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Corporate Governance: Introduction

1.1 CORPORATE GOVERNANCE: THE CONCEPT

The concept of corporate governance is gaining momentum because of various factors as well as the changing business environment. The EEC, GATT and WTO regulations have also contributed to the rising awareness and are compelling us to think in terms of adhering to the good governance practices. Corporate governance, by the very nature of the concept, cannot be exactly defined. However, there can be no two opinions that “effective accountability to all shareholders is the essence of corporate governance.”

The following definition should help us to understand the concept better. “Corporate governance is not just corporate management, it is something much broader to include a fair, efficient and transparent administration to meet certain well-defined objectives. It is a system of structuring, operating and controlling a company with a view to achieve long-term strategic goals to satisfy shareholders, creditors, employees, customers and suppliers, and complying with the legal and regulatory requirements, apart from meeting environmental and local community needs. When it is practised under a well-laid out system, it leads to the building of a legal, commercial and institutional framework and demarcates the boundaries within which these functions are performed.”

Corporate governance cannot disregard the diverse interests—shareholders, lenders, employees, government, etc. It is believed that shareholders would increasingly assert their rights, hitherto virtually unknown; similarly the lending institutions, having to justify their performance in a market-driven environment, have no choice but to demand effective and efficient corporate governance; besides FIIs with substantial foreign investment in India would demand greater transparency and internationally recognised, sound corporate practices. The new paradigm of governance to bring about quality corporate governance is not only a necessity to serve the diverse corporate interests, but it is also a key requirement in the best interests of the corporates themselves.

Corporate practices in the matter of disclosure, transparency, group accounting, role of directors, degree of accountability to the shareholders, lenders and overall public good are some of the critical issues which require a fresh and closer look. A framework for addressing concerns public good, such as regard for environment, overall conservation of resources, cost effective managerial input—all these would, among other things form part of the core of corporate governance. Government can play a catalytic role in creating the enviroment for quality governance through an appropriate regulatory framework. Corporate leadership and its mindset would also determine the sort of governance that would ultimately evolve.

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1 Corporate governance: Time for a Metamorphosis’ The Hindu July 9, 1997.
The Cadbury committee has also defined the term “Corporate Governance” and according to the committee, it means,

“(It is) the system by which companies are directed and controlled.” It may also be defined as a system of structuring, operating and controlling a company with the following specific aims:-

(i) Fulfilling long-term strategic goals of owners;
(ii) Taking care of the interests of employees;
(iii) A consideration for the environment and local community;
(iv) Maintaining excellent relations with customers and suppliers;
(v) Proper compliance with all the applicable legal and regulatory requirements.

We may also note what the CII constituted committee has to say on the definition, “Corporate governance deals with laws, procedures, practices and implicit rules that determine a company’s ability to take informed managerial decisions vis-à-vis its claimants–in particular, its shareholders, creditors, customers, the State and employees. There is global consensus about the objective of ‘good corporate governance: maximising long-term shareholder value.” Further the Kumar Mangalam Birla committee constituted by SEBI has observed that, “Strong corporate governance is indispensable financial reporting structure.” According to ICSI, “We may define ‘corporate governance as a blend of rules, regulations, laws and voluntary practices that enable companies to attract financial and human capital, perform efficiently and thereby maximise long term value for the shareholders besides respecting the aspirations of multiple stakeholders including that of the society.”

In India, the question of corporate governance has come up mainly in the wake of economic liberalisation and deregulation of industry and business, as well as the demand for a new corporate ethos and stricter compliance with the law of the land. In the context of the unique situation in India where the financial institutions hold substantial stakes in companies, the accountability of the directors, including non-executive directors and nominees, has come into sharp focus.”

In the UK and USA the corporate system and structure is characterised by diffused ownership and shareholding, as a large percentage of shares is subscribed by the public. They have a well developed capital market with active shareholder participation. Firms are subject to strict disclosure norms and investor protection. The focus of good governance in these countries ‘is the code of best practices.’ However, the Japanese and German models are somewhat different. There is a close association between the financial institutions and the firms, as with the predominant shareholders. Both have close relationship towards their commitment to a philosophy of lifetime association. In India, a strident demand for evolving a code of good practices by the corporates themselves is emerging. In the global perspective, it may constitute a necessity to cut through the maze of prevalent questionable practices, indefensible management attitudes to stakeholders and penetrable non-disclosures.

