Corporate Governance in India: evolution and challenges ahead

"Good corporate governance is about 'intellectual honesty' and not just sticking to rules and regulations, capital flowed towards companies that practised this type of good governance" - Mervyn King

While it is unlikely that Mervyn King had foreseen a Satyam scandal while he said the aforesaid sentence, Lex Witness takes you through a journey as we navigate the sea of corporate governance in India....

■ Avinash Mohapatra

Probably, the CWG scam didn't attract as much international attention as the Satyam Scandal. Corporate governance has been hotly debated in the USA and Europe over the last two decades. It would be fair to say that, in India, this debate has come up only in the last couple of years, more or less after the Satyam scandal. It is universally acknowledged that strengthening the Board of Directors of a company is the best bulwark against insufficient governance. Experts are of the opinion that a careful balancing of various factors, including adequate information to directors; accountability; competence and activism from promoters may aid in implementing effective corporate governance in India.

CORPORATE GOVERNANCE CODE

The corporate governance code proposed by the Confederation of Indian Industry is modeled on the lines of the Cadbury Committee (Cadbury, 1992) in the United Kingdom. On account of the interest generated by Cadbury Committee Report, the Confederation of Indian Industry (CII), the Associated Chambers of Commerce and Industry (ASSOCHAM) and the Securities and Exchange Board of India (SEBI) constituted Committees to recommend initiatives in Corporate Governance. The main objective of it was to develop and promote a code for Corporate Governance

Rajiv Luthra
Managing Partner, Luthra & Luthra Law Offices, New Delhi

Q. Is Clause 49 of the Listing Agreement a bold initiative towards strengthening corporate governance in India?

A. When compared against the global average, India has a very high ratio of companies controlled by their founding families. Considering this, requirements such as having independent directors on the board and an audit committee with defined responsibilities, are absolutely imperative. Clause 49 of the Listing Agreement, particularly after the amendments which have come in after the Narayana Murthy Committee report, goes a long way towards integrating these and other concepts in the structures and processes of Indian companies.

However, when it comes to good corporate governance, following the spirit of the law is as imperative as following its letter, and this is perhaps one area where we need to improve. The board of Satyam was supposedly in compliance with all the Clause 49 requirements in relation to independent directors, but they still failed to prevent, or even detect, such a spectacular fraud. This demonstrates that good corporate governance is something that needs to be embedded in the psyche of the managers and officers of a company. No law can ensure that a director asks the right questions in a board meeting, and no regulation can ensure that a whistleblower feels safe enough to report unethical behavior.

...as told to Avinash Mohapatra of Lex Witness Bureau

to be adopted and followed by Indian companies, be these in the Private Sector, the Public Sector, Banks or Financial Institution, all of which are corporate entities.

