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Seema Sangwan
Department of Management, Assistant Professor, UILMS, Gurgaon, India.

Correspondence:
Seema Sangwan
Department of Management, Assistant Professor, UILMS, Gurgaon, India.

Framework of Corporate Governance: Issues and challenges

Seema Sangwan

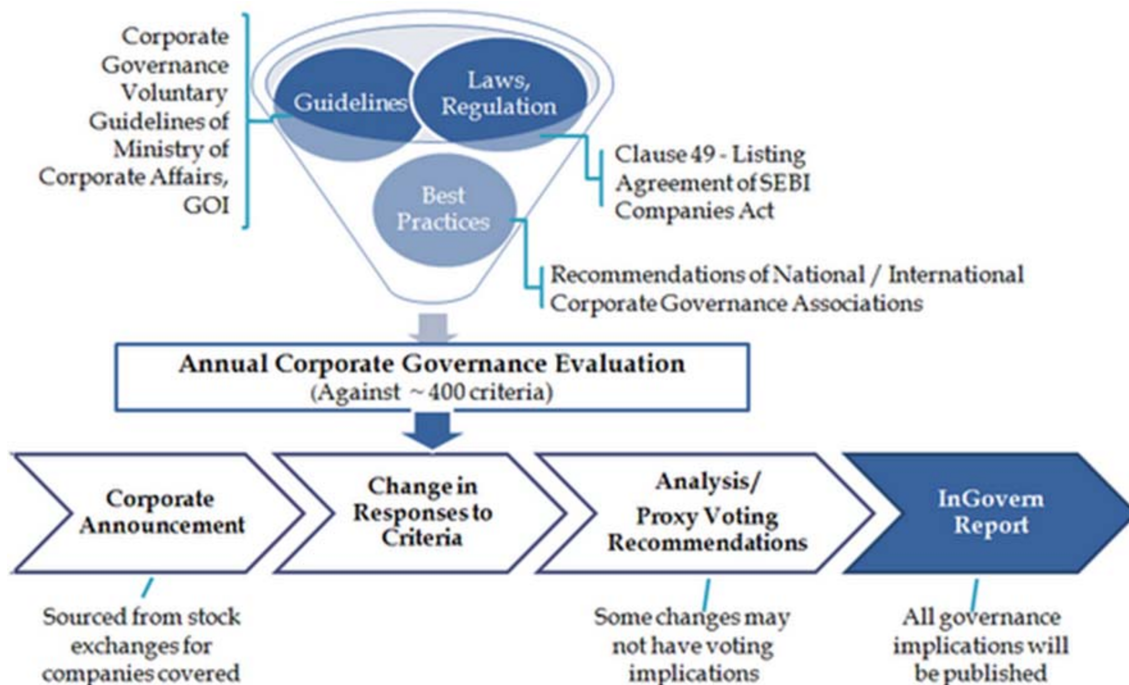
Abstract
Since 1990s, Indian regulators as well as industry representatives and companies have undertaken significant efforts to revamp the country's corporate governance. The Corporate governance is the system of principles, policies and procedures, which clearly defined the responsibilities and accountabilities of different stakeholders of corporate-houses. India's corporate governance reforms were initially spearheaded by corporate India and quickly became component of the work of the country's primary capital markets regulatory authority, the Securities Exchange Board of India (SEBI), and the Ministry of Corporate Affairs (MCA). Indian companies, banks and financial institutions (FIs) can no longer afford to overlook better corporate practices. Corporate governance provides the framework for attaining a company's objectives. As India gets incorporated in the world market, then it demands greater revelation, more translucent explanation for major decisions and better shareholder value. Through this paper I want to cover different legal obligations like listing agreements, company laws etc. which is required to be followed to ensure effective security market and stakeholders interest. It will also cover the challenges faced in the Indian market and different ways to overcome them.

Keywords: SEBI, MCA, Financial Institutions and capital market.

