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Corporate Governance in the Changing Scenario

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Abstract

Corporate governance is in existence since 1961 but hardly being implemented effectively in practice. However, with the failure of giant business firms such as Enron, Tyco International, Adelphia, peregrine systems and WorldCom, the economy of several nations was shaken. This forced them to consider the implementation of good governance practices as one of the primitive responsibility for the real economic development of their nation. In fact, it has been realized that in the absence of efficient governance mechanism, no nation in the world can think about its progress.

Considering these facts, the objective of this paper is to describe the reforms initiated in respect of corporate governance practices since inception and further to highlight the conceptual framework regarding corporate governance prevalent in India. For this purpose, existing literature has been reviewed and analyzed to present a generic framework of some important aspects of corporate governance practices in India.

Keywords: Corporate Governance, Disclosure, Transparency

Introduction

The existence of corporate governance practices came into effect since 1961, though hardly be implemented effectively in practice. The economy of several nations was shaken with the failure of leading business firms such as Enron, Tyco International, Adelphia, peregrine systems and WorldCom; due to this US investors had lost their confidence in US security market. This forced them to consider the implementation of good governance practices as one of the essential priority of their economic development.

As a result, major reforms were initiated by various stock exchanges and regulatory bodies across different countries like Sarbanes-Oxley act (2002) of US. These reforms were implemented to create a system of regulations and controls and to regain investor's confidence in the corporate firms. In fact, it has been realized that in the absence of efficient governance mechanism no nation in the world can survive in the dynamic environment.

Considering these distressing situation, nations throughout the globe started thinking towards the system of transparency and disclosures as well as the importance for the compliance with good governance norms on the part of firms. India was lagging behind in this respect. However with the introduction of liberalization and globalization in the beginning of 1990's, when liberalization took place and corporate governance established an international context. Due to globalization,

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India started moving from a closed economy towards an open and welcoming economy. In the open economy, the number of listed firms was increased proportionately and foreign investors were attracted towards the tremendous opportunities for investment. India also started realizing the need for corporate governance with the Harshad Mehta's securities scam, the scam was uncovered in April 1992, involving a large number of banks and resulting huge changes in the stock market for the first time since the initiation of reforms in 1991.

The paramount concern of the government is to save the economy from such a precarious situation. Therefore, the corporate governance movement was started with the establishment of Securities and Exchange Board of India (SEBI) in1992.The main objective of SEBI is to supervise and standardize stock trading, but it gradually formed many corporate governance rules and regulations. The next major change is the formation of Confederation of Indian Industry (CII) in 1996, with the intent to develop the set of laws for Indian companies related to corporate governance. Then two committees Kumar Mangalam Birla and Narayan Murthy under Securities and Exchange Board of India started laying the groundwork for formalizing the best practices on corporate governance. Based on suggestions from these committees, Clause 49 was made a part of the listing contract for the companies listed on the Indian stock exchange. However, corporate scandals like Enron, Satyam and WorldCom etc. forced the clause 49 to be reframed to overcome the problems that caused these companies to collapse and shatter the economies of the respective countries. (N.Sanan and S.Yadav,2011).

Since, in 2004 India became the second most attractive FDI location among manufacturing investors (Kearney, A. C., 2004). But the foreign direct investments in India are more skill intensive rather than capital intensive. Due to the competition in the global market there is a need to attract talent from a worldwide employment pool. It became a motivating factor for Indian firms to improve their regulations and practices related to corporate governance and to adopt international corporate governance standards. (Khanna & Palepu, 2001). Indian companies have to be more focused on transparency and Shareholders value maximization to attract more foreign direct investments.(R. Ramakrishna, 2007).

Considering these facts, the objective of this paper is to give an overview of the corporate governance reforms initiated since inception and to develop a conceptual framework regarding corporate governance practices prevalent in India. Existing literature has been reviewed in this context to develop a generic frame work of corporate governance practices.

