International Journal of Commerce and Management Research
ISSN: 2455-1627; Impact Factor: RJIF 5.22
Received: 04-04-2020; Accepted: 06-05-2020; Published: 12-05-2020
www.managejournal.com
Volume 6; Issue 3; 2020; Page No. 15-17

Corporate governance in India: Emerging imperatives

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Abstract
Competitive business environment has redefined business rules. With their ever-expanding size and scope, corporates have been struggling to reconcile conflicting objectives of its various stakeholders. Agency problem, as in the past, has compelled both the regulator and legislatures to search for effective ways to ensure that the corporates are run in an efficient, transparent, accountable and fair manner. In this travail, good corporate governance (CG) has become the new mantra. Begun as a check against corporate scandals and frauds, it has assumed manifold roles today. It is in this context, the present paper traces the evolution of corporate governance along with identifying its roles.

Keywords: identifying, evolution, economy, management

Introduction

A country's economy depends on the drive and efficiency of its companies. Unlike in the past where the ownership and management were with the same group, expansion in size and scope has changed the very nature of companies. While ownership lies with its equity shareholders, spread across the countries, the management is carried-out by elected, Board of Directors. Though, in general, managements pursue 'shareholders' wealth maximisation' as their prime goal, cases of insider trading, excessive executive compensation, false reporting and other malpractices and manipulations have become the order of the day. It was in this situation; a paradigm shift was proposed in the form of corporate governance across the world.

Corporate governance (CG) is a system by which companies are directed and controlled (Cadbury Committee, UK). The OECD defines CG as involving "a set of relationships between a company's management, its board, its shareholders, and other stakeholders. It also provides the structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined". It involves set of processes, customs, policies, laws and institutions affecting the way in which a company is directed, administered or controlled. Its major players are the shareholders and the management/board of directors. Other stakeholders include employees, suppliers, customers, lenders, regulators, the environment and the community at large. CG structure spells out the rules and procedures for making decisions on corporate affairs. It is also used to monitor whether the outcomes are in accordance with plans or not.

Corporate Governance – Historical evolution

CG guidelines and best practices were evolved over a period of time. The Cadbury Report on the financial aspects of CG, published in UK in 1992, was a landmark in this regard; it led to the publication of the Vienot Report in France in 1995. The report advocated the removal of cross-shareholdings. The General Motors' Board of Directors' Guidelines in the United States and the Dey Report in Canada also influenced the evolution of codes and guidelines across the world. Various countries have issued recommendations for CG. Law does generally not mandate compliance with them; sometimes codes that are linked to stock exchanges may have mandatory content.

The Sarbanes–Oxley (2002) has brought about sweeping changes in financial reporting. Besides directors and auditors, the Act has also laid down new accountability standards for security analysts and legal counsels. In November 2003, the Securities Exchange Commission (SEC) approved the changes to New York Stock Exchange and NASDAQ listing requirements. The changes focused mainly on-Board independence, independent committees of the Board, Audit committee composition, Code of business conduct and ethics and related party transactions. The Higgs Report on non-executive directors and the Smith Report on audit committee, both published in January 2003, formed part of the systematic review of CG being undertaken in the UK and Europe.

Indian scenario

Before the onset of liberalisation, the Indian organised sector, dominated by public sector enterprises, did not meet the expected norms and standards of governance. Since 1990-91, both the public and the private sector enterprises were bracing themselves to meet the challenges of globalisation. With the increasing foreign investment, accountability to shareholders had become an increasing necessity. With the institutional investors emulating the practices of their counterparts from developed economies, better governance practices were compelled to be adopted to sustain themselves in the scenario.

Varied opinions were articulated in India in response to wide ranging corporate scandals like violations of foreign exchange regulations, making clandestine payments to politicians, involvement in illegal activities and unethical deals by top industrial houses. While some suggested that the investigations might scare away the foreign investors and the economy would once again be in tatters, others stressed on the importance of social responsibilities of the businesses. However, until the groundwork done in terms of preparing a code for corporate conduct by the Confederation of Indian Industries (CII) in 1998, the importance of CG was not officially realised.

Corporate Governance in India

In India, the Confederation of Indian Industry (CII) in its publication titled 'Desirable Corporate Governance – a Code', proposed the first structural initiatives on CG (1997). The code was prepared with a view that the Indian companies had to adopt best of corporate practices if they were to access domestic as well as foreign capital at competitive rates. With increased exposure to global markets, it became an imperative on the corporations to focus on transparency and adopt full disclosure mechanism. The code initially focused on public listed companies. This was followed by the recommendations of Kumar Mangalam Birla Committee (KMBC) on Corporate Governance (1999), appointed by Securities and Exchange Board of India (SEBI). CG practices have gained greater impetus after the adoption of KMBC Report. Its acceptance and ratification has paved the way to rationalise and restructure governance practices in corporate India. The recommendations were enshrined in Clause 49 of the Listing Agreement of every Indian stock exchange. Accordingly, proper disclosure for CG has to be made by the companies in the areas such as Board of Directors and its procedures, Audit committee, Remuneration committee, and information to the shareholders. SEBI also constituted a committee under the chairmanship of Mr. N.R Narayanamurthy, who recommended enhancements in CG; SEBI revised Clause 49 accordingly. The revised Clause 49 has been made effective from January 1 2006.

