Corporate Governance Practices – The New Strategic Imperative

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Abstract

Corporate governance is the set of processes, customs, policies, laws, and institutions affecting the way a corporation is directed, administered or controlled. Corporate governance also includes the relationships among the many stakeholders involved and the goals for which the corporation is governed. The principal stakeholders are the shareholders, management, and the board of directors. Other stakeholders include employees, customers, creditors, suppliers, regulators, and the community at large.

Corporate governance has emerged as an important both in India and globally. Expectations of stakeholders are extremely high and the scrutiny by regulators and investors incredibly stringent. As a consequence, Indian companies are proactively implementing measures for the same. Going forward, one of the most important challenges for Board members is to build a foundation of trust with management, the investment community, regulatory agencies and the public. The stakes are high and the margin for error is low and while new standards are emerging, one thing remains clear: the responsibility to adopt sound governance practices has been placed squarely on corporate Directors and officers.

Keywords-*whistleblower, sebi, listing agreement, stakeholders, transparency, accountability, confederation of Indian industry, audit committee*

Introduction

Corporate governance is a key element in enhancing investor confidence, promoting competitiveness and ultimately improving economic growth. Corporate governance is the set of processes, customs, policies, laws, and institutions affecting the way a corporation is directed, administered or controlled. Corporate governance also includes the relationships among the many stakeholders involved and the goals for which the corporation is governed. 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.
According to Milton Friedam, "corporate governance is to conduct the business in accordance with owner's or shareholders desires, which generally will be to make as much money as possible" but this context is based on marked maximization that underpins shareholder capitalism. But this context was further expanded by J.Wolfensohn, president, World Bank, has said that "corporate governance is about promoting corporate fairness, transparency and accountability.

Even the Experts at Organization of Economic Co-Operation and Development (OECD) have defined "corporate governance" as the system by which business corporations are directed and controlled, it means according to them it is a structure which specifies the distribution of rights and responsibilities among different participants in the corporation.

But today the concept of corporate governance has taken a new dimension and it runs as follows, "Corporate governance is the application of best management practices, compliance of law in true letter and spirit and adherence to ethical standards for effective management and distribution of wealth and discharge of social responsibility for sustainable development of all stakeholders".

REVIEW OF LITERATURE

Issues of corporate governance have been hotly debated in the United States and Europe over the last decade or two. In India, these issues have come to the fore only in the last couple of years. Naturally, the debate in India has drawn heavily on the British and American literature

on corporate governance. There has been a tendency to focus on the same issues and proffer the same solutions. For example, the corporate governance code proposed by the Confederation of Indian Industry (Bajaj, 1997) is modelled on the lines of the Cadbury Committee (Cadbury, 1992) in the United Kingdom. The corporate governance literature in the US and the UK focuses on the role of the Board as a bridge between the owners and the management (see for example; Cadbury, 1992; Salmon, 1993; Ward, 1997).

Gupta, Nair and Gogula (2003) analyzed the CG reporting practices of 30 selected Indian companies listed in BSE.The study found variations in the reporting practices of the companies, and in certain cases, omission of mandatory requirements as per Clause 49. Bhattacharyya and Rao (2005) examined whether adoption of Clause 49 predicts lower volatility and returns for large Indian firms.The authors find insignificant results for volatility and mixed results for returns. Collett and Hrasky (2005) analyzed the relationships between voluntary disclosure of CG information by the companies and their intention to raise capital in the financial market.

Barako et al., (2006) examined the extent of voluntary disclosure by the Kenyan companies over and above the mandatory requirements. The results revealed that "the audit committee was a significant factor associated with level of voluntary disclosure, while the proportion of non-executive directors on the board was negatively associated. Subramanian (2006), he identified the differences in disclosure pattern of financial information and governance attributes. The study finally concluded that "there were no differences in disclosure pattern of public/private sector companies, as far as financial transparency and information disclosure were concerned. K. C. Gupta (2006) traced out the differences in CG practices of few local companies of an automobile industry. The study did not observe significant deviations of actual governance practices from Clause 49.

WHY CORPORATE GOVERNANCE?

Investors primarily consider two variables before making investment decisions--the rate of return on invested capital and the risk associated with the investment. 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. The lure of achieving a high rate of return, however, does not, by itself, guarantee foreign investment; the attendant risk weighs equally in an investor's decision-making calculus. Good corporate-governance practices reduce this risk by ensuring transparency, accountability, and enforceability in the marketplace.