For this purpose, the paper has been divided into six sections. The first section is related to the introduction, specifying the emergence of corporate governance practices and the framework of the paper. Second is the literature review. Third section describes the methodology opted for the paper. The fourth section presents a brief overview of corporate governance initiatives initiated by Indian government, This section also explains the recommendations of various committees formed by the government such as Narayan Murthy committee, Naresh Chandra committee, Kumar Managalam Birla committee, J.J. IRANI committee etc. to initiate good governance practices in India.

Further the fifth sectionof this paper discusses the importance and use of some parameters of corporate governance, for instance, CEO compensation, board meetings, whistle blower policy, disclosure and transparency, code of conduct, independent director, composition of board and board committees; these parameters havelaid an impact on the performance of a firm.

Lastly, sixth section is related to the concluding observations. It enumerates some recommendations that need to be addressed to save the economy from corporate scandals.

LITERATURE REVIEW

This section of the paper summarizes existing researches conducted at national and international level related to corporate governance .

Some of the researchers have supported to the corporate governance practices, have an impact on the firm survival and growth while others have found no such relationship. Eccles et al. (2012)have explained that sustainability is to be embedded in the organizational culture and the governance structure needs to be tailored accordingly. They emphasized on the significance of two key elements of Corporate Governance, i.e. Board of Directors (BOD) and Executive Compensation, to ensure sustainable growth of the organization. Gompers et al. (2003) have studied governance index for 1500 large US firms, and find the risk-adjusted returns of firms with strong governance are 8.5% higher than firms with poor governance. L. Som (2006) states that corporate governance of property protection and safe modes of ownership registration affects the firm's capital mobilization. The author suggests that for receiving the funds from the market, the firm has to be consistent in disclosing its details. Further, for effectively handling the capital received, by the company they should have well-planned incentive schemes, proper resource allocation and resource distribution. Zahra and Pearce (1989); Jonnergard et al. 1995 and Maasen 1998) have analyzed that corporate governance has an indirect effect on the company performance, they have studied the integrative models encompassing board involvement, different theoretical perspectives and various board attributes such as board size, board composition and number of non-executive directors on the board .

S. Claessens and B. Yurtoglu,(2013) explain the affect of corporate governance on the performance of firm as well as on the nation. They have stated that corporate governance help the firms in accessing outside finance and generating wealth by better distribution of resources and good management practices. As a result there Capital cost is decreased and the firms are valued at higher cost; on the one hand this directs them towards the growth path by reducing unemployment and on the other hand corporate governance can be associated to reduce financial crises at national or at country level, Since these crises, have devastating effects on economy of any country. The authors enumerate, if corporate governance practices are followed properly, this creates better rapport with the stakeholders.

On the contrary,Laing and Weir (1999) have found the basic reasons for no such positive relationship between non-executive directors and firm performance are part-time employment of non-executive directors, lack of highly technical issues and non availability of sufficient information while taking key decisions. Further, Mukherjee and Ghosh (2004) portray dismal scenario and have concluded that corporate governance in India is still in a young and developing stage and the investment decisions of Indian investors are volatile. Bhasin (2010), Brahmbhatt et al, (2012), Bhardwaj and Rao (2014) have analyzed that there is still a loop hole present between applying governance norms and required governance norms for the effective and efficient system, there exists a haziness in correlation between compliance of corporate governance parameters and net profit. However, authors have recommended an additional range of existing mandatory needs of Clause 49. Sharma et al (2009) describes that all the firms listed on renowned stock exchanges of India have completed agreement with mandatory corporate governance practices as per the clause 49 SEBI listing agreement(Securities and Exchange Board of India), however, with reference to non mandatory needs and the extent of corporate responsibility disclosure, the outcome were quite disappointing. Patel and Patel (2012) mention that there exist the inter-company differences in the adherence to corporate governance norms, as different parameters are given importance by companies as per their level of Market capitalization and working laws pertaining to the industry they are belonging in.

