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A Study of Corporate Governance Practices in Companies Across Countries with a view to Identify Measures for Good Corporate Governance In India

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Corporate Governance (CG) has become the area of increasing focus for corporations the world over on account of various reasons that include corporate scandals, increased need for trust by stakeholders in corporate management as well as the ever increasing role of corporations in world economy. Corporate governance aims to bring together the need to maximize long term stakeholder value in a sustainable manner with ethical business practices. Though the term 'Corporate governance' refers to various aspects of corporate functioning, at the core of good corporate governance are high ethical standards that are often demonstrated through high standards of integrity and openness as well as greater transparency and accountability in the decision making process. These being important aspects for corporate functioning all over the world for all times to come, it is in the specific details that corporate governance requirements and practices differ in different parts of the world. This paper reviews the need for improved corporate governance in India and examines ongoing trends in corporate governance in different parts of the world, particularly USA and Europe. It examines the impact of good governance on market value and operating performance besides reviewing various initiatives aimed at improving corporate governance across the globe, with a focus on the CII initiative in India. The paper discusses CII's desirable code of corporate governance followed by the areas for increased attention as regards perception of corporate governance practices in India before making recommendations on the need to have a combination of legal and voluntary framework to ensure effective corporate governance.

Key Words: Ethical Code of Conduct, Transparency, Stakeholders, Risk Management, Financial Performance, Environmental Standards, Quality

Introduction

Hurst[1] (2004) defined Corporate Governance as"Corporate governance refers to the broad range of policies and practices that stockholders, executive managers, and boards of directors use to (1) manage themselves and (2) fulfill their responsibilities to investors and other stakeholders." Kumar[4] (2007) of Central Vigilance Commission defines Corporate Governance as, "'Corporate Governance' encompasses commitment to values and to ethical business conduct to maximize shareholder values on a sustainable basis, while ensuring fairness to all stakeholders including customers, employees, and investors, vendors, Government and society at large. Corporate Governance is the system by which companies are directed and managed. It influences how the objectives of the company are set and achieved, how risk is monitored and assessed and how performance is

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optimized. Sound Corporate Governance is therefore critical to enhance and retain investors' trust." Corporate Governance is really about ethical conduct ion business and what constitutes good Corporate Governance must really evolve with the changing circumstances of the company making it difficult to have one single model for Corporate Governance. While openness, transparency, integrity and accountability are the key elements of Corporate Governance for any Corporate entity, Kumar lists the following as Essential Principles of Governance:

1. Lay solid foundation for management and oversight;
2. Structure the board to add value;
3. Promote ethical and responsible decision making;
4. Safeguard integrity in financial reporting;
5. Make timely and balanced disclosure;
6. Respect the rights of shareholders;
7. Recognize and manage risk;
8. Encourage enhanced performance;
9. Remunerate fairly and responsibly;
10. Recognize the legitimate interests of stakeholders;
11. Corporate Governance ratings to be made mandatory for listed companies.