The presence of a good corporate-governance framework ensures neither stability nor success, it is widely believed that corporate governance can raise efficiency and growth, especially for countries that rely heavily on stock markets to raise capital. In fact, some contend that the Asian financial crisis gave developing countries ... a lesson on the importance of a sound corporate governance system.

In an open market, investors choose from a variety of investment vehicles. The existence of a corporate-governance system is likely a part of this decision-making process. In such a scenario, firms that are more open and transparent, and thus well governed, are more likely to raise capital successfully because investors will have "the information and confidence necessary for them to lend funds directly" to such firms. Moreover, well-governed firms likely will obtain capital more cheaply than firms that have poor corporate-governance practices because investors will require a smaller risk premium for investing in well-governed firms.

Also, sound corporate-governance practices enable management to allocate resources more efficiently, which increases the likelihood that investors will obtain a higher rate of return on their investment. Finally, leading indices show that developing countries that have good governance structures consistently outperform developing countries with poor corporate-governance structures. Thus, in an efficient capital market, investors will invest in firms with better corporate-governance frameworks because of the lower risks and the likelihood of higher returns.

At a macro level, if firms in developing countries attract investment, they will stimulate growth in the local economy. If they cannot attract equity capital, they are doomed to remain on a small,

inefficient scale, and they will be unable to stimulate growth in their host country.

Good corporate governance benefits developing countries in a number of ways. According to at least one scholar, good corporate-governance practices can decrease the likelihood of a domestic financial crisis and the severity if such a crisis does occur. Additionally, scholars have found strong evidence linking corporate governance to corporate efficiency and have shown that corporate governance creates more efficient corporate management. Finally, research shows that well-governed firms are valued significantly higher than firms with imperfect corporate-governance practices. The policy challenge that exists for governments in developing countries is to provide a hospitable environment for such funds; a sound corporate-governance framework can play a decisive role in creating this hospitable environment. Good corporate governance can reduce this wasteful behavior and, thus, overcome the obstacles to productivity growth. Moreover, corporate governance can play a role in reducing corruption, and decreased corruption significantly enhances a country's developmental prospects. Ultimately, corporate governance is not just one of those imported western luxuries; it is a vital imperative.

CORPORATE GOVERNANCE IN INDIA

From the beginning of 1980s, situations have changed in India. There have been wide-ranging changes has taken place in both the laws and the regulations in the field of corporate law and the capital market. As a result of several scams in India a need has arisen to bring reforms, in response to that, reforms began in 1991 in India. The most important event in the field of investor protection in India was the establishment of Securities and Exchange Board of India (SEBI) in 1992.

In India, the Confederation of Indian Industry (CII) took the lead in framing a desirable code of corporate governance in April 1998. This was followed by the recommendation of the Kumar Mangalam Birla Committee on corporate governance appointed by the SEBI in the year 1997.The introduction of Clause 49 in Listing Agreements in the year 2000 by SEBI was a major turning point in the history of corporate governance in India.

In the Report of SEBI committee (India) on Corporate Governance defines corporate governance as, the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. The recommendations of the committee were enshrined in clause 49 of the Listing Agreement of every Indian Stock Exchange. Every Company which has opted to list its shares in the recognized Stock Exchanges should enter into a listing agreement and non-compliance of the terms and conditions of the agreement can lead to a stringent action by the Stock Exchanges like de-listing of shares.

CLAUSE 49 OF LISTING AGREEMENT

Clause 49 of the listing agreement to be entered into by the listed companies with the Stock Exchanges refers to certain conditions under the heading “Corporate Governance”. The said clause 49 mandates various conditions to be complied with by the Companies under the head “Corporate Governance”. Thus, it is specific to the Listed Public Companies though the word “Corporate Governance” is used in general and as a synonymous to “Good Governance”. An important decision taken in this regard in India is that all listed companies should have 50% independent directors in their board.

The listing agreement to be complied with by all the listed companies, though lists out many conditions, clause 49 occupies significance. Clause 49 of the listing agreement emphasizes on executive directors, composition of directors, independent directors, disclosures by non-executive directors and their compensation, provisions as to committees like Audit Committee, Code of Conduct, some additional disclosures, CFO/CEOcertification and a report on Corporate Governance etc. The logic behind the further conditions on the listed companies under clause 49 of the listing agreement is just a further effort to eliminate the loopholes and for the protection of investors/shareholders.