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2 Corporate Governance Reporting (Model Formats) by ICSI 2003.
3 Corporate Governance: The new paradigm Charted Secretary October 1997.
1.1.1 Corporate Governance Abuses and the General Scene

In the Indian business groups, the concept of dominant shareholders is more amorphous. The promoters' shareholding is spread across several friends and relatives and also corporate entities. It may be difficult to establish the total effective holding of this group. However, the aggregate holding of all these entities taken together is typically swell below a majority stake. Since financial institutions have historically played a passive role, it paves the way for the promoters acting as the dominant shareholders, despite they may not even be the largest single shareholder. The promoters are thus enabled to play all the games that a dominant shareholder can play, namely structuring of businesses and transfer of assets between group companies, preferential allotments of shares to themselves, payment for “services” to closely held group companies and the like. This has led to the situation of what could be termed, “There may be many financially sick companies but no financially sick promoters”. Thus corporate governance abuses perpetrated by a dominant shareholder poses a difficult regulatory dilemma; The regulatory intervention is therefore required to be concerned with micro—management which are related to routine business decisions. The general scene with regard to the Indian corporate sector, as perceived by Dilip Kumar Sen may be noted, which are as follows: 4

- Companies are often run as if they were the managing director’s or CEO’s personal freedom;
- Those at the helm are only about the principal shareholders’ interests, any benefit to other shareholders is only consequential;
- Majority of directors are unaware that they are agents of shareholders and their position is one of trust and faith
- Participation of non-executive directors in meetings whether of the board or any committee thereof is inversely proportional to the health of the bottom line—better the bottom line lesser the participation.
- Most directors do not consider it necessary to update themselves on changes in laws, regulations;
- Non executive directors do not see themselves as watch-dog of the owners.
- Boardrooms are invariably filled up by ‘yes’ men who do not raise relevant questions.
- Except in a crisis even nominee directors tend to play a passive role at board meetings and do not oppose the proposals of the management.

Therefore, the author of the above article, concludes, “Hence, no amount of regulation can enforce the true spirit of good corporate governance practices in a company unless it comes from within the organisation”.

1.1.2 What are the objectives of corporate governance?

The development of corporate governance concept is naturally and essentially related to the ‘objectives of corporate governance’ and it may be important to note what the ‘Introductory framework’ has to say on this: 5

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5 Corporate Governance Reporting (Model formats) by ICSI 2003.
“Good governance is integral to the very existence of a company. It inspires and strengthens investor’s confidence by ensuring company’s commitment to higher growth and profits. It seeks to achieve following objectives:

(i) That a properly structured Board capable of taking independent and objective decisions is in place at the helm of affairs;

(ii) That the Board is balanced as regards the representation of adequate number of non-executive and independent directors who will take care of the interests and well being of all the stakeholders;

(iii) That the Board adopts transparent procedures and practices and arrives at decisions on the strength of adequate information.

(iv) That the Board has an effective machinery to subserve the concerns of stakeholders;

(v) That the Board keeps the shareholders informed of relevant developments impacting the company;

(vi) That the Board effectively and regularly monitors the functioning of the management team; and

(vii) That the Board remains in effective control of the affairs of the company at all times.

The overall endeavour of the Board should be to take the organisation forward, to maximise long-term value and shareholders’ wealth.”

1.1.3 Code convergence in Asia

The points of convergence, according to ‘Code Convergence in Asia: Smoke or Fire?’

Although Asian countries are not moving towards identical systems of governance, there is a striking agreement among the proponents of reform in each country on the centrality of certain principles and these include:

- Enhancing shareholder value as the primary focus of companies, and upholding or extending shareholder rights (this is accepted, even in places like China, as a fundamental prerequisite for the development of capital Markets).

- The need for non-executive and independent non-executive directors to provide an “outside” view on strategic direction and to counterbalance the executives on the board (or to help strengthen the supervisory board vis-à-vis the management board in two-tier systems).

