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SIGNIFICANCE OF CORPORATE GOVERNANCE

Gagan K[1]

Dr. Ramesh[2]

ABSTRACT

Whenever economic disasters happen, Governments get into damage control mode. In a few days, we find Government coming out with fresh rules to tackle the situation. The policy makers think about the possible reasons for the fallout and suggest changes to the system. Enquiries happen, commissions are set up. The Government takes preventive steps, so that such a disaster won't repeat. Corporate Governance (CG) is also one matter which emerges for a debate in such situations. The first few years of the twenty-first century was marked by world crisis in Corporate Governance – be it in USA or European Union. The impact of these crises was so wide that it forced the legislators to take suitable measures and in certain cases pass new Legislations.

Today's integration of market has made sure that the finance flows easily between the borders, investment is more democratized and the developments in one country affect the other very easily. All these factors make corporate disasters have far reaching consequences. Hence, in today's global economy, Corporate Governance is very much relevant. This paper seeks to examine the details pertaining corporate governance in India, its significance and relevance to the economy.

ORIGINS:

It was Adam Smith[3] who stated that when a firm is run by individuals who do not own it, it leads to the dilution of the objectives of the owners. Berle and Means (1932) initiated the debate on the separation of ownership and control in large corporations. Jenson and Meckling (1976) aggregated all this into a single concept of "agency problem" and said that the managers who do not own the resources of a corporation are more prone to committing 'moral hazards' instead of maximizing the profits for shareholders. In 1970s and 1980s, more

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[1] Research Scholar, Department of Studies in Law, University of Mysore
[2] Chairman, Department of Studies in Law, University of Mysore
[3] Wealth of Nations (1776)

studies were conducted on US corporations. By 1990s, similar work had been done in Japan, Germany and the United Kingdom. Indian Corporate Governance draws heavily on Anglo-American experience, literature and practice.

CONCEPT OF CORPORATE GOVERNANCE:

In a narrow sense, corporate governance involves a set of relationships amongst the company's management, its board of directors, its shareholders, its auditors and other stakeholders.[4] This relationship, which involves various rules and incentives, provide the structure through which the objectives of the company are set and the means of attaining these objectives as well as monitoring performance are determined. Thus the key aspect of good corporate governance includes transparency of corporate structures and operations, the accountability of managers and the boards to shareholders, and corporate responsibility toward stake holders. In a broader sense, however, good corporate governance, the extent to which companies are run in an open and honest manner, is important for overall market growth and development of countries industrial bases, and ultimately, the nations overall wealth and welfare.[5]

In other words, corporate governance is a system by which companies are directed and controlled. It is a set of standards which aims to improve the company's image, effectiveness and social responsibility. The concept of corporate governance hinges on transparency, integrity and accountability of management, with focus on public interest in general and investor protection in particular.[6]

WHAT IS CORPORATE GOVERNANCE?

Due to the separation of ownership and management of a corporation, a question arises on how the owners (shareholders) exercise their control over the management. This is where corporate governance assumes importance. The discipline of governance has developed as a way of ensuring that:

[4] Dr. R.N. Prasad, Need of Corporate Governance for Corporate Excellence, (2005) 6 Comp LJ
[5] Ibid
[6] Suresh Thakur Desai, Corporate Governance: Its meaning and scope, SEBI and Corporate Laws – Magazine, February 18, 2002

a. Investors other than promoters receive a fair return on their investment by protecting then against management expropriation or use of the investment capital to finance poor projects[7] and

b. Other stakeholders are assured that their interests are properly catered for. Corporate Governance is a system by which firms are directed and monitored.[8]

Sir Adrian Cadbury has observed: "Corporate Governance is concerned with holding the balance between economic sand social goals and between individual and community goals. The governance framework is there to encourage the efficient use of resources an equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society.'

In sum, good governance means, amongst others, transparency, fair dealings, proper disclosure of financial results, proper care of stakeholders, etc. Corporate governance is not merely to enact legislation. It is to establish a climate of trust and confidence.

TRADITIONAL AND SCRIPTURAL PERSPECTIVES:

Whether the modern day CEOs who have a lavish life in big bungalows and who travel in chartered aircrafts be equated with the ancient Kings? Yes, opines Dr. N. Balasubramanian[9] in one of his articles.[10] He argues that we can draw similarities between the ancient and modern times, although King actually did not run a corporation, but a kingdom. Making a comparison taking some academic license leads us to know a few interesting things. Dr. N. Balasubramanian takes the details of ancient governments from Kautilya's *Arthashastra*, *Dharmashastras*[11] and *Thiru Kural* of Thiru Valluvar.