In light of the reforms undertaken in the recent years in respect of corporate governance and evidences from various empirical researches exhibit that some of the parameters like board directors, executive compensation, board size and number of non-executive directors on the board have been used considerably to study the impact of corporate governance on firm performance in India. However, there is no such study has been found which has summarized the reforms undertaken by government and presented a brief overview of corporate governance since its inception. Therefore, objective of this paper is to present a summary of corporate governance practices, norms and recommendations in India since inception. The paper also develop a conceptual framework in this respect.

RESEARCH METHODOLOGY

This paper discusses the conceptual framework of corporate governance practices since inception. For this purpose existing literature review with the national and international experience has been summarized.

Some of the important component of corporate governance practices referred as key components and their implications has been described in this paper. Similarly, the recommendations of some of the important committees has also been enumerated in this paper.

CORPORATE GOVERNANCE IN INDIA

This part of the study describes the corporate governance practices in India. Corporate governance has became an important issue for India as problems related to investor protection, lack of capital formation in the economy, unemployment, intense competition from multinationals firms are of paramount concern and can never be resolved without good corporate governance practices .In order to solve these problems and to keep the Indian economy on growth track it is important that good corporate governance practices matching the international best practices must be enforced. These are not only necessary for the survival and growth of the firms but these are also vital for the economic development of a nation. There are many instances revealing that the business could not survive in the market without following ethical standards be is national or international market.

The foundation for the corporate governance in India is led with the established of Securities and exchange board of India (SEBI) In 1992 with the objective to supervise and standardize stock trading, In fact, gradually SEBI had started forming rules and regulations for the corporate governance to enhance transparency. The major initiative was the formation of confederation of Indian Industries in 1998 which gave desi rable corporate governance code to be followed by firms in the country. Further many committees were constituted from time to time in order to cope with the changing scenario which came up with recommendations that can improve the corporate governance practices in India. In this regard, Kumar Managalam Birla Committee which was formed in 1999 that suggested various mandatory and non- mandatory recommendations applicable for all the listed companies having paid- up capital of over Rs 3 core or net worth of over Rs 25 core at any given point of time. Adoption of these recommendations was ultimately the responsibility of board of directors. Department of corporate affairs formed a task force on corporate excellence under the chairmanship of Dr.Sanjeev Reddy in 2000.

Till Then corporate governance was not given due importance, Whereas economies crisis in US due to corporate failures alarmed the Indian government to look back at their preparedness from such collapses. For strengthening the corporate governance practices in India, Naresh Chandra committee was formed in 2002 and also the RBI consultative group of directors of banks / financial institutions came up with the recommendations applicable on all public as well

as private sector banks, Afterwards to examine the role of companies in responding to price – sensitive information circulated in market,. The Narayana Murthy committee in 2003 studied seven parameters – ease of implementation, transparency, verification, importance, accountability, enforcement and fairness. In this direction, J.J. Irani committee also gave recommendations in the year 2005 and addressed the on issues such as management and board governance, related party transactions, minority interest, investor education and protection, access to capital, accounts and audit, mergers and acquisitions, investigations under the companies act and restructuring and liquidation.

Keeping in view the recommendations of these committees clause 49 was introduced on 1 January 2006. In addition, ICSI gave recommendations to further strengthen the corporate governance framework. Recently, in 2012 Adigodrej committee recommended "guiding principles of corporate governance which also stand incorporated in companies' act 2013. Finally, all these efforts led to the enforcement of companies'act 2013 in place of companies' act 1956. To incorporate the necessary changes in clause 49 SEBI issued guidelines in 2014. In order to ensure the transparency in the working of firms, SEBI introduced listing obligations and disclosures requirement(LODR) in 2015. (NFCG report – 2017).

KEY COMPONENTS OF CORPORATE GOVERNANCE PROCTICES

The vast phenomena of Corporate governance has been studied in many ways. This section of the paper focuses on some of the important aspects that influences the firm performance, few of them listed below are.