As regards banks and banking practices, "Banks deal in trust. If trust is in suspicion, damaged or lost, the resulting financial loss cannot measure the true risk. Trust being the foundation of banking, the discussion over applicability of good governance has really been a non-issue. Good governance and practices are synonymous to banking, banks and bankers." Cornford2 describes corporate governance as being concerned with the relationships between business' management and its board of directors, its shareholders and lenders, and its other stakeholders such as employees, customers, suppliers and the community of which it is a part. The scope of corporate governance is, therefore, very wide and includes the framework through which business objectives are set and the means of attaining them and otherwise monitoring performance are determined. Cornford points to one major lesson of the Enron case, "…………like other social constructs, corporate governance and financial systems are susceptible to the effects of flaws and fault lines which are the product of financial innovation, human ingenuity (not all of it necessarily legal), and other changes in mores and in the social and economic context. Outcomes will continue to reflect the never-ending efforts of rule-setters and regulators to accommodate, and to handle the problems posed by, the evolution of accounting and other financial practices…….." This suggests that the focus on Corporate Governance will continue for a long time to come. The need for good corporate governance has grown on account of several factors, some internal to the functioning of corporates while others that have their origin outside the organization. Chakrabarti, Megginson and Yadav[7] (2007) examined how the corporate governance in India supported as well as held back economic accent in India. In the years preceding this study, India experienced big successes in terms of its economic growth with the stock market also growing manifold and the number of trades at the National Stock Exchange of India rising to the third highest in the world behind NASDAQ & NYSE. The Indian legal provides excellent investor protection on paper, enforcement was a problem. Corporate ownership remained concentrated with family business being the dominant business model (60% of companies comprising about 65% of the total market capitalization of the Exchange) with significant pyramiding and tunneling among Indian business groups being observed. When compared with corporate governance in countries like Brazil, China or Russia, India ranked high on ease of getting credit as well as a well functioning banking system that has one of the lowest percentage of non-performing assets. As regards other factors of institutional framework, India ranked 72nd out of 180 countries on Corruption Perception Index with an absolute score that suggested corruption being perceived as a 'serious challenge'. Red tape and regulations were among the main deterrents for business and foreign investment in India. Despite significant variation in labour laws across stares, India ranked 85th overall for ease of employing workers, ahead of Brazil (119th), Russia (101st) and China (86th). India ranked very high on disclosure and liability requirements as well as quality of public enforcements of the regulations controlling securities markets though there were problems in enforcing compliance particularly in areas like price manipulation and insider trading. An area where India ranked particularly low (137th out of 178) was 'Ease of closing a business' being among the countries where it takes the longest time to go through bankruptcy in the world (10 years on average). Considering the importance of relationship based informal controls and governance mechanisms in India's Small and Medium Enterprises, there is scope to develop the formal corporate governance mechanisms in India. This paper is a study of the need for Corporate Governance practices in Indian corporations with the objective of highlighting its strengths as well as areas for improvement. Several studies have been conducted on the corporate sector across the world but there is a relative dearth of similar studies in Indian corporations. This study aims to partly fill that gap and will add to the existing knowledge on Corporate Governance in large as well as Small and Medium Enterprises (SMEs).

Literature Review

As per the report on Corporate Governance[3] by the Global Compact and Global Corporate Governance Forum located within IFC, explains why corporate governance is important, "Corporate governance refers to the way that Boards oversee the running of a company by its managers, and how Board members are held accountable to shareowners and the company. This has implications for company behavior not only to shareowners but also to employees, customers, those financing the company, and other stakeholders, including the communities in which the business operates. Research shows that responsible management of environmental, social and governance issues creates a business ethos and environment that builds both a company's integrity within society and the trust of its shareowners." The benefits of good corporate governance are many. As stated by Rachel Kyte, Vice President, Businress Advisory Services, IFC "Good corporate governance practices instill in companies the essential vision, processes, and structures to make decisions that ensure longer-term sustainability. More than ever, we need companies that can be profitable as well as achieving environmental, social, and economic value for society." An identical view is offered by George Kell, Executive Director, UN Global Compact, "A well-governed company takes a longer-term view that integrates environmental and social responsibilities in analyzing risks, discovering opportunities and allocating capital in the best interests of shareowners. There can be no better way to restore public confidence in both businesses and markets and build a prosperous future." As per Thierry Buchs, Head, Private Sector Development Division of Switzerland's State secretariat for Economic Affairs (SECO), "Good corporate governance is the glue that holds together responsible business practices, which ensures positive workplace management, marketplace responsibility, environmental stewardship, community engagement, and sustained financial performance. This is even more true now as we work worldwide to restore confidence and promote economic growth."

Roberts[5] (2004) explores the place for ethics in Corporate Governance and concludes that it is hard to find a place for ethics within agency theory assumptions since moral hazard is ensured by prevalence of self interested opportunism that can, at best, only be constrained. Here ethics needs justification in terms of some threat or benefit that accrues from ethical conduct and can only be ensured through monitoring and controls. The paper discusses 'the ethics of narcissus' where the problem of ethics is cast in terms of the desire to be seen as ethical and, at worst, the recent proliferation of codes of ethics as well as environmental and social reports is viewed as a knowing attempt to counter criticism through the building/restoration of corporate image with the corporations themselves being the prime beneficiaries of such presentations. The author refers to the combination of reports and codes complimenting new forms of internal measurement and reward as being more of consequence.