Department of Company Affairs, Govt. of India constituted a nine-member committee under the chairmanship of Mr. Naresh Chandra, in 2002 to examine the various issues in CG including auditor-company relationship and the role of auditors. The terms of reference to the Committee were to review the performance of CG and determine the role of companies in responding to rumours and other price-sensitive information circulating in the market. The committee came out with two sets of recommendations-mandatory and non-mandatory recommendations.

The mandatory recommendations focus on strengthening the responsibilities of audit committees, improving the quality of financial disclosures, including those pertaining to related party transactions and proceeds from IPOs etc. They required corporate boards to assess and disclose business risks in the annual report of the companies calling upon the board to adopt a formal code of conduct, the position of nominee directors and improved disclosures relating to non-executive directors. The non-mandatory recommendations pertain to moving to a regime providing for unqualified corporate financial statements, training of Board members and evaluation of non-executive directors' performance by a peer group comprising the entire board of directors excluding the director being evaluated.

Features a Good CG Model

A good CG model has the following features.

1. It avoids/reduces conflicts of interest. By including a majority of independent directors (not having financial or close personal ties to the company or its executives), a good CG model attempts to take managerial decisions in the best interest of the company.
2. The company will have audit, compensation and other committees consisting of independent directors. Such a system helps to ensure better monitoring and control over internal management of the company.
3. The board should obtain shareholders approved for any action that could significantly affect the relationship between the board and shareholders.
4. The company should base executive compensation plans on 'pay for performance' and should provide full disclosure of these plans.
5. The company shall make all the relevant disclosures and ensure true and fair financial reporting of the material information.

In general, a good CG model shall have the following characteristics

1. Participatory in approach
2. Consensus oriented
3. Accountable
4. Transparent
5. Responsive
6. Effective and efficient for corporate goals
7. Equitable
8. Inclusive and
9. Follows the rule of laws

Role of Corporate Governance

The system by which companies are directed and controlled has great significance to various segments of the economy. The key theme of CG deals with the issues of accountability, transparency and accountability. It advocates the implementation of better corporate practices for ensuring good corporate behaviour for protecting the interests of its shareholders. Another key focus is the economic efficiency through which it aims to optimise economic results, with a strong emphasis on shareholder value.

The manifold roles of good corporate governance are explained below;

1. **To attract and retain investment**
   CG has vital implications for the functioning of the financial sector and, by extension, the economy as a whole. As investors prefer to invest in properly supervised/governed companies and tend to avoid the mysterious environments, a good CG influences investment decisions too. It has a particular role while the country is expecting massive foreign investment in infrastructure and such other core sectors. Unless Indian companies are governed at globally competitive standards, investors' confidence cannot be gained nor retained.
2. **Principal's right to be informed**
   The shareholders being the principal of the management, they have to be informed as to condition, performance and risk profile of the firm in a transparent and fair manner. Information asymmetry with regard to corporate operations should be eliminated by sufficient disclosures.
3. **3. Satisfy wealth maximisation goal**
   Maximisation of shareholders' wealth is the primary goal of any managerial decision. In order to achieve this, the market consisting of all the stakeholders has to be taken into confidence. The value, reflected by market price per share is a result of risk being perceived

by the market players. Thus, the value will be adjusted for the corporate issues including financial reporting, employee management, meeting financial and other obligations, social responsibility initiatives, compliance with government and other regulatory requirements and so on.

4. 4. Minority Rights protection

CG aims to eliminate manipulative and fraudulent practices in the concern. CG is important to ensure that the rights and interests of the minority groups are also protected while making decisions.

5. Others

CG is vital for any pro-development organisation. It is responsive to the present and future needs of the entity. It ensures the commitment to values and ethical standards of business conduct.

Conclusion

The modern-day uproar over the problems like insider trading, excessive executive compensation, managerial expropriation of shareholders' wealth, false reporting, and governance malpractices are assumed to be related to the theory of separation of ownership and control (agency theory). A good CG model should provide proper incentive for the Board/management to pursue the objectives that are in the best interests of the company and its shareholders. It should facilitate effective monitoring thereby encouraging the firm to use its resources most effectively and efficiently. In order to ensure accountability, transparency and fairness in governance, a good CG model has to be adopted as a continuing process rather than merely restricting to regulatory and legal requirements. Corporate India need to get into the spirit and culture of a good CG which should go beyond paying lip service to the check boxes of mandatory/regulatory requirements.

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