Composition of board

Boards of directors, consisting executive and non- executive directors are elected by the stockholders of the firm, they are entrusted with the responsibility to manage the company. The former is directly responsible for business functions such as finance and marketing andthe day-to-day affairs of the company. (Weirand Laing, 2001). They are full time employees of the company and have clearly defined roles and responsibilities. However, the later one i.e. executive directors are not in a strong position to monitor or discipline the CEO (Daily and Dalton, 1993). It is therefore important to have a mechanism in monitoring the actions of the CEO and executive directors and to ensure that they pursue shareholder interest.

On the other hand, for effective management of a company experts and experienced persons with requisite knowledge and specialized skills are also required. Non- executive directors also known as senior most directors or outside directors of the company, treated as an experts and selected from within the country or outside the country. Dare (1993) argues that non-executive directors are effective monitors when ask firm's strategy related questions. They are able to provide independent judgment when dealing with the executive directors in areas such as pay awards, executive director appointments and dismissals.

While some research studies have questioned the presence of non- executive directors on the board and have stated that they do-not contribute effectively towards the performance of the firm. Two recent US studies Yermack 1996, Bhagat and Black, 1999have found a negative relationship between the proportion of outside directors and corporate performance. Chaganti et.al. (1985) also found that there is no difference in the proportion of non-executive directors on the boards of failed and non-failed firms. Likewise,(Vageas and Theodorou 1998; Laing and Weir, 1999) also do not find a relationship between the proportion of non-executive directors and corporate performance.

Board meetings

In board meetings, governing body of the company meets for conducting the affairs of a company or discuss the issues related to the functioning of the firm. Generally, such meetings are presided by the chairperson and all the members including the chairperson are liable for the decisions taken at such meetings. The details of the decisions taken in such meetings are recorded and made available to others as minutes of the meetings.

Vafeas (1999) has noted that one of factor that effect how boards operate is the frequency of board meetings. From meetings Board members get a chance to come together and discuss and exchange the ideas on monitoring strategies. More frequent the meetings, closer the supervision and control over managers, the more relevant would be the advisory role. All these will lead to a positive impact on the performance (proactive boards). P.D. Andres (2008) found a positive relationship between the number of board meetings and bank performance. The results supported that bank board meeting plays a role that is more proactive than reactive. (1999);

But on the other hand, Berthelot, S., et.al (2012) found that the frequencies of board meetings are negatively related to the firm's net book value or income.

On the other hand, frequent meetings might also be a result of board's reaction to poor performance (reactive boards).

Code of conduct

In general, code of conduct is the guidelines for ethical behavior are applicable to individuals as well as organizations. As individuals and organizations are an integral part of the society so they must also act in the desired manner and must not harm the society by their wrong deeds. In this respect, Kumar Managalam Birla committee (1999) has suggested that - It should be obligatory for the Board of a company to lay down the code of conduct for all Board members and senior management of a company. This code of conduct shall be posted on the website of the company.

The Narayanamurthy committee (2003) also recommended that board of the companies should be made responsible for adoption of formal code of conduct in the companies. Clause 49 states that all board members and senior management personnel shall affirm compliance with the code on an annual basis. The annual report of the company shall contain a declaration to this effect signed off by the CEO and COO.

Whereas companies' act 2013 provides for the code of conduct for independent directors under schedule IV of the act .This schedule ensure adherence to various standards required to be comply by the independent directors. Focusing on detailed guidelines and deliberations for the professional conduct, role, functions and duties, code emphasizes on the appointment, re-appointment process, and removal and resignation procedure. Under this code separate meetings of independent directors and their evaluation mechanism has a scope to strengthen and bring transparency in the board affair.