Nordberg[11] (2007) discusses the useful normative character of three of the six theories of Corporate Governance outlined by Stiles and Taylor (2001). These include, the legal view (a narrow view), class hegemony and managerial hegemony (entirely descriptive but providing implicit salutary advise to boards), organizational economics approach (using agency theory to suggest that the board's role is to control abuses in managerial power) and transaction-cost theory to lead decision making. A stewardship approach assumes that managers and directors will be motivated by a desire to be good stewards and do things driven not just by narrow self interest while the resource-dependence approach sees outside or non executive directors as having a role in facilitating access to funds, people and other resources. These theories, however leave out the stakeholder theory and shareholder value that have an important role to play in decision making by managers as well as directors. The Cadbury Committee Report on Financial Aspects of Corporate Governance[6] (1992) laid emphasis on openness (as relates to disclosures), integrity (indicating straight forward dealings and completeness) and accountability (of directors to their shareholders). The committee believed that their approach based on compliance with a voluntary code coupled with disclosure would be more effective than a statutory code. Braga-Alves and Shastry[10] (2011) conducted a study in Brazil to examine the effect of better corporate governance based on a sample of 236 non financial firms and 849 firm-year observations from 2001 to 2005. They constructed a composite index (NM6) that combines six proxies for the main governance practices targeted by Sãu Paulo Stock Exchange (Bovespa) reforms and found that higher scores on the index are statistically and economically related to higher market value but not to better operating performance. Finally, the study found that a zero investment strategy that purchased stocks of firms with high NM6 and sold stocks of firms with low NM6 would have resulted in a 10.68% abnormal return per year over the stated sample period (2001-2005), a result that does not support the hypothesis that stock prices quickly incorporate information regarding changes in corporate governance standards. The six practices that serve as proxies for the set of rules targeted by the corporate governance reform prompted by Bovespa are:

1. Ratio of cash flow to voting rights owned by controlling shareholders not less than one;
2. Minimum free float of 25% of outstanding shares;
3. Tag along rights granted to minority shareholders beyond what is required by law;
4. Board of directors with five or more effective members;
5. Directors elected for concurrent terms of one or two years; and
6. Financial statements available in accordance with IFRS or US GAAP.

Key Findings Relevant to International Operations

The study by Hurst[1] (2004) comparing European business practices to those in the US offers various recommendations for multinational companies based on both sides of the Atlantic that include:

1. Offer shareholders the power to unseat board members through voting proxy to address situations where Chief Executives fill the board with allies leading to conflict of interest and low levels of governance;

2. Fully disclose executives' pay to primary shareholders;
3. Send a clearly outlined whistle blowing framework with code of conduct to all employees;
4. Apply company ethical, social, and environmental standards to joint partners, affiliates, subsidiary operations and throughout supply chains;
5. Focus more of their CSR communications efforts on staff and suppliers, not least by sending them tailored social reports;
6. Move beyond just acknowledging CSR and publishing reports to the next stage by embedding CSR into their core business activities and not simply treating it as an add-on; and
7. Put pressure on business schools to make business ethics and strategies in CSR a part of the core curricula.

The recommendations specific to Europe include:

1. Europe needs a body akin to the SEC to provide cross border supervision of auditors;
2. The EU should implement stiff penalties on those committing frauds;
3. European governments should require senior company managers to report to the board, the audit committee and the auditors any frauds they become aware of which affect the company along the same lines as the Sarbanes-Oxley Act of the US; and
4. Auditors in Europe need to implement a more aggressive standard against fraud and emphasize a "prove it to me" rather than a "tell me" approach so as to eliminate chances of looking the other way instead of calling out ethical violations as well as being more skeptical of management's explanations and audit evidence;

The recommendations specific to US include:

1. The U.S. Government should swiftly implement and enforce all provisions of the Sarbanes-Oxley Act (P.L. 107-204), a sweeping reform of accounting regulation, as non enforcement would mean that the act will not be taken seriously by greedy business executives;
2. The New York Stock Exchange should collect a common body of information on the social, environmental and ethical performance of companies, which investors can then use to inform their voting decisions;
3. The SEC should require social and environmental reporting for all companies that file with the agency; and
4. Corporate America should use the news media to educate consumers on socially and environmentally responsible business practices and the role they can play to help build a sustainable future.