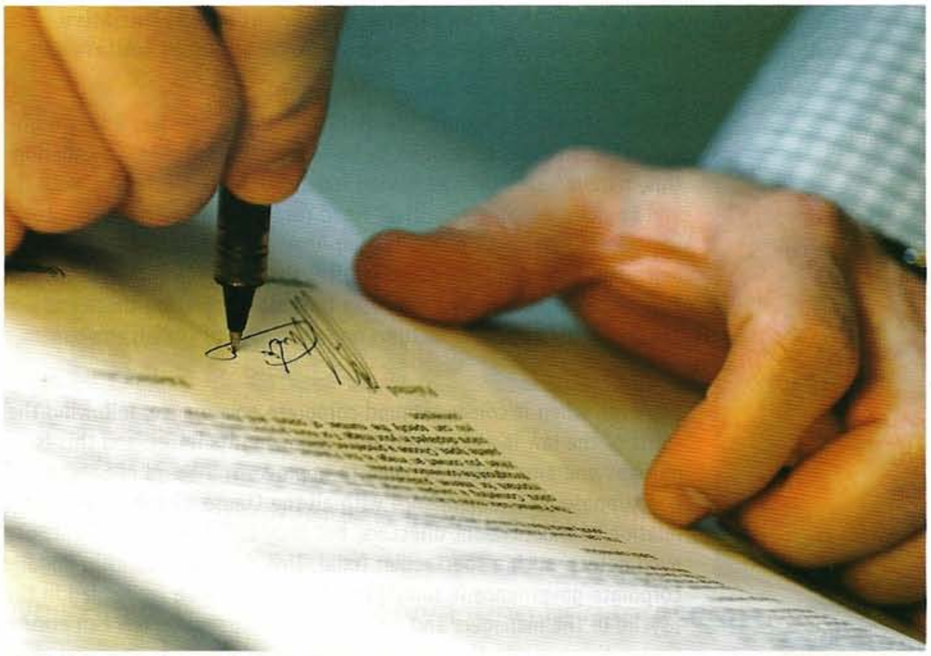
In the Indian context, the need for corporate governance has been highlighted because of the scams occurring frequently since the emergence of the concept of liberalization from 1991. We had the Harshad Mehta Scam, Ketan Parikh Scam, UTI Scam, Vanishing Company Scam, Bhansali Scam and so on. In the Indian corporate scene, there is a need to induct global standards so that at least while the scope for scams may still exist, it can be at least reduced to the minimum.

TYPES OF CORPORATE GOVERNANCE MECHANISMS

There are two broad categories of financial systems; the market-based system exemplified by the British and American systems and the bank-based system typified by Japan and Germany.

The market-based system, marked with effective distancing of ownership and control, trusts financial markets with the ultimate role of corporate governance. It is characterized by the chairman of the board of directors who is accountable to a group of shareholders who generally find selling shares an easier way to express their dissatisfaction with inefficient management. Block shareholders have relatively less power though financial

In the Indian context, the need for corporate governance has been highlighted because of the scams occurring frequently since the emergence of the concept of liberalization from 1991. We had the Harshad Mehta Scam, Ketan Parikh Scam, UTI Scam, Vanishing Company Scam, Bhansali Scam and so on. In the Indian corporate scene, there is a need to induct global standards so that at least while the scope for scams may still exist, it can be at least reduced to the minimum.



A director who as an interest in a company transaction is under a duty to ensure that the provision of the Act and of Articles are complied with namely , his declaration of interest and the names of the directors who voted is recorded in the minutes of the Board Meeting

institutions like pension funds do hold big chunks of stocks. Banks have practically little control over management.

Whereas, corporations in the bank based systems in Germany and Japan function quite differently. In Germany for instance, share ownership is less diffuse and banks play a much more important role as providers of finance and monitors of day-to-day activity. The board structure is substantially different with corporations being run by giant sized supervisory boards and the management is carried out by another board. The company has a very close relationship with its Hausbank, a universal bank that owns shares in the company and usually has board representation.

The Indian situation may be thought of as a combination of these two conflicting models. Though the basic corporate legal structure is market-based system, share ownership is far less dispersed and financial institutions play a much bigger role in financing corporate activity. Share ownership and board representation of financial institutions give these bodies the abilities to serve as important monitors of management activities though the relationship. The powers, however, are considerably limited as compared to those in typical bank-based systems.

LEGAL PROVISIONS ON CORPOR GOVERNANCE

SEC 192A OF COMPANIES ACT 1

A committee on Corporate Govern set up by the SEBI under the Chairmanship of Shri Kumaramangl Birla suggested that voting at the gen meeting of companies is the most val and fundamental mechanism by whic shareholders would either accept or r the proposals of the Board of Directo Voting is the only mechanism availab through which the shareholders can exercise an external check on the Bo and the management. With a view to strengthening shareholders' democra is felt that all the shareholders of a company should be given the right to on certain critical matters through a p ballot system , which was also reflect the Companies Bill 1997.