Introduction

The initiatives taken by Indian Government in 1991, aimed at economic liberalization and globalization of domestic economy, led India to initiate reform process. This includes Corporate Governance norms as well in order to suitably respond to the developments taking place worldwide. Good corporate-governance practices reduce this risk by ensuring transparency, accountability, and enforceability in the marketplace. The concept of good governance is very old in India dating back to third century B.C. where Chanakya (Vazir of Parliputra) elaborated fourfold duties of a king viz. Raksha, Vriddhi, Palana and Yogakshema. Substituting the king of the State with the Company CEO or Board of Directors the principles of Corporate Governance refers to protecting shareholders wealth (Raksha), enhancing the wealth by proper utilization of assets (Vriddhi), maintenance of wealth through profitable ventures (Palana) and above all safeguarding the interests of the shareholders (Yogakshema or safeguard). Corporate Governance was not in agenda of Indian Companies until early 1990s and no one would find much reference to this subject in book of law till then. In India, weakness in the system such as undesirable stock market practices, boards of directors without adequate fiduciary responsibilities, poor disclosure practices, lack of transparency and chronic capitalism were all crying for reforms and improved governance. The fiscal crisis of 1991 and resulting need to approach the IMF induced the Government to adopt reformative actions for economic stabilization through liberalization. The momentum gathered albeit slowly once the economy was pushed open and the liberalization process got initiated in early 1990s. As a part of liberalization process, in 1999 the Government amended the Companies Act, 1956. Further amendments have followed subsequently in the year 2000, 2002 and 2003. A variety of measures have been adopted including the strengthening of certain shareholder rights (e.g. postal balloting on key issues), the empowering of SEBI (e.g. to prosecute the defaulting companies, increased sanctions for directors who do not fulfill their responsibilities, limits on the number of directorships, changes in reporting and the requirement that a 'small shareholders nominee' be appointed on the Board of companies with a paid up capital of Rs. 5 crore or more) Regional Training Institute, Allahabad.

The major corporate governance initiatives launched in India since the mid 1990s are discussed below: The CII Code On account of the interest generated by Cadbury Committee Report of UK, the Confederation of Indian Industry (CII) took special initiative with the objective to develop and promote a code of Corporate Governance to be adopted and followed by Indian Companies both in private & public sector, Banks and Financial Institutions. The first draft of the code was prepared by April 1997, and the final document, *Desirable Corporate Governance: A Code*2, was publicly released in April 1998. The code was voluntary, contained detailed provisions, and focused on listed companies. The Committee was driven by the conviction that good corporate governance was essential for Indian Companies to access domestic as well as global capital at competitive rates. The code was voluntary, contained detailed provisions with focus on listed companies. Kumar Mangalam Birla Committee Report While the CII code was well received by corporate sector and some progressive companies also adopted it, it was felt that under Indian conditions a statutory rather than a voluntary code would be more meaningful. Some of the major recommendations of the committee primarily related to audit committees, audit reports, independent directors, related party transactions, risk management, directorships and director compensation, codes of conduct and financial disclosures. With enactment of this legislation in 1956 the Companies Act 1913 was repealed. The need for streamlining this Act was felt from time to time as the corporate sector grew in pace with the Indian economy and as many as 24 amendments have taken place since 1956. The major amendments to the Act were made through Companies (Amendment) Act 1998 after considering the recommendations of Sachar Committee followed by further amendments in 1999, 2000, 2002 and finally in 2003 through the Companies (Amendment) Bill 2003 pursuant to the report of R.D. Joshi Committee. It was decided by this committee that seven Task Forces be set up at Mumbai, Delhi, Chennai, Kolkata, Ahmadabad, Bangalore and Hyderabad with Regional Directors/Registrar of Companies of respective regions as convener, and Regional Offices of SEBI and Stock Exchanges as Members. The main task of these Task Forces was to identify the companies, which have disappeared, or which have misutilised the funds mobilized from the investors and suggests appropriate action in terms of Companies Act or SEBI Act. National Foundation of Corporate Governance Recently the Ministry of Company Affairs has set up National Foundation for Corporate Governance (NFCG) in association with Confederation of Indian Industry (CII), Institute of Company Secretaries of India (ICSI) and Institute of Chartered Accountants of India (ICAI). The NFCG would focus on the following areas: Creating awareness on the importance of implementing good corporate governance¬ practices both at the level of individual corporations and for the economy as a whole. The CII, ASSOCHAM & SEBI constituted committees to recommend initiatives in Corporate Governance. KPMG in its survey on State of Corporate Governance in India has stated that, the Good corporate governance is characterized by a firm commitment and adoption of ethical practices by an organization across its entire value chain and in all of its dealings with a wide group of stakeholders encompassing employees, customers, vendors, regulators and shareholders (including the minority shareholders), in both good and bad times. In late 2009 MCA has released a set of voluntary guidelines for corporate governance. Lately, Brazil, Russia, India and China (BRIC) countries have emerged as an influential economic power in the global economy. It is estimated that the combined GDP of the BRIC countries is likely to be higher than that of developed countries. Studies have projected that amongst the BRIC economies, India has the potential to grow the fastest over the next 30-50 years (Wilson & Purushothaman, 2003). A McKinsey survey conducted in 2002, found that investors were willing to pay a premium of up to 25% for a well governed company (Barton, Coombes, & Wong, 2004). In a review of the global research on corporate governance, it was found that majority of the studies had the US institutional context as the unit of analysis (Durisin & Puzone, 2009). The development of corporate governance as an area of research started with the publication of the Cadbury Committee report and further developed through a series of seminal works of La Porta *et al.* (1997) [7].