In 2002, the Naresh Chandra Committee on corporate audit and governance submitted its Report. Subsequently, in order to review the existing corporate governance code, SEBI constituted the Narayana Murthy Committee based on whose recommendations made in 2003, far-reaching changes were made in the Listing Agreement in 2004. The Ministry of Corporate Affairs also

constituted an Expert Committee on Company Law under the chairmanship of Dr. J J Irani which released its Report in May 2005.

As per the revised clause 49 of the listing agreement based on the Narayana Murthy Committee , the companies are required to submit a quarterly report to the stock exchange within 15 days from the end of every quarter. The report should be signed by the compliance officer or CEO of the company. This revised clause is not applicable to mutual funds. The stock exchange should see whether the company has fulfilled all the provisions of the revised clause 49 like whether it has set up its Board and constituted committees such as, audit committee, investor grievance committee etc before seeking in principle approval for listing.

Along with that the Stock Exchanges shall also set up a separate monitoring cell with identified personnel to monitor the compliance with the provisions of the revised clause 49 on corporate governance. The cell, after receiving the quarterly compliance reports from the companies which are required to comply with the requirements of the revised clause 49, shall submit a consolidated compliance report to SEBI within 60 days from the end of each quarter. In the revised clause 49 it made mandatory that there should be a separate section on corporate governance in its annual report and its should obtain a certificate from either the auditors or practicing company secretaries regarding compliance of conditions of corporate governance. The certificate along with the directors report to be sent annually to all the shareholders of the company.

WHISTLE BLOWER POLICY

The SEBI had constituted a Committee on Corporate Governance under the Chairmanship of Shri N. R. Narayana Murthy to further improve the standards of corporate governance in India. Basing on the committee report, SEBI vide its circular dated 26th August 2003, has introduced some major amendments to Clause 49 of the Listing Agreement. One of the important amendments is the Whistle Blower Policy. The main object of the Whistle Blower Policy is to detect frauds, irregularities and encouraging employees to come forward to Audit Committee. The following are the main features of the "Whistle Blower Policy" they are:

i. Personnel who observe an unethical or improper practice (not necessarily a violation of law) shall be able to approach the audit committee without necessarily informing their supervisors.
ii. Companies shall take measures to ensure that this right of access is communicated to all employees through means of internal circulars, etc.
iii. The employment and other personnel policies of the company shall contain provisions protecting "whistle blowers" from unfair termination and other unfair prejudicial employment practices.
iv. Company shall annually affirm that it has not denied any personnel access to the audit committee of the company (in respect of matters involving alleged misconduct) and that it has provided protection to "whistle blowers" from unfair termination and other unfair or prejudicial employment practices.
v. Such affirmation shall form a part of the Board report on Corporate Governance that is required to be prepared and submitted together with the annual report.

But the SEBI because of the pressures from different corporate sectors it has now made the Whistle Blower Policy a non-mandatory requirement, before such revise of Clause 49 of the listing agreement it was a mandatory requirement. This shows how the SEBI is still under the impact and within the clutches of the corporate field sectors.

CONCLUSION AND SUGGESTIONS

In India, guidelines for corporate governance are provided in clause 49 of the listing agreement and also in various sections of the Companies Act. Industry experts hold view that once appointed, the performance and contributions of these directors should be monitored and evaluated objectively with peer reviews serving as a means of such evaluations. A stronger corporate governance framework is needed to prevent Satyam-like financial frauds. There is a need to strengthen regulators and company laws to improve corporate governance, by the corporate ministry. A new Companies Bill, which is pending in

Parliament, would make regulation more stringent for auditors. The new bill seeks to revamp archaic laws to help India's growing corporate sector adopt international best practice, and make boards and senior management of companies more accountable.

What is to be kept in mind is that in India adequate safeguards are provided for in the form of various laws but the penalty stipulated for is comparatively meagre and thus the wrong doers have no fear of punishment. Only if the punishments to be imposed are made stringent and it acts as a deterrent can it be expected that such frauds can be controlled in future. More so, there is no expertise of the implementing authorities for detecting and curing the Economic Offences. There is a need to make a separate body to look into the affairs and implement the laws and other provisions to curtail such offences. There is also a lack of political will power to curb such offences, the politicians take a lenient view and leave the investigation and other vital steps into the hands of CBI which is not a body made to specifically deal with such white collar crimes. Unless there reason enough for the miscreants to be scared of penal provisions that send a shiver down their spine. Such offences will continue to happen and we will keep thinking of devising ways to tackle with them.

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