This section enables members to ex their voting right sitting at home throu the postal ballot which they might not otherwise done because of their inabil attend meetings or to appoint proxies. There is a prescribed procedure for p ballot given in the Companies Act.

SECTION 217 (2AA) OF COMPAN ACT 1956

Under this provision, the report of Board of Directors is to be attached t balance sheet and it is manadatory to provide the following information:

- State of companies affair
- Amount, if any proposed to be car to any reserves in the balance shee
- Amount, if recommended for the payment of dividends.
- Particulars regarding conservation energy technological absorption ar

foreign exchange earnings.

- Reasons for the failure, if any, to complete the buy back within 12 months
- Directors responsibility statement

Board's report to include Director's Responsibility Statement: This provision was inserted by the Companies Act (Amendment) Act, 2000 to include in the Directors Report-

- A statement that Accounting Standards have been followed and explanation for material departure
- Accounting policies adopted
- Care taken for the maintenance of accounting records
- Accounts prepared on a "going concern" concept.

Review of information by Audit Committee: The Audit Committee shall mandatorily review the following information:-

- Management discussion and analysis of Financial condition.
- Statement of significant related party transaction.
- Internal audit reports.

SECTION 299 OF COMPANIES ACT 1956

This section applies to all private as well as public companies and states that there should be clear and specific allegation of facts creating duty of disclosure and violation of that duty should be established. There should be intention to defraud shareholders as was held in Gordon Woodroff & Co. Ltd V. Gordon Woodroff Ltd. (1997)97 Com Cases 582.

A director who as an interest in a company transaction is under a duty to ensure that the provision of the Act and of Articles are complied with namely , his declaration of interest and the names of the directors who voted is recorded in the minutes of the Board Meeting.

CLAUSE 49 OF THE LISTING AGREEMENT

With the introduction of Clause 49 in the Listing Agreement, the issue of corporate governance has acquired centre-stage. In its constant endeavour to improve the standards of corporate governance in India, SEBI, in October 2002, constituted a Committee on Corporate Governance under the Chairmanship of Shri N. R. Narayana Murthy. Based on the recommendations of the said Committee and public comments received thereof, SEBI issued a circular on August 26, 2003 revising Clause 49 of the Listing Agreement, to review the progress of the corporate sector in meeting the norms of corporate governance and to determine the role of companies in responding to rumour and other price-

Vinay Ahuja

Legal Adviser, DFDL Mekong Law Group, Laos

Q) What efforts have been made to enhance corporate governance in India ? Have they been implemented successfully?

A. The efforts for enhancement of corporate governance in India was mainly started by the constitution of the Committee on Corporate Governance in 2002 under Securities and Exchange Board of India, in order to evaluate the adequacy of existing corporate governance practices and further improve these practices. The key points of focus in limited time have been on strengthening the responsibilities of audit committees; improving the quality of financial disclosures, including those related to related party transactions and proceeds from initial public offerings; requiring corporate executive boards to assess and disclose business risks in the annual reports of companies; introducing responsibilities on boards to adopt formal codes of conduct; the position of nominee directors; and stock holder approval and improved disclosures relating to compensation paid to non-executive directors.

With scams like Satyam Computers which have haunted the corporate governance regime in India, I believe that India is certainly lagging behind and needs to go a long way for implementation of good corporate governance practices. Primarily, all the large corporate houses /& institutions need to evolve certain initiatives and practices like codes of conduct and whistle blower policies; board members and senior management to lead by example; making the selection of independent directors more rigorous, transparent and aligned to the company's needs; focus on the sustainability of business models; developing criteria that focus on substance of governance; compensation of executive directors flowing from an objective performance evalution process conducted by the board; and greater transparency and disclosure of executive performance criteria including financial and non-financial measures.