The first initiative was undertaken by confederation of Indian industry, India's largest industry and business association which came up with first voluntary code of corporate governance in 1998.In early 2000s through the introduction of clause 49 of listing agreement, as all companies listed on stock exchanges were required to comply with these norms.

Clause 49, includes the following key requirements

- Board Independence Boards of directors of listed companies must have a minimum number of independent directors. Where the Chairman is an executive or a promoter or related to a promoter or a senior official, then at least one-half the board should comprise independent directors; in other cases, independent directors should constitute at least one-third of the board size.
- Audit Committees Listed companies must have audit committees of the board with a minimum of three directors, two-thirds of whom must be independent; in addition, the roles and responsibilities of the audit committee are specified in detail.
- Disclosure Listed companies must periodically make various disclosures regarding financial and other matters to ensure transparency.
- CEO/CFO certification of internal controls The CEO and CFO of listed companies must (a) certify that the financial statements are fair and (b) accept responsibility for internal controls.
- Annual Reports Annual reports of listed companies must carry status reports about compliance with corporate governance norms.

Literature Review

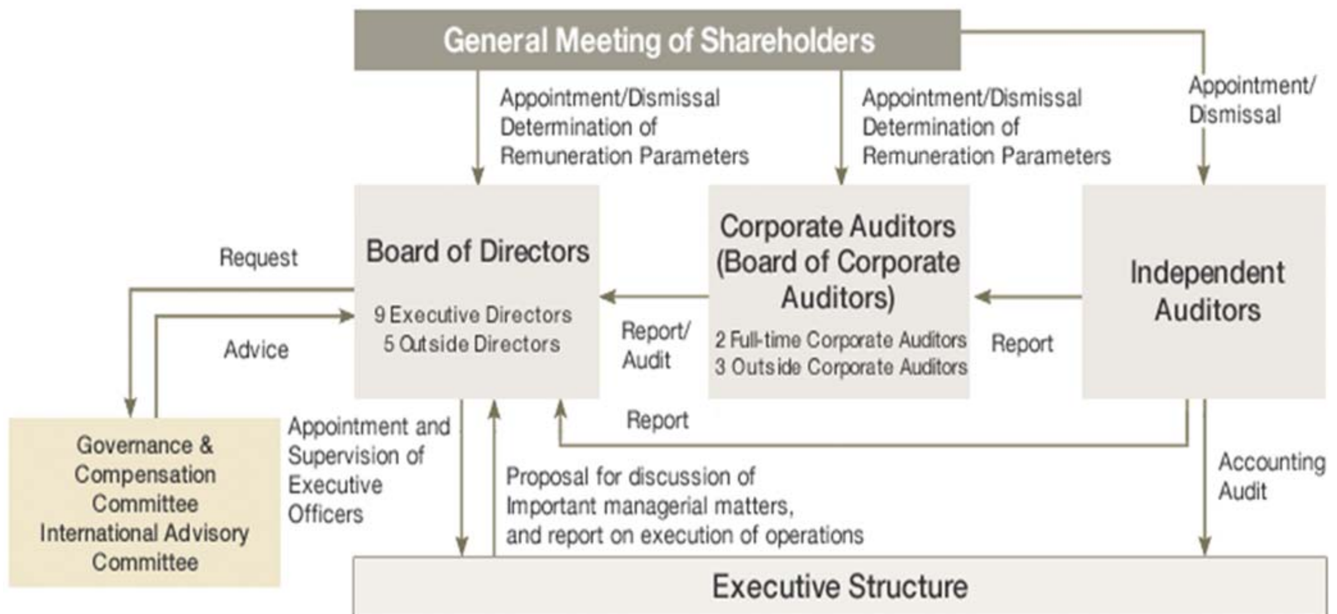
The development of corporate governance as an area of research started with the publication of the Cadbury Committee report and further developed through a series of seminal works of La Porta *et al.* (1997) [7]. Governance issues stems from agency problems that have been dealt in literature extensively. The international papers on origins trace the development of corporate governance in India and analyse the status of governance in terms of the country's legal system, ownership structures (Gollakota and Gupta, 2006) [8] institutions that are involved in governance (Chakrabarti *et al.* 2008) [9]. Path dependence theory and the Anglo Saxon model of governance adopted in India are also examined (Machold and Vasudevan, 2004) [10]. Researchers have examined the development of governance models from managing agency model during British rule, the post 14 independent business house model and the recent Anglo-American model and their suitability to India (Reed 2002, Afsharpour, 2009) [11, 12]. A few papers also discuss the value based corporate governance through the ethos of ethical theories of traditional Hinduism i.e. of "Manusmriti" (Sivakumar, 2009) [13] "Dharma" (Bhasin, 2008) [14] and Kautilya's Artha Shastra. (Muniapan *et al.* 2007) [15]. An interesting question in the finance literature is whether the corporate governance practices of an individual firm influence its market value. Many researches have been conducted and varied findings have emerged (Black 2001) [16]. A survey carried out by McKinsey & Co., found that investors pursuing a growth strategy did not worry about corporate governance, but investors who pursued value strategy and invested in under-valued or stable companies were willing to pay for good governance. These investors has the belief that a company with good corporate governance will perform better over a period of time and that good governance can reduce the risk and attract further investment (Agrawal *et al.* 1996) [6]. Even though there is a growing literature on governance issues such as board composition, board leadership structure the results are unclear with respect to firm performance (Dalton *et al.* 1998) [5]. Many studies that have demonstrated positive relationships between variables of interest and firm performance, when meta-analytically reviewed show negative relationships and no statistically significant relationship at all (Dalton *et al.* 1998) [5]. Yermack (1996) [4] documents those firms having small board sizes have higher stock market value. He finds an inverse relationship between firm value and board size by using a sample of large US corporations.