Disclosure and transparency

In the today's globalized world when economies are integrated with each other. It is indeed the need of the hour to have such disclosure to ensure the transparent working of the corporates. Because transparency and fair dealings are two main pillars that aid the firms in achieving their goals. Therefore several committees have tried to cover different aspects by that corporate frauds can be minimized and an environment of investor trust and confidence could be created.

Clause 49 also emphasis for the disclosure of related party transactions, accounting treatment, risk management, proceeds from public issue, right issues, preferential issues, as well as disclosure of remuneration of directors, management and shareholders.

Naresh Chandra committee (2002) has also recommended that management should provide a clear description in plain English for each and every material contingent liability and its risks; which should be accompanied by the auditor's clearly worded comments on the management's view .So that investors and shareholders could obtain a clear view of a company's contingent liabilities as these may be significant risk factors that could adversely affect the company's future financial condition and results of operations. Further,

Narayanamurthy committee (2003) emphasized on improving the quality of financial disclosure, including those related to third party transactions and proceeds from IPO.

J.J. Irani committee (2005) has given parameters such as disclosure of routine information on periodic basis, standards for accounting, audit and non- financial disclosure and also about a regime of stringent penalties both civil and criminal for default on disclosure.

In the same way Listing obligations and disclosure requirements (LODR) Regulations, 2015 provides principles of governing disclosures and obligations such as; rights of shareholders, timely information, equitable treatment, role of stakeholders in corporate governance, disclosure and transparency and responsibilities of the board of directors. In addition, it is emphasized that disclosure of information having bearing on performance / operations of listed entity and /or price sensitive information and disclosure of material facts should be prepared by companies and that information should be placed before board of directors.

SEBI guidelines 2014 also cover some more aspects such as disclosure of information of the resignation of directors in annual report by the companies and that information to be placed before board of directors in order to aid corporate excellence and sustainability.

Whistle blower policy

Whistle blower policy empowers the employees of an organization to report misdeeds of the company. Only a policy document is not sufficient, the employees should be given adequate rights as well as protection so that they can fearlessly bring to light such deeds of the firms. Employees should be made aware of their rights in this regard. SEBI guidelines 2014, recommended a compulsory whistle blower mechanism in all firms.

Clause 49 states for establishing a mechanism for employees in a company to report the management concern about unethical behavior, actual or suspected fraud, violation of the company's code of conduct or ethical policies. This mechanism could also provide adequate safeguards against victimization of employees who avail it and it also provide for direct access to the Chairman of the Audit committee in exceptional cases. Once established, the existence of the mechanism may be appropriately communicated within the organization

Kumar Managalam Birla committee says that Companies shall take measures to ensure that this right of access is communicated to all employees through means of internal circulars, etc. The employment and other personnel policies of the company shall contain provisions protecting "whistle blowers" from unfair termination and other unfair prejudicial employment practices.

Companies shall annually affirm that they have not denied any personnel access to the audit committee of the company (in respect of matters involving alleged misconduct) and that they have provided protection to "whistle blowers" from unfair termination and other unfair or prejudicial employment practices. 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.

CEO compensation

A representative agency theory infers that generally goals adopted by a firm's management and the shareholders are generally not similar. As such, shareholders should attach their financial benefits to compensation paid to a firm's management. Once management behavior is unclear, compensation is a corporate governance mechanism to encourage management to run a firm in the interest of shareholders. This link will resolve an agency issue between management and shareholders and contribute to a firm's performance positively (Jensen and Murphy, 1990; Mehran, 1995)

Lerong He (2008)has analyzed studied that there are two types of CEO-compensation, i.e. These are incentive compensation and total compensation (overall pay level) incentive compensation is the variable part of CEO annual compensation which includes the sum total of bonus, long-term incentives awards, restricted stock awards and the stock option grants. While total fixed compensation includes base salary, annual bonus and incentive compensation. The author has applied the ordinary least square (OLS) regression with stratification method to estimate the compensation regression and reveals that Founder CEO is associated with smaller incentive compared to total compensation of the professionals CEOs because of larger job security and unique intrinsic characteristics distinct from professionals CEOs.