Evolution of Corporate Governance in India

As far as Corporate governance in India is concerned, the Confederation of Indian Industry took the first institutional initiative in India in 1996 out of a need to protect investor interests especially those of the small investors by developing a desirable code of Corporate Governance8 for Indian companies in the Public or Private sector, Banks or Financial Institutions. The draft guidelines were widely circulated and debated before release in 1998. This code evolved out of an understanding that: There is no one unique structure or type of corporate governance that is unambiguously better than others as a result of which corporate governance structure or type can't be mechanically imported for Indian companies; With increased integration with the world market investors will demand greater disclosures and more transparency in important decisions and; Corporate governance by its very definition needs to go beyond company law because the quantity, quality and frequency of disclosures, the extent to which company directors exercise their fiduciary responsibilities towards shareholders, the quality of information that management share with their boards, and commitment to transparency in a manner that maximizes long term shareholder value are extremely difficult to legislate at the level of detail that would address all existing and near-future situations. The Desirable Code of Corporate Governance address the (a) Board of Directors; (b) Desirable disclosures; (c) Capital market issues; (d) Creditors rights and (e) Financial Institutions and Nominee Directors. Most of the Desirable Code of Corporate Governance by CII was subsequently incorporated in SEBI's Kumar Mangalam Birla Committee Report and thereafter in Clause 49 of the Listing Agreement. The report of the CII Task force on Corporate Governance[9] chaired by Mr.Naresh Chandra (2009) was aimed at further recommending ways to improving practice of corporate governance standards in letter and spirit in listed companies and wholly owned subsidiaries of listed companies. The report advises against over regulating with the best-in-class corporate governance being voluntary with companies going beyond the letter of the law. The report discusses and discusses the different elements of corporate governance, namely:

1. The Board of Directors including non-executive and independent directors, committees of the board and significant related part transactions: The recommendations made include the Nomination Committee, Letter of appointment to Directors, option of paying non-executive directors a fixed contractual amount as against a percentage of profits as well as the structure of their compensation, remuneration committees, audit committees of the board and separation of office of the Chairman and CEO besides other recommendations.
2. Auditors, their independence and rotation of audit partners: The recommendations are aimed at achieving and demonstrating high levels of independence for the auditing company as well as individual Audit Partners; Increasing the consequences of negligence or dereliction of duty through auditor liability; Appointment of suitably qualified and experienced auditors by the Audit Committee of board of directors that will also recommend to the board of directors along with reasons for the appointment, reappointment or removal of statutory auditors; Auditors sticking to the standardized language of disclaimers and sufficiently explaining anything beyond the scope of language; Instituting a mechanism for whistle blowing by employees and ensuring safeguards against victimization of employees who avail of the whistle blowing mechanism; Collective identification of risks to ensure risk minimization and setting up a framework for management of critical risks and overseeing them every six months;
3. Regulatory agencies as regards legal and regulatory standards as well as effective and credible enforcement: The recommendations include the need for concurrence between the government and SEBI as the market regulator in corporate governance standards deemed desirable for listed companies to ensure good corporate governance; Strengthening ICAI Quality Review Board and ensuring quality audits through an oversight mechanism on the lines of Public Company Accounting Oversight Board (PCAOB) of USA; Joint investigations/interrogations by regulators to be conducted in tandem and disposed off within 6-12 months; Providing for confiscation or cancellation of fraudulent securities; Imposing personal penalties on employees or directors seeking personal enrichment by committing offences that go beyond disgorgement of wrongful gains wherein non executive directors are kept out of the purview of the trial unless it can prima facie be established that they were liable for the failure on part of the company.
4. External institutions including institutional investors and the press: The recommendations aim at shareholder activism to proactively monitor and ensure good corporate governanceand the media, especially those in financial analytics and reporting

business to invest more in rigor and enhancing their capacity for analytical and investigative reporting.