- The usefulness of board committees responsible for audit, nomination and compensation and comprising a majority of independent directors.

- The importance of higher levels of information disclosure from listed companies.

- Allowing or encouraging institutional investors to act as a check against management and a lever for enhancing board independence.

Some of these principles have been incorporated into laws and regulations governing companies and securities trading, or have been expressed in the listing rules of stock exchanges. Most are now included in codes of best practice developed over the past two years, and may or may not be mandatory.

The Cadbury Committee. A spate of scandals and financial collapses in the UK in the late 1980s and early 1990s made the shareholders and banks worry about their investments. The UK Government therefore recognised the insufficiency of existing legislation role of self-regulation as a measure of controlling scandals and financial collapses. In order to prevent recurrence of business failures, the Cadbury committee was set up by the London stock Exchange in May 1991 inter alia to help raise standards of corporate governance. The “Code of best practices” (1992) of the Cadbury committee report spelt out the methods of governance needed to achieve a balance between the essential powers of the Board and their proper accountability.

1.1.4 Developments in India

On account of the interest generated by Cadbury committee report and also in the wake of Government initiatives to respond to corporate developments world over, the following major developments have taken place:

- The Confederation of Indian Industries (CII), the Associated Chambers of Commerce and Industry and the Securities and Exchange Board of India constituted committees to recommend initiatives in corporate governance. The CII, in 1996, took a special initiative on corporate governance. It was the first institutional initiative in Indian industry. The objective being to develop a code for corporate governance to be adopted by the Indian companies (private sector, the public sector, banks and financial institutions which are corporate entities), a code by CII carrying the title “Desirable Corporate Governance” was released.

- The SEBI appointed committee, known as the Kumar Mangalam Birla committee’s recommendations led to the addition of Clause 49 in the Listing Agreement. Compliance of provisions of Clause 49 was largely made mandatory by listed companies. The committee recommended that there should be a separate section on Corporate governance in the Annual Report of companies. This section was required to detail the steps taken to comply with the recommendations of the committee and thus inform the shareholders of specific initiatives taken to ensure corporate governance. The committee accorded recognition to the three vital aspects of corporate governance, namely accountability, transparency and equality of treatment for all stakeholders.

- The Department of Company Affairs (DCA) appointed a study group on 15.5.2000 under the Chairmanship of the then Secretary DCA to suggest ways and means of achieving corporate governance. The study group appointed a task force. The study group recommended the setting up of an independent, autonomous centre for corporate excellence with a view to accord accreditation and promote policy research and studies, training and education and awards etc., in the field of corporate excellence through improved corporate governance. It favoured greater shareholders’ participation, formal recognition of corporate social responsibility, non-executive directors being charged with strategic and oversight responsibilities,
minimisation of interest–conflict potential, and also suggested application of corporate governance principles to public sector.

- The Department of Company Affairs also constituted on August 21, 2002 a high level committee, popularly known as Naresh Chandra committee, to examine various corporate governance issues and to recommend changes in the diverse areas such as the statutory auditor-company relationship, rotation of statutory auditors, procedure for appointment and determination of audit fees, restrictions if necessary on non-audit fees, independence of auditing functions, ensuring presentation of ‘true and fair’ statement of the financial affairs of companies, certification of financial statements and accounts, regulation of oversight functionaries, setting up an independent regulator and the role of independent directors. The committee has made very significant recommendations for changes, inter alia, in the Companies Act.

- Yet another major development includes the constitution of a committee by SEBI under the Chairmanship of Shri N.R. Narayana Murthy, for reviewing the implementation of corporate governance code by listed companies. The mandatory recommendations of the committee on various matters are detailed in the Annexure.

- The Department of Company Affairs also has set up a proactive standing company law advisory committee to advise on issues like inspection of corporates for wrong doings, role of independent directors and auditors and their liability, suggesting steps to enhance imposition of penalties. A High powered Central Coordination and Monitoring committee (CCMC) co-chaired by Secretary DCA and Chairman SEBI was also set up to monitor action against vanishing companies and unscrupulous promoters, who misused funds raised from public.

