some crucial aspects of the code of conduct are avoided. Elaborating on the corporate frauds issue further, it is responsibility of the CEO/CFO to certify financial statements including CG report stating that the matters contained therein are true and fair. These financial statements are audited by the auditors culminating in the audit report.

SCOPE OF THE STUDY

The scope of this study covers three years' viz: 2005-06, 2006-07, 2007-08, including the year-end from which CG reporting has been made mandatory. Co-incidentally, most of the sample companies are manufacturing entities. 50 companies in each of the years that feature in the S&P CNX NIFTY Index are taken up for study because the criteria for CG compliance are met by such listed and larger companies. Moreover, these being generally well-regarded companies, recommendations of this study may serve as a model of good practices for others to emulate. However the results of the study should be viewed in the background of limitations such as sample size, sampling technique, veracity of available information and the duration of the study.

CONCLUSION:

A majority of the companies has adhered to most of mandatory provisions of CG as per requirements. However, though a majority of companies complied with the mandatory requirement of certification of financial statements by CEO/CFO, the level of compliance is comparatively lower vis-à-vis other mandatory requirements. Encouragingly, since the year 2005-06, compliance with the certification requirement shows an improving trend. The results further suggest that a majority of the companies has not adhered to all non-mandatory provisions of CG prescribed by the aforesaid clause. The majority of companies has adhered to the non-mandatory provisions of CG with respect to the remuneration committee in all the years studied. However, in case of the whistle-blower policy, the results do not uphold compliance in the year 2006-07 though there is adherence to this requirement in the years 2005-06 and 2007-08. Further, companies follow exemplary CG practices but they do not constitute a majority.

However, adherence to such exemplary CG practices over the three years shows an increasing trend, which is heartening. The picture that emerges is a mixed one as results strongly support a view that there exists compliance with mandatory CG provisions but not so with all non-mandatory provisions and exemplary CG practices. A fallout of the findings is that regulatory attention and if need be, action, are warranted to ensure full compliance with mandatory provisions. Further, regulatory persuasion and self-regulatory impetus are desirable with regard to adherence to non-mandatory provisions of CG, in the larger public interest.

Apart from lack of compliance with non-mandatory provisions of CG, inappropriate size of the Board, lack of formal training to directors in CG matters, lack of evaluation for Non-Executive Directors, a failure to articulate priorities about the protection of interests of shareholders vis-à-vis other stakeholders and lack of representation of Independent Directors especially on the Board of Government companies may work as barriers to CG reforms.

REFERENCES:

- Baskin, Jonathan Barron, and Paul J. Miranti, Jr., *A History of Corporate*

- *Finance*, Cambridge University Press, Cambridge, England, 1997 cited by

- Benjamin, Hermalin E., “Trends in Corporate Governance,” *The Journal of Finance*, Vol. LX, No. 5, October 2005, p. 2351.

- Maira, Arun, “Corporate Governance Beyond NYSE,” *The Economic Times*, Ahmedabad, September 12, 2006, p. 8.

- Prasad, Kesho, *Corporate Governance*, Prentice-Hall of India Private Limited, New Delhi, 2006, p. 17.

- Sisodiya, Amit Singh, “Corporate Governance - Lessons from the East India

- Company,” *Effective Executive (Special Issue),* October 2003, p. 52.

- Sivaram, Y. G., “Wealth of Companies and Corporate Governance,” *Icfai Reader*, August 2007, p. 50.

- Roy, Smith C. and Ingo Walter, *Governing the Modern Corporation – Capital Markets, Corporate Control and Economic Performance*, Oxford University Press, New York, 2006, p. 49.

- Prasad, op. cit., pp. 17-19.

- Roy and Walter, op. cit., p. 50.

- Prasad, op. cit., pp. 17-19.

- Sisodiya, op. cit., p. 53.

- Roy and Walter, op. cit., p. 50.

- Jensen, Michael C., “Self-Interest, Altruism, Incentives, and Agency Theory,” in Chew, Donald H. Jr., and Stuart L. Gillan (Eds.), *Corporate Governance at Crossroads: A Book of Readings,* Tata McGraw-Hill Publishing Company Limited, New Delhi, 2006, p. 124.

- Cannan, Edwin (Ed.), *An Inquiry into Nature and Causes of The Wealth of Nations*, by Adam Smith, Vol. II, Methuen & Co. Ltd., Frome and London, 1961, pp. 264-265.

- Chew, Donald H. Jr., and Stuart L. Gillan (Eds.), *Corporate Governance at Crossroads: A Book of Readings,* Tata McGraw-Hill Publishing Company Limited, New Delhi, 2006, p. xiii.