Effective corporate governance enhances acce to external financing by firms, leading to greater investment as well as high growth and employment. the statistics suggest, the ratio of stock market capitalization to GDP in countries in the highest quartile of shareholder rig enactment and enforceme is about four times as larg as that for countries in the lowest quartile. We have also learnt from the weste world that, poor corporat governance also hinders t creation and developmen of new firms.

sensitive information circulating in the market in order to enhance the transparency and integrity of the market players and participants.

Major changes have been made to the definition of 'independent directors', 'strengthening the responsibilities of audit committee', 'improving the quality of financial disclosures' and finally, the board as a whole has been tasked with the adoption of a formal code of conduct for senior management and the certification of financial statements issued by the CEO.

Accordingly, companies are now required to form various committees like a 'nomination committee', 'compensation committee', 'governance committee' to adhere to corporate governance. Hence, summing up, the major changes in the new Clause 49 are as follows :

- Amendments/additions to provisions relating to definition of independent directors,
- Strengthening the responsibilities of audit committees,
- Improving quality of financial disclosures, like
- Related party transactions
- Proceeds from public/rights/preferential issues,
- Requiring Boards to adopt formal c of conduct and also for senior management,
- Requiring CEO/CFO certification financial statements,
- Improving disclosures to sharehold

CONFLUENCE WITH CORPORATE SOCIAL RESPONSIBILITY

Erasing the distinction between corporate governance and corporate responsibility reveals the challenge of developing a well-rooted programme it is submitted that it would be difficu separate the two. The Ministry of

Corporate Affairs (MOCA) has adopted the role of an enabler, facilitator and regulator for effective functioning and growth of the corporate sector. In order to assist the business to adopt responsible governance practices, the MOCA has endeavoured to bring out a set of Corporate Social Responsibility (CSR) voluntary guidelines in December 2009. These guidelines have been prepared after taking into account the governance challenges faced in India.

ADVANTAGES OF EFFECTIVE CORPORATE GOVERNANCE

Effective corporate governance enhances access to external financing by firms, leading to greater investment as well as higher growth and employment. As the statistics suggest, the ratio of stock market capitalization to GDP in countries in the highest quartile of shareholder right enactment and enforcement is about four times as large as that for countries in the lowest quartile. We have also learnt from the western world that, poor corporate governance also hinders the creation and development of new firms.

Good corporate governance additionally lowers the cost of capital by reducing risk and creates higher firm valuation once again boosting real investments. It has the potential of significantly reducing the risk of nation-wide financial crises. There is a strong inverse relationship between the quality of corporate governance and currency depreciation. Poor transparency and corporate governance norms are believed to be the key reasons behind the Asian Crisis of 1997.

Such financial crises have massive economic and social costs and can set a country several years back in its path to development. Efficient corporate governance can remove mistrust between different stakeholders, reduce legal costs and improve social and labour relationships and external economies like environmental protection.

EPILOGUE

The Companies Bill, 2008 and even the 2009 Bill (drafted after Satyam scandal) does not provide for rotation. However, in the wake of the Satyam saga, the Select Parliamentary Consultative Committee (SPCC) has recommended rotation of audit firms. This would mean that the large Indian companies will be forced by private equity investors and international bankers to move to Big Four and the mid-tier Indian firms will be left with those companies which the international banks and financial institutions stay away from.

The legal system of a country plays a crucial role in creating an effective corporate governance mechanism in a country and protecting the rights of investors and creditors. The legal environment encompasses two important aspects – the protection offered in the laws (de jure protection) and to what extent the laws are enforced in real life (de facto protection). Both these aspects play important roles in determining the nature of corporate governance in the country in question. Having said that, the fact remains that while important investor protection legislations are on paper, their implementation leaves a lot to be desired when compared to the international best practices.

ABOUT THE AUTHOR:

Avinash Mohapatra is the Resident Editor for Lex Witness. Avinash holds an LLM in International Finance Laws from King's College London and has also worked with a law firm in London. Mr Mohapatra is a practising Advocate and happens to be an alumnus of Symbiosis Law School, Pune.