Objectives

- To study the framework of corporate governance and legal rules and regulations followed regarding this.
- To find out the challenges faced and essentials required for the effective corporate governance practices.

Research Methodology: This paper examined the corporate governance's framework and legal rules and regulations related to them. Data for the same was collected using secondary sources like journals, newspaper, magazines and various other such related researches done by other researchers. Various reports have also been analysed, like a report on corporate governance by Regional Training Institute, Allahabad and report on Corporate Governance - Implementation, Challenges and Trends by UBS.

The corporate governance framework in India primarily consists of the following legislations and regulations: The Companies Act, 1956: Companies in India, whether listed or unlisted, are governed by the Companies Act. The Act deals with rules and procedures regarding incorporation of a company; prospectus and allotment of ordinary and preference shares and debentures; management and administration of a company; annual returns; frequency and conduct of shareholders' meetings and proceedings; maintenance of accounts; board of directors, prevention of mismanagement and oppression of minority shareholder rights; and the power of investigation by the government. The Securities Contracts (Regulation) Act, 1956: It covers all types of tradable government paper, shares, stocks, bonds, debentures, and other forms of marketable securities issued by companies. The SCRA defines the parameters of conduct of stock exchanges as well as its powers. The Securities and Exchange Board of India (SEBI) Act, 1992: This established the independent capital market regulatory authority, SEBI, with the objective to protect the interests of investors in securities, and promote and regulate the securities market. The Depositories Act, 1996: This established share and securities depositories, and created the legal framework for dematerialization of securities.



Five Golden Rules of best corporate governance practice are: Ethics: a clearly ethical basis to the business, Align Business Goals: appropriate goals, arrived at through the creation of a suitable stakeholder decision making model, Strategic management: an effective strategy process which incorporates stakeholder value, Organisation: an organisation suitably structured to effect good corporate governance and Reporting: reporting systems structured to provide transparency and accountability.

Challenges

- To achieve excellence in Corporate Governance
- To permanently meet the mix of strict legal regulations and regulatory requirements softer best practice guidelines
- Global applicability versus compliance with local jurisdiction
- Conflicting rules in a trans-border environment.
- Timely implementation of best Corporate Governance throughout the Group
- Consistency in internal rules and regulations
- Internal controls and documentation

Recommendations for improving the effectiveness of the corporate governance

- Expand the jurisdiction of SEBI to control unlisted companies and their activities, since they constitute a large chuck of business in India. Normally SEBI has the power to control the behaviour of listed companies in India.
- It is the responsibility of the government and its various nodal agencies to furnish every area of business with necessary provisions to ensure that it is working, according to the interest of the nation and different share-holders, at large.
- Make necessary clarity and transparency in provisions dealing with regulating business towards the general objectives of the nation.
- Establish necessary banking institutions in the rural parts of India and make awareness among the people about various banking products.
- Pre-emptive policies should put in place to keep away corporate-houses from political interventions, which enlarge the magnitude of corporate scams. It is clear that behind every corporate scam, there is an unscrupulous political nexus with corporate institutions.
- All the informal collective investment schemes must be brought under the jurisdiction of a centralised enforcement authority with necessary stipulations and moreover, discourage the unscrupulous investment schemes.

Conclusions: It can be concluded that a moderate regulatory regime is required with strong ethical code of conduct for the key players in the governance of a company. This paper has discussed the role of regulator (the company law administration as well as the securities regulator) and the capital market. In spite of the corporate governance challenges, it also covers the recommendations to overcome them. Thus it also includes that for listed companies, the vast majority of Clause 49 requirements are mandatory. It remains to be seen whether some of the more recent voluntary corporate governance measures will become mandatory for all companies through a comprehensive revision of the Companies Act.

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