- SEBI has also undertaken a project for development of a comprehensive instrument by a reputed rating agency for rating the good corporate governance practices of listed companies.

1.1.5 Good Governance and Value Addition

What benefits or value addition, the corporates are likely to achieve through sound and effective corporate governance practices? The answer, as provided by ICSI runs as follows and the road map is Factors which add greater value through good governance, may be summarised as follow:  

- Adoption of good governance practices stability and growth to the enterprise.

- Good governance system, demonstrated by adoption of good corporate governance practices, builds confidence amongst stakeholdders as well as prospective stakeholders. Investors are willing to pay higher price to the corporate demonstrating strict adherence to internationally accepted norms of corporate governance.

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7 Corporate Governance Reporting (Model Formats) by ICSI 2003.
• Effective governance reduces perceived risks, consequently reduces cost of capital; it also enables board of directors to take quick and better decisions which ultimately improves bottom line of the corporates.
• In to-day’s knowledge driven economy, demonstrating excellence in skills has become the ultimate tool in the hands of board of directors to leverage competitive advantage.
• Adoption of good corporate governance practices provides long-term sustenance and strengthens stakeholders’ relationship.
• A good corporate citizen becomes an icon and enjoys a position of respect.
• Potential stakeholders aspire to enter into relationships with enterprises whose governance credentials are exemplary.
Appendices

1.1 HISTORY OF CORPORATE GOVERNANCE

The seeds of modern Corporate Governance were probably sown by the Watergate scandal in the United States. As a result of subsequent investigations, US regulatory and legislative bodies were able to highlight the control failures that had allowed several major Corporations to make illegal political contributions and to bribe government officials. This led to the development of the Foreign and Corrupt Practices Act of 1977 in USA that contained specific provisions regarding the establishment, maintenance and review of systems of internal control.

This was followed in 1979 by the Securities and Exchange Commission of USA’s proposals for mandatory reporting on internal financial controls. In 1985, following a series of high profile business failures in the USA, the most notable one of which being the Savings and Loan collapse, the Treadway Commission was formed. Its primary role was to identify the main causes of mis-representation in Financial Reports and to recommend ways of reducing incidence thereof. The Treadway Report published in 1987 highlighted the need for a proper control environment, independent Audit Committees and an objective Internal Audit function. It called for published reports on the effectiveness of internal control. It also requested the sponsoring organizations to develop an integrated set of internal control criteria to enable companies to improve their controls. Accordingly COSO (Committee of Sponsoring Organizations) was born. The report produced by it in 1992 stipulated a control framework, which has been endorsed and refined in the four subsequent UK reports: Cadbury, Rutteman, Hampel and Turnbull. While developments in the United States stimulated a debate in the UK, a spate of scandals and collapses in that country in the late 1980s and early 1990’s led the Shareholders and Banks to worry about their investments. These also led the Government in UK to recognize that the then existing legislation and self-regulation were not working.

The issue of corporate governance became particularly significant in the context of globalisation because one special feature of the late 20th century/21st century globalisation is that in addition to the traditional three elements of the economy, namely physical capital in terms of plant and machinery, technology and labour, the volatile element of financial capital invested in the emerging markets and in the third world countries is an important element of modern globalisation and has become particularly powerful. Thanks to the ubiquitous application of information technology, at the touch of a computer mouse, it is possible now to transfer billions of dollars across borders. The significance and the impact of the volatility of the financial capital was realised when in June 1997 the currency of South East Asian countries started melting down in countries like Thailand, Indonesia, South Korea and Malaysia. It was realised by the World Bank and all investors that it is not enough to have good corporate management but one should have also good corporate governance because the investors want to be sure that

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8 Extract from Dharma in Corporate Governance Charted Accountant, December 2003.
the decisions taken are ultimately in the interest of all stake holders. Honesty is the best policy is a fact that is now being re-discovered.

In practical terms, corporate governance has meant that there should be at the board level non-official directors who are professionals and who have no conflicting interests and who can particularly operate the two key committees, the Ethics Committee and the Finance Committee to see that there is greater transparency in the management of the enterprise. Corporate governance ultimately has to come to mean better transparency in the operations without sacrificing business strategy or business secrets which are necessary for success in the market place, and absolutely ethical behaviour where the conduct of the company will not only be legal but also ethical.