Firth et al. (2007) has studied a sample of 549 listed firms in China between 1998 and 2000. They find ownership and governance factors as determinants of cash pay and a link between cash compensation and firm performance. In the earlier related research, Firth et al (1999) have worked on the cash compensation in Hong Kong and have found that there is a little statistical correlation between pay and firm's stock market performance.

Bauer, R. et al (2008) have investigated the relationship between corporate governance and corporate performance in Japan. A unique governance index is used to rate the firm's corporate governance using six different categories. The relationship of each sub-index with stock price performance was investigated. It was revealed that remuneration has a significant impact on stock performance.

Board committee

For carrying out the diverse functions within a company various committees like audit committee, remuneration committee, shareholders/investor grievance committee, nomination committee, CSR and sustainable development committee etc. are formed within the organizations. It is mandatory for the companies to disclose the committees that they have formed for other stakeholders of the company such as,

Stakeholders' Relationship Committee stated by (J.J IRANI COMMITTEE) Companies having combined shareholder/deposit holder/ debenture holder base should be required to constitute a Stake Holders Relationship Committee to monitor the redressal of their grievances. The Committee should be chaired by a Non-Executive director.

Likewise, for the (Remuneration Committee) There should be an obligation on the Board of a public listed company, or any other company accepting deposits, is, to constitute a Remuneration Committee, comprising non-executive directors including at least one Independent Director in the case of a company where Independent directors have been prescribed as a part of substantive law. In such cases, Chairman of the Committee should be an independent director. Small companies are exempted from such a requirement.

The Remuneration Committee will determine the company's policy as well as specific remuneration packages for its managing/executive directors/senior management. The Chairman or in his

absence at least one member of the Remuneration Committee should be present in the General Meeting to answer shareholders' queries. (Also recommended by Shri Adi Godrej committee (2012); SEBI guidelines (2014.)

Independent director

The term independent director is defined as a non-executive director of the company who:

i. Apart from receiving director remuneration, does not have any material pecuniary relationships or transactions with the company, Its promoters, senior management, holding company, subsidiaries and associated companies;

ii. Is not related to promoters or management at the board level or at one level below the board;

iii. has not been an executive of the company in the immediately preceding three financial years;

iv. Is not a partner or an executive of the statutory audit firm or the internal audit firm that is associated with the company. He 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.

v. is not a supplier, service provider or customer of the company This should include lessor-lessee type relationships also; and

vi. Is not a substantial shareholder of the company, i.e. owning two percent or more of the block of voting shares

The considerations /remuneration paid to an independent director shall be the same as those applied to a non-executive director.(Kumar Mangalam Birla Committee)

In addition, J.J IRANI COMMITTEE States that presence of Independent directors may vary depending on the size and type of company. There cannot be a single prescription For all the companies. Therefore number of Independent directors may be prescribed through rules for different categories of companies. A minimum of one third of the total number of directors as independent directors should be adequate for a company having significant public interest, irrespective of whether the Chairman is executive or non-executive, independent or not.

CONCLUSION

To enhance the transparency and consistency in the economy, the formation of proper corporate structure and governance practices are essential. This paper describes the need of corporate governance practices and the framework related to that. In order to minimize the corporate failures, more inflow of foreign investments and to develop a system of disclosures where investors are not hesitated to invest their money, it is eminent to have an improved and transparent system of corporate governance.

It has found from the literature review that whistle blowing policy, code of conduct are the least studied variables, the study has explored them in detail and highlighted their impact on the of the firm's performance. It is also observed that government has made continuous efforts to introduce the transparent disclosure practices in order to overcome the problem of corporate frauds and loss of investor trust in the security market. However, there are some loopholes that need to be reframed to assure safe investment environment. The paper brings fore that only making reforms are not sufficient, their implementation must be enforced. The non-compliance of these should result in stringent penalties and punishments.

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