Corporate Governance Strategies in India: Emerging Issues for Global Competitiveness

Prof. Dr. S. Manimaran*
Hari Sundar G**
Jaspreet B.Chandok***

Introduction

As a term, 'corporate governance' is an outcome of the post-liberalization economic phase when various committees were appointed in India and outside under the circumstance of the governments and the regulatory agencies appointing such committees
to inspect the causes of corporate failure and suggest some suitable recommendations to check them.

Corporate Governance refers to the rules and incentives by which the management of a company is directed and controlled to maximize the profitability and long-term value of the firm for shareholders while taking into account the interests of other legitimate stakeholders.

Corporate Governance mechanisms may be broadly classified as external and internal mechanisms.

External mechanisms are determined by outsiders. These include,

- Institutional shareholdings
- Outside block holdings
- Takeover activity

Internal mechanisms are decided by the firm's decision makers. These consist of,

- Insider shareholding
- Board membership and characteristics (such as size of the board, number of outside independent directors, and remuneration committees)
- Debt financing
- Use of outside markets for managerial talent.

Good corporate governance, complemented by a sound business environment, can strengthen private investment, corporate performance, and economic growth.

Corporate governance has two special features in comparison to its earlier version, company or corporate management. First, the erstwhile concept of company management has two connotations: good or bad, but corporate governance means only good company management. Secondly, company management asks for maximization of wealth of the shareholders or the owners, whereas corporate governance stands for all the stakeholders in doing justice to all of them and thus not affecting any one. As a term, 'corporate governance' is an outcome of the post-liberalization economic phase when various committees were appointed in India and outside under the circumstance of the governments and the regulatory agencies appointing such committees to inspect the causes of corporate failure and suggest some suitable recommendations to check them. The three primary groups as almost unanimously identified in corporate governance by the experts are: Board of Directors, Management and Shareholders. Hunger and Wheelen (1998) defines corporate governance as ".... the relationship among these three groups in determining the direction and performance of the corporation"1. Among many other definitions of the term given by the corporate experts, authors and researchers, Narayanaswamy (2003)'s definition seems to be a compiled one with an addition of a new component, the auditors. According to him, "Corporate governance is the system by which corporate entities are directed and controlled. It encompasses the entire mechanics of the functioning of a company and attempts to put in place a system of checks and balances between the shareholders, directors, auditors and the management"2. Very rightly, in the context of so many corporate governance codes already recommended and the legislations of different countries consequently incorporating them, corporate frauds are still taking place allover the world behind which the role of the auditors has been found to be most crucial. The cases of Enron (2001) in U.S. and Securities Scam (2002) in India can be mentioned here only as two examples of many such corporate frauds that took place in the last few years allover the world.

Corporate Ownership and Governance in India

The brief features of corporate governance in India are as follows:

1. Corporate sector is divided into - family-managed private sector and public sector.
2. Unitary board structure mainly comprises of the promoters, the institutional nominees and professionals.
3. Institutional investors are generally supportive of the promoters.
4. Individual shareholders are benign, tolerant, ignorant, scattered and ill-organized,as a result of which the controlling shareholders, typically business families are responsible for expropriating minority shareholders
5. A number of corporate governance codes are recommended by various committees appointed either by the CII or DCA or SEBI and have got significant legal backing.

According to his observations, institutional and public ownership have gradually declined over a period of time (from 20% and 45% respectively in 1965, to 14% and 29% in 1999). The management of smaller firms is found to hold more than 40%. Financial institutions, which on an average hold 14%, concentrate on bigger firms by having more than 20%, although they are supposed to lend a helping hand to smaller firms. It was also found in contrary to the general belief that public shareholdings had been concentrated in smaller firms, evenly distributed in medium sized firms and low in large firms.

Major Causes of Poor Corporate Governance:

- Faulty Risk Management (e.g., Concentrating much on fixed-income business)
- Poor Internal Control Systems (e.g., Making decisions without the knowledge of the board or other senior management)
- Lack of transparency (e.g., Disclosing the transactions under the listing regulations of SEBI)
- Improper monitoring system by the government

Emerging Issues

The emerging issues in corporate governance are given as follows:

1. Change in attitude

A three-tier change is necessary in the attitudes of the promoters or entrepreneurs, the professional managers and different sections of the members. The entrepreneurs should become professional entrepreneurs, the managers should become entrepreneurial professionals and different members should become corporate citizens. Corporates have emerged as vital economic institutions for growth, commanding a large proportion of social resources. Hence, they are, like the State, answerable to society for its efficient use and its members are like the citizens.

2. Removal of agency-related problems by remunerating the managers partly in stocks and Shares
Agency problems have been advised to be solved in two principal ways:

1. by more top managerial supervision of the activities of the professional managers and
2. by remunerating the managers partly in stocks and shares.