He says that the ancient governance laid more stress on collection of taxes and the details of governance revolved mostly around the economic aspects. Manu says that the King had to duty and responsibility to protect his subjects. In *Dharmasastras*, we come across a set of principles called Rajadharma[12] which says that the subjects identified king as the all powerful

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7 Shleifer and Vishny, 'A survey of Corporate Governance', Journal of Fiancne, 52, June 1997, pp 737-84
8 Lalita S Som, 'Corporate Governance Codes in India', Economic and Political Weekly, September 30, 2006
9 Professor of Corporate Governance, Indian Institute of Management, Bangalore
10 N. Balasubramanian, Corporate Governance in India: Traditional and scriptural perspectives, Chartered Sevcratary, March 2005
11 Edited by P. V. Kane
12 The word Dharma connotes a wide meaning in Sanskrit which does not have an equivalent word in English language. It means morals, justice, duty, responsibility and so on

and most trusted person capable of protecting them, and hence gave him the authority. The Rajadharma (Duties of King) further deliberates that the king had the primary duty of protecting his subjects from the enemies, ensure justice and well being of the subjects. This, we may draw a parallel with the modern day agency theory. Though the property belonged to the subjects, it was held by the king and he had to ensure their well being. We can compare the king to the modern day CEO and his ministers to the modern day board of directors. We can compare the subjects to the modern day shareholders and stakeholders. We can infer that some traces of corporate governance concepts were found in ancient India. Though in modern times, we have relied extensively on foreign literature (especially the Anglo-American model), there's no doubt that these governance structures are not totally alien to the Indian soil.

CADBURY COMMITTEE REPORT ON CORPORATE GOVERNANCE:

The Committee on the Financial Aspects of Corporate Governance, forever after known as the Cadbury Committee, was established in May 1991 by the Financial Reporting Council, the London Stock Exchange, and the accountancy profession. The spur for the Committee's creation was an increasing lack of investor confidence in the honesty and accountability of listed companies, occasioned in particular by the sudden financial collapses of two companies, wallpaper group Coloroll and Asil Nadir's Polly Peck consortium: neither of these sudden failures was at all foreshadowed in their apparently healthy published accounts.[13]

Even as the Committee was getting down to business, two further scandals shook the financial world: the collapse of the Bank of Credit and Commerce International and exposure of its widespread criminal practices, and the posthumous discovery of Robert Maxwell's appropriation of £440m from his companies' pension funds as the Maxwell Group filed for bankruptcy in 1992. The shockwaves from these two incidents only heightened the sense of urgency behind the Committee's work, and ensured that all eyes would be on its eventual report.

The committee gave its report[14] in May 1999. The highlights of its recommendation were as follows:

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[13] http://www.jbs.cam.ac.uk/cadbury/report/index.html, Cambridge University, Cadbury Report

[14] Report of the Committee on Financial Aspects of Corporate Governance (1992), available at http://www.ecgi.org/codes/documents/cadbury.pdf, last visited on 15.08.2011

- There should be a greater usage of non-executive directors (NED). These appointments should be independent of the company and have no financial or business stake in it.
- There should be regular board meetings to retain full and effective control over the activities of the company and to monitor its management.
- Responsibilities and duties at board level should be decided to ensure that no single person has an over-concentration of power. The independentr elements among NEDs should help to accomplish this.
- There should be a restriction of three years on the contracts of executive directors, which would not be renewed without the shareholders approval.
- There should be full disclosure of the emoluments (total earnings) of each director.
- The company should establish the following three sub-committees of the board, which would be staffed or overseen mainly by non-executive directors:
    - An audit committee to examine the internal affairs of the company;
    - A remuneration committee to recommend the levels of directors pay; and
    - A nominations committee to recommend appointments to the board.
- There should be a separation of the roles of chairperson and chief executive, i.e., these two pivotal positions should not be held by the same person (as is the case in some smaller companies).

The Cadbury Committee did not propose that these recommendations be made statutory, but these were expected to be followed voluntarily. However, at the London Stock Exchange, these recommendations off the Cadbury report have become influential in reshaping the Corporate Governance.