The section on Desirable Disclosures refers to the inadequacy of corporate disclosure norms and discusses the financial and non financial disclosures recommended by the Working Group on the Companies Act. The non-financial disclosures include reporting on relatives of directors to be an integral part of Directors' Report of all listed companies; disclosing directors' shareholding or any interests of directors in company contracts or other arrangements including loans, and disclosing appointment of sole selling agents in foreign markets as part of Directors' Report accompanying the annual audited accounts. The financial disclosures recommended include disclosing directors' remuneration and commission in table form, costs incurred on using the services of a Group Resource Company, giving key information on a company's divisions or business segments as part of the Directors' Report in the Annual Report, showing through a detailed statement the end use of funds raised through issue of shares, debentures or other securities, debt exposure to the company, difference between fixed assets and long term liabilities as at the end of the financial year and the date on which the board approves the balance sheet and P&L Account should be disclosed and full disclosure of fixed asset acquired through or given out on lease but not reported under appropriate sub-head. The recommendations refer to the inequitable disclosure norms when companies go in for GDRs or private placements with foreign portfolio investors and another for Indian shareholders and the need to end this practice. KPMG poll by Rekhy and Dumasia (2008) on The State of Corporate Governance in India: 2008 involving over 90 respondents covered various aspects of Corporate Governance in India including Corporate Governance regulations; Corporate governance concerns in India; Board oversight in risk management and importance given to integrity and ethical values; Practices fundamental to good Corporate Governance. The findings of this poll include:

1. Corporate governance should be based on principle based standards and moderate regulations;
2. Scope for stronger regulatory review and monitoring effectiveness of CG through audits by specialists;
3. Weak monitoring and oversight are the biggest risk to corporate governance;
4. Scope for improvement as regards board members having right information or time to discharge their duties;
5. Remuneration of the Chief Executive should be linked to company performance;
6. The need for independent a transparent process to evaluate performance of board members;

CONCLUSIONS AND RECOMMENDATIONS

Based on the study above, the following conclusions can be arrived at for Indian companies:

1. No single approach to corporate governance that would meet the requirements of all industry worldwide;
2. Good corporate governance results from a combination of legal framework and voluntary commitment;
3. Despite the difficulty in formulating a single approach, some indicators of good corporate governance are:

a. Protecting the small investor;
b. Adequate checks and balances on the functioning and remuneration of CEO and board members;
c. Auditor Independence coupled with high integrity and sense of responsibility;
d. Transparent mechanism that records reasons for appointment and/or removal of qualified and experienced auditors;
e. Suitable mechanism for protecting whistle blowers;
f. Collective identification of risks, management of critical risks and overseeing them every six months;

g. Strong ICAI Quality Review Board that ensures quality audits through an oversight mechanism;

h. Joint and time bound investigations by various regulatory authorities;

i. Provision of confiscation/cancellation of fraudulent securities & imposition of personal penalties;

j. Financial/non financial disclosures that demonstrate openness and transparency of decision making;

k. Consistency in reporting/disclosure to Indian investors as well as foreign portfolio investors.

4. While lack of good corporate governance shows itself in innumerable ways, weak monitoring and oversight are big risks to good governance as also providing right information to board members to make decisions;

5. Good corporate governance has payoffs in terms of higher market value, and therefore, better investments, even if it does not lead to improved operating performance in the short term.

Lastly, based on the study carried out it appears that good corporate governance is, at the core, about ethical conduct that fosters trust. As such, it requires sustained effort born out of deep commitment to values and not just rules, legal or voluntary to ensure good corporate governance. Openness to sharing information and transparent decision making would be the hallmark of good corporate governance.

LIMITATIONS OF THE STUDY AND SCOPE FOR FURTHER RESEARCH

Our understanding of good and poor corporate governance is the outcome of learning from past experiences as well as past mistakes. Just as there can be no single approach corporate governance that would meet the requirements of all industry worldwide, similarly this concept is sure to evolve with changes in economic and business scenario. As such, there is a need and scope for continuous upgrading of the concepts on corporate governance in the context of the companies operating environment.

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