In widely-held companies, the second way has been found to be more effective by the researchers.
In this direction, findings of various empirical studies examining the relationship between corporate performance and ownership structure are mentioned as follows.,

- The insider / outsider ratio is related with performance in a curvilinear way – that is, it is beneficial to have either a very small or very large proportion of insiders.
- The performance of owner controlled firms was far better than that of management controlled firms
- Negative relationship of market to book value ratio with low levels of insider ownership, but positive relationship with insider ownership above 25 per cent.

3. Codetermination
Codetermination is the other name for Employees' Stock Option Plan (ESOP). This has been recently introduced by the countries like United States, Sweden, Norway, Denmark, Austria and India. But countries like Germany and Japan have already experienced it very successfully. Specially, Germany is the most prominent user of codetermination and pioneered this system during 1950s with a two-tiered system: a supervisory system elected by the shareholders and employees to decide or approve corporate strategy and policy and a management board composed primarily of top management appointed by the supervisory board to manage the company's activities. Hoechst AG, the German chemical multinational, has 20 members in the supervisory board of which 10 members are elected by the shareholders. Out of the remaining 10 members, 7 members are elected from the employees of the parent company and its dependent firms and 3 members are elected by the labour union Representatives. This 20 member supervisory board appoints a 17 member management board to manage the company's activities. In India, there have been a very few examples of codetermination and also in such cases the percentage representation is negligible. It is quite easy to understand that the degree of involvement of shareholder employees will unquestionably more than that of non-shareholder employees.

4. Human face of corporate governance
Human face of corporate governance is emerging as an issue in all the countries including India. It is being increasingly looked into due to the following reasons:
1. It is too easy to forget that corporate governance is for human beings and is carried out by human beings.
2. Those in power have the potential to improve or destroy the quality of lives of many people.
3. The most difficult thing is to tackle the institutionalized abuse of power since there is no single person to deal with.

Following above, McGregor defined governance as “the process whereby the people in power make decisions that create, destroy or maintain social systems, structures and processes.” McGregor thus explained systematic governance as a combination of three components:

- Inter-group governance,
- Interpersonal governance and
- Personal governance.

5. Independence of Auditors

The external auditors owe a statutory duty to the shareholders of a company about the truth and fairness of the accounts prepared by the company officials. They also owe similar duty in respect of the statement of profit and loss and the statement of assets and liabilities, which are the natural outcomes of these accounts. The auditors’ independence is therefore quite necessary for shareholders’ reliance upon their report. At the time of doing the audit work, which is conducted during a reasonably long time, the auditors come into close contact with the internal auditors and also with different sections of company officials. Besides, to continue for getting audit assignments in the present company and its group and associated companies and to continue getting various non- audit consultancy work in the same company and other related companies (since the fees for such consultancy work far exceeds the auditor’s remuneration), the auditors often want to maintain a cordial relationship with the company administration. Besides different kinds of illegal earnings also allure them towards disobeyance of their professional duties and to lose the professional independence significantly. The provisions in the Companies Act for ensuring auditors’ independence should reflect public interest and ensure proper accountability of management to the shareholders who have provided the risk capital to the company16. However, provisions in this regard are found to be either inadequate or not very relevant in the changing corporate environment. Presently appointment and reappointment of auditors include certain legal provisions to ensure independence. For becoming an auditor of the company a person too has to fulfill certain conditions which ensure his independence. Yet still the compulsory provision of rotation after a certain period in the same company has not been carried out. Again, any provision regarding no consultancy assignment to an auditor apart from his audit assignment has not yet been included. Statutory auditorship in the Indian private sector continues to remain a monopoly of the Chartered Accountants. The Institute of Chartered Accountants of India (ICAI) itself is not very much transparent about its role in taking action against the auditors involved in different scams from time to time. One such lapse of the institute can be identified with the failure to take proper action against the erring auditors involved in the Securities Scam in India during the early part of the nineties in spite of the JPC’s report in this regard. Merely, blacklisting of nearly one hundred auditors for one year has not been enough against the volume and significance of their professional misconduct. The case of influencing an external auditor is often reflected in an unqualified audit report despite the pursuance of accounting policies, non-report of fraud and errors, weaknesses in the internal control contingencies, etc.. Though the auditors have every right as per Companies Act to present a qualified report if he does not get sufficient information and / or he observes any material misdeed by the company accountants as mentioned above. However the Chartered Accountants Act, 1949, explains professional misconduct on the part of auditors where he fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary to make the financial statements not misleading; where he fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity; where he is grossly negligent in the conduct of his professional duties, where he fails to obtain sufficient information to warrant the expression of an opinion or his exceptions are sufficiently material to negate the expression of an opinion, and where he fails to invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances. ICAI has Standard Auditing Practices (SAPs), which if not followed by an auditor would prove him guilty of committing professional misconduct.