KUMAR MANGALAM BIRLA COMMITTEE REPORT:

In early 1999, Securities and Exchange Board of India (SEBI) had set up a committee under Shri Kumar Mangalam Birla, member SEBI Board, to promote and raise the standards of good corporate governance. The report submitted by the committee is the first formal and comprehensive attempt to evolve a ‘Code of Corporate Governance', in the context of prevailing conditions of governance in Indian companies, as well as the state of capital markets.[15]

The Committee's terms of the reference were to:

- suggest suitable amendments to the listing agreement executed by the stock exchanges with the companies and any other measures to improve the standards of corporate governance in the listed companies, in areas such as continuous disclosure of material information, both financial and non-financial, manner and frequency of such disclosures, responsibilities of independent and outside directors;
- draft a code of corporate best practices; and
- Suggest safeguards to be instituted within the companies to deal with insider information and insider trading.

The highlights of the report are as follows:

Board of Directors:

The role of the chairman is to ensure that the board meetings are conducted in a manner which secures effective participation of all directors, executive and non-executive alike, and encourages all to make an effective contribution. The measure of performance of the board is not simple whether it fulfils its legal requirements but more importantly the board's attitude and the manner to translate its awareness and understanding of its responsibilities. Composition of the board is critical to the independent functioning of the board. No one individual or group should be able to dominate or overwhelm in the board's decision. Nominee directors from financial institutions should maintain arm's length relationship with the company by not seeking a seat on the board of the company. Board meetings should be held four to six times in a year, with a maximum time gap of two months between any two meetings. Each meeting should have agenda items that require at least half-a-day's discussion.

Audit Committee:

A system of good corporate governance promotes relations of accountability between the principal actors of sound financial reporting the board, the management and the auditor. The

[15] http://business.gov.in/corporate_governance/kumarmangalam.php, last visited on 16.08.2011

audit committee's role flows directly from the board's duty of overseeing the affairs of the company.

Remuneration Committee:

This committee would evaluate the remuneration package for its attractiveness to bring into the Board only persons of high integrity and conduct, retain and motivate the directors of the quality required.

Accounting Standards and Financial Reporting:

A company should be required to give consolidated accounts in respect of all its subsidiaries in which it holds 51 percent or ore of the share capital. Equally in companies with several businesses, it is important that financial reporting in respect of each product segment should be available to the shareholders and the market to obtain a complete financial picture of the company.

Maximization of shareholder value:

The most important objective of management is to maximise the shareholder value without detriment to the interests of the stakeholders. The management, however, is subservient to the board of directors and must operate within the boundaries and the policy framework as laid down by the Board.

NARAYANA MURTHY COMMITTEE REPORT:

The Report of the SEBI Committee on Corporate Governance is famously as *Narayana Murthy Report.*[16] With the belief that the efforts to improve corporate governance standards in India must continue because these standards themselves were evolving in keeping with the market dynamics, the Securities and Exchange Board of India (SEBI) had constituted a Committee on Corporate Governance in 2002, in order to evaluate the adequacy of existing corporate governance practices and further improve these practices. It was set up to review Clause 49, and suggest measures to improve corporate governance standards.

The terms of reference of the committee were to:

- Review the performance of corporate governance; and

[16] Report of the SEBI Committee on Corporate Governance (February 8, 2003), available at http://www.nfcgindia.org/library/narayanamurthy2003.pdf, last visited on 15.08.2011

- Determine the role of companies in responding to rumour and other price sensitive information circulating in the market, in order to enhance the transparency and integrity of the market.

The issues discussed by the committee primarily related to audit committees, audit reports, independent directors, related parties, risk management, directorships and director compensation, codes of conduct and financial disclosures.

The committee's recommendations in the final report were selected based on parameters including their relative importance, fairness, accountability and transparency, ease of implementation, verifiability and enforceability.

The key mandatory recommendations focused 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.

Non-mandatory recommendations included:

- moving to a regime where corporate financial statements are not qualified;
- instituting a system of training of board members; and
- evaluation of performance of board members.

As per the committee, these recommendations codify certain standards of 'good governance' into specific requirements, since certain corporate responsibilities are too important to be left to loose concepts of fiduciary responsibility. Their implementation through SEBI's regulatory framework will strengthen existing governance practices and also provide a strong incentive to avoid corporate failures.

The Committee noted that the recommendations contained in their report can be implemented by means of an amendment to the Listing Agreement, with changes made to the existing clause 49.

CORPORATE GOVERNANCE ASPECTS IN COMPANIES ACT 1956

The Companies Act which came into force much before the Cadbury Report and Kumar Mangalam Report has a few provisions which we can identify as pointers for Corporate Governance. They are as follows:

Section 210 – Annual accounts and balance sheet:

The board of directors to lay at the annual general meeting of company a balance sheet and profit and loss account for the prescribed period.

Section 211 – Form and contents of balance sheet and profit and loss account

Every balance sheet and profit and loss account to give a true and fair view of the state of affairs of the company as at the end of the financial year as prescribed in Part I and Part II of Schedule VI.