1.2 CORPORATE GOVERNANCE RATING/BENCHMARKING CORPORATE GOVERNANCE

According to SEBI sources, SEBI has no intention to making rating of governance of listed companies mandatory. According to SEBI, it may be wrong to conclude that governance norms compelled companies to sacrifice long-term interests or outlook in the pursuit of short-term interests and responses to market signals. SEBI has commissioned a study to determine the cost of compliance incurred by companies in respect of the regulatory framework, including Clause 49 of the listing agreement. The Narayana Murthy committee on corporate governance code had gone about its work in a highly professional and democratic manner and SEBI wanted that the professionals should study the issues raised and its recommendations, including the proposal for facilitation of ‘whistle blowing’; ICRA which rated companies, adopted certain parameters and procedures for the purpose and the agency clarified that it normally required four to six weeks and the rating was not an audit or certification of regulatory compliance by the listed company and the exercise was not a guarantee against fraud. Its primary focus in the rating was on the business processes. Key variables analysed in rating included the shareholding structure, governance structure, management processes, board structure and processes, stakeholder relationship, transparency and disclosures and financial discipline. The starting point was an assessment of the corporate’s compliance with statutory regulations as laid down in clause 49 of the listing agreement. Feedback from independent directors was a ‘key part’ of the rating process. International Finance Corporation, Washington which also carried out rating of companies followed OECD guidelines. The corporation faced the task of adopting the model and developing best practices suited to companies in emerging economies. Global experience showed that good governance helped corporates in accessing capital, especially long-term finance and equity. The IFC, as a major lender, looked at corporate governance as a tool to reduce investor risk and took account of the risk to reputation arising from bad governance. It was observed that companies which focused much on short term profits tended to lose in the long-term. Further according to international research, corporates with sound governance practices received higher premium for the shares in the stock market.

Measuring Corporate governance practice: It may be noted that Standard & Poor has recently launched a new service, known as Corporate Governance Scores, to evaluate corporate governance practices, both at a country and at a company level. In the case of country governance assessment, the analysis starts with an evaluation of governance issues at the country level. Depending upon the level of support, a country
would be assessed as providing “strong support”, “moderate support” or “weak support”. The primary focus of this analysis is at the country or national level. However when the external environment is affected by the policies of regional/state governments, the focus of analysis would be modified to consider such influences. In the country governance analysis the following four main areas are considered: legal infrastructure, regulation, information infrastructure and market infrastructure.

The second part of the analysis is concerned with company analysis which is concerned with evaluating the practices at individual companies. Standard and Poor assigns scores to a company’s overall practices using a synthesis of the OECD’s and other international codes and guidelines of corporate governance practices. The analysis has four main components. These four components and sub categories are as follows:

Component 1 concerned with ownership structure, relates to transparency of ownership structure, concentration and influence of ownership.

Component 2 concerned with financial stakeholder relations, has subcategories such as regularity of, access to, and information on shareholder meeting, voting and shareholder meeting procedures and ownership rights.

Component 3 concerned with financial transparency and information disclosure comprises sub-categories like quality and content of public disclosure, timing of, and access to, public disclosure and independent and standing of the company’s auditor.

Component 4, concerned with board structure and process, is related to Board structure and composition, role and effectiveness of board, role and independence of outside directors and directors and executives compensation, evaluation and succession policies.

The Anglo-Saxon system focuses primarily on the shareholder, while others, such as the German system, attempt to achieve a greater balance of interest between shareholders and other external stakeholders (creditors, employees, the community, the environment etc.). By addressing the interest of both creditors and shareholders, the scoring model recognises the importance of stakeholder’s right beyond the rights of the shareholder. Finally how can corporate governance scores can benefit different sections? Investors can use the scores to identify and compare corporate governance standards of different companies in their portfolios or the risk characteristics associated with the corporate governance practices of potential investments. Corporate governance scores and the accompanying analysis also helps investors understand how a company’s management treats the interest or shareholders, including minorities.