Corporate governance in a corporate set up focuses on the accountability of the management (agent) towards its shareholders (principal) and the former is expected to discharge its function to the best interest of its principal and other stakeholders. The need

to ensure this accountability has helped to emerge the role of the third parties, the auditor. Financial reporting and its authenticity play an important role in the overall accountability. To make the team of auditors totally independent and impartial, various recommendations have been put up by the various committees appointed in India and abroad starting from the formation of an Audit Committee to the general functioning of

an auditor. These recommendations have also wide applicability from the viewpoint of protection of general investors. The Indian Companies Act, in its various amendments, and the SEBI Act have also significantly incorporated such recommendations.

6. Independence of directors

The members of the board can only take some strategic decisions applying their skill, intelligence and judgment, irrespective of the agency-related problem, for the maximum welfare of the shareholders if they are financially independent. Independence of directors is therefore quite necessary and such independence along with independence of auditors only can assure about the fullest protection.This has been given good importance in the recommendations of various committees appointed in Indiaand also latter in the Companies Amendment Bill (2003). The concept of independent directors has been explained in recommendation no. 4.1 of the Naresh Chandra Committee (NCC) Report18. According to this recommendation, an independent director of a company is a non-executive director who: _ apart from receiving director’s remuneration, does not have any material pecuniary relationship or transactions with the company, its promoters, its senior management or its holding company, its subsidiaries and associated companies;_ is not related to promoters or management at the board level, or one level below the board (spouse and dependent parents, children or siblings);_ has not been an executive of the company in the last three years;_ is not a partner or an executive of the statutory auditing firm, the internal audit firm that is associated with the company, and has not been a partner or an executive of any such firm for the last three years. This will also apply to legal firm(s) and consulting firm(s) that have a material association with the entity;_ is not a significant supplier, vendor or customer of the company;_ is not a substantial shareholder of the company, i.e. owning two persons or more of the block of voting shares;_ has not been a director, independent or otherwise of the company for more than three terms of three year each (not exceeding nine years in any case);_ an employee, executive director or nominee of any bank, financial institute, corporations or trustees of debenture and bondholder, who is normally called a “nominee director”. Narayana Murthy Committee (NMC) report (2003) has more or less confirmed the eligibility criteria of independent directorship. The Companies Amendment Bill (2003) has incorporated the above stipulations more or less in line of the NCC or NMC for an independent director in section 252A. Clause 119 of section 252A has thus mentioned eleven negative attributes, which would render a person incapable of being treated as an independent director. Two new points of ineligibility in relation to the NCC and NMC recommendations have been proposed for any person, who is holder of any equity share of a company in which he is an independent director during his tenure as such and six months after he ceases to be an independent director and for a person who is a nominated director in any other company which has nominated a director in the company in which he is an independent director.19 In addition, the bill has recommended that an independent director needs to undergo training from the prescribed institute of the government.

End Note

Narayana Murthy (2003) made some important comments on corporate governance which are as follows: "..... Corporate governance is about ethical conduct in business. Corporate governance is beyond the realm of law. It stems from the culture and mindset of management and cannot be regulated by legislation alone." Corporate Governance is actually a celebrated topic in India but not so implemented. If the Indian corporates do not yet employ meaningful corporate governance procedures, they in future may have to pay a heavy cost in raising capital from the more competitive capital market in competition with the globally efficient companies. Moreover, these companies will simply fail to cope with the increasing pressure of other global factors like losing market share of the products to the MNCs, human resource problems in form of losing the best management to the competitors, failure to comply with the requirements of the codes, etc... Thus it is a time for us not to make corporate governance only a corporate philosophy but to make it a corporate practice.

References

1. Dr. Arindam Gupta "Corporate Governance In India - Some Issues" JIMS 8M, January - March, 2005
2. Stephen Y L Cheung "Corporate Governance in Hong Kong, China – Rising to the challenge of Globalization" The Icfaian Journal of Management Research (Jan 2005)
3. Hunger, J. David and Wheelen, Thomas L."Strategic Mangement", Addison – Wesley,International Edition.
4. Narayanaswamy, T. V. : "Corporate Governance and the Composition of the Board of Directors", Chartered Secretary, Vol. XXXIII, August.
5. Panchali, Jinesh : "Ownership Patterns and Corporate Performance", Management Review, Vol. 12, No. 4, December(1998)
6. Narayana Murthy, N. R. "Corporate Governance: The Key Issues", Vikalpa
7. Berle, A. A. and Means, G. C. "The Modern Corporations and Private Properties", Macmillan, New York.
8. Gopalsamy, N. "Corporate Governance", Wheeler Publishing, First Edition

****