Section 217 – Board's report:

The board of directors to lay its report, before annual general meeting of the company, to be attached to balance sheet, with respect to the state of affairs of the company, including statement of remuneration of employees and directors' responsibility statement.

Section 292A – Audit Committee:

Every public company having paid up capital of Rs. 5 crore or more to constitute an audit committee, consisting of minimum three directors or more but two-third of them must be non-executive directors. The composition of the Audit Committee to be disclosed in the Annual Report and its recommendations are binding on the board of directors. The Chairman of Audit Committee has to attend the annual general meeting to provide clarifications on matters relating to audit.

Section 297 – Board's sanction to be required for certain contracts in which particular directors are interested:

Sanction of the board of directors is required for contracts of sale or purchase or supply of any goods, materials or services, in which directors or their relatives or firms in which directors are partners are interested.

Section 299 – Disclosure of interest by Director:

Directors have to disclose their interest in contracts to be entered on behalf of their company.

Section 300 – Interested director not to participate or vote in Board's proceedings:

Interested directors not to participate or vote in the board meeting where any contract or arrangement in which they are interested is being discussed. The presence of such an interested director is not to be counted for forming a quorum at the time of discussion.

Section 314 – Directors etc., not to hold office or place of profit:

Directors not to hold office or place of profit except with the approval of the company accorded by special resolution

CLAUSE 49 OF THE LISTING AGREEMENT:

Based on the report submitted by Kumar Mangalam Birla, the SEBI introduced Clause 49 of the Listing Agreement. The code prescribed detals to composition of Board of directors, audit committee, disclosure of director's remuneration, board meetings, restrictions on membership of committees of directors, corporate governance report, etc. However, in case of listed body corporates which are not companies but are incorporated under other statures, the clause in respect of corporate governance will apply only to the extent it does not violate their respective statutes and guidelines or directives issued by the relevant regulatory authorities.

In case of Mutual funds, they are regulated by SEBI (Mutual Fund) Regulations. The asset management company and the trustees already have a structure which ensures independence of decision making. Hence the provisions of corporate governance are not applicable to mutual find schemes.

JUDICIAL APPROACH IN INDIA:

The judicial authorities have time and again recognized the need that corporate organizations should adhere to the corporate governance practices. But at the same time the judicial authorities in India have also recognized the fact that proper code for corporate governance is still not in place in India.

In an important decision in *All India Shaw Wallace Employees Federation v. Shaw Wallace & Co. Ltd* [17], the Company Law Board observed as follows:

"All over the world, more particularly in India, it is an undisputed state of affairs that the largest shareholder, with variation in degrees, whether in the board or not, does have a commanding say in the management of the affairs of a company. Such a role could be either direct or indirect. Such a shareholder is always in a position to influence the composition of the board and the board mostly, if not always, gives utmost consideration to the wishes of such a shareholder. It is irrespective of the fact whether the company is professionally managed or not. This is a position of reality and we should not shy away from recognizing the same. In other words, no one can complain that the largest shareholder is playing a major role in conducting the affairs of a company. This is perhaps one of the reasons that now there is a clamor for evolving a code on corporate governance. Till such a time an appropriate code is evolved, we have to carry on with the present style of management…"

The Board further held:

"Having said that the largest shareholder cannot be shut from having a major role to play in the affairs of a company, we hasten to add that such a right or privilege cannot be used to subvert the interest of the company or for the purpose of enriching himself. There has to be absolute transparency whatever he does and in whatever manner he is in a position to influence the decision-making process…"

The decision in *Shaw Wallace* highlights the following points:

- It is a world wide known fact that a member, with largest shareholding of the corporate organization, controls operations of the organization.

- Control over the operations of the corporate organization does not give right to the member of the corporate organization with largest shareholding to enrich himself at the cost of the company.

[17] (1998) 31 CLA 254

- There is a need of transparency in managing the affairs of the company, corporate governance is important to protect interest of shareholders and stakeholders.

CONCLUSION:

Corporate Governance in India has been in the process of development in India. Our economy is progressing at a situation where globalization is taking new shapes and forms. The business laws are having a change; the markets are having new schemes. At this stage, corporate governance assumes greater importance. Ethical business behavior and fairness cannot be legislated. For strengthening corporate governance, Government and the private sector must encourage synergy of political, social and cultural processes. Corporate governance extends beyond corporate laws. Its fundamental objective is not mere fulfillment of requirements of law ensuring commitment of the long-term shareholder values. It is much more than that.