CHAPTER- I

INTRODUCTION

The term “Corporate Governance” is gaining momentum in today’s business and corporate world. It can be traced back to the great work of Berle\(^1\) and Means\(^2\) in *The Modern Corporation and The Private Property*\(^3\) which for the first time indicated the salient features of evolution in corporate structure. The changes in the corporate structure were because of lack of management’s responsibility not only towards shareholders, but also towards society at large.\(^4\) In recent times a corporation is considered a social institution, interacting with the society in many ways and affecting its individuals. The major concern of all conscious citizens i.e. shareholders, employees, creditors, customers and government should be to govern this institution in a rational manner\(^5\). In addition, corporate governance by and large is related with the system and processes by which companies are directed and controlled with the single overriding objective of all publicly listed companies being its preservation and the greatest practical enhancement over time of the shareholder’s investment. The corporate governance system also involves the entire network of formal and informal relations and interactions between the board, management, shareholders, auditors, and other interested parties. These relations and interactions determine how a company is controlled and how risks and returns from corporate activities are determined.\(^6\) In short, ‘Corporate governance’ is the system by which company is directed, administered and

\(^{1}\) Adolf Augustus Berle, Jr , January 27, 1895 – February 17, 1971) was a lawyer, educator, author, and U.S. diplomat.\(^{2}\) He was the author of *The Modern Corporation and Private Property*, a groundbreaking work on corporate governance, and an important member of U.S. President Franklin Roosevelt’s "Brain Trust."

\(^{2}\) Gardiner Coit Means (June 8, 1896 in Windham, Connecticut\(^{1}\) – February 15, 1988 in Vienna, Virginia\(^{2}\)) was an American economist who worked at Harvard University, where he met lawyer-diplomat Adolf Berle. Together they wrote the seminal work of corporate governance, *The Modern Corporation and Private Property.*


\(^{4}\) Indrajit Dube, *Corporate Governance* 4 (Lexis Nexis Butterworths Wadhwa, New Delhi, 2009).


\(^{6}\) *Ibid.*
controlled through a set of corporate processes, customs, policies and law. It is a 
congregation of various stakeholders, namely, customers, employees, investors, 
vendor partners, government and society.

1.1 Meaning of Corporate Governance

The term ‘Corporate governance’ denotes the entire process by which 
corporations are managed and controlled. It is the set of processes, customs, 
policies, laws and institutions by which corporation are directed, administered and 
controlled. It also provides the structure through which the objectives of the 
company are set, and the means of attaining those objectives and monitoring 
performance of the company are determined. It involves regulatory and market 
mechanism, and the roles and relationships between a company’s management, its 
board, its shareholders and other stakeholders.7

Hence, the best way to define the concept of corporate governance is to list 
different definitions rather than just mentioning one definition. Some of the 
definitions of corporate governance given by various experts in this field are 
mentioned below:

I. According to Mathiesen8, “Corporate governance is a field in 
economics that investigates how to secure/motivate efficient 
management of corporations by the use of incentive mechanisms, 
such as contracts, organizational designs and legislation. This is 
often limited to the question of improving financial performance, 
for example, how the corporate owners can secure/motivate that the 
corporate managers will deliver a competitive rate of return”.9

8 Henrik Mathiesen is ViamInvest's founder. Previously he worked from 2002 to 2005 as a 
research assistant professor at Aarhus School of Business, Denmark. In 2002 he earned a Ph.D. 
in economics from Copenhagen Business School, Denmark. He got his M.Sc. in economics 
from Copenhagen University in 1996 that included one year of graduate studies at University of 
Western Ontario, Canada.
9 http://www.mbaknol.com/strategic-management/definitions-of-corporate-governance/ (Visited 
on November 15, 2014).
II. According to Sheilfer\(^{10}\) and Vishny\(^{11}\), “Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”\(^{12}\).

III. According to James D. Wolfensohn\(^{13}\), President of World Bank, "Corporate governance is about promoting corporate fairness, transparency and accountability.”\(^{14}\)

IV. According to Shann Turnbull\(^{15}\), “Corporate governance describes all the influences affecting the institutional processes, including those for appointing the controllers and regulators, involved in organizing the production and sale of goods and services. Described in this way, corporate governance includes all types of firms whether or not they are incorporated under civil law.”\(^{16}\)

V. According to Tricker\(^{17}\), “Corporate Governance is concerned with the way entities are governed, as distinct from the way business within those companies are managed. Corporate Governance

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10 Andrei Shleifer (born February 20, 1961) is a Russian American economist and Professor of Economics at Harvard, where he has taught since 1991. Shleifer was awarded the biannual John Bates Clark Medal in 1999 for his seminal works in three fields: corporate finance (corporate governance, law and finance), the economics of financial markets (deviations from efficient markets), and the economics of transition.

11 Robert Ward Vishny (born c. 1959) is an American economist and is the Myron S. Scholes Distinguished Service Professor of Finance at the University of Chicago Booth School of Business. He was the Eric J. Gleacher Distinguished Service Professor of Finance at the University of Chicago Booth School of Business. He received his A.B. with highest distinction (economics, mathematics, and philosophy) from the University of Michigan in 1981 and Ph.D. (Economics) from Massachusetts Institute of Technology in 1985.


13 James David Wolfensohn, (born 1 December 1933) is an Australian-American lawyer, investment banker and economist who served as the ninth president of the World Bank Group.


15 Shann Turnbull began work as an electronics engineer before becoming a corporate raider, company promoter, chief executive and chairman of publicly traded corporations in Australia. In 1975 he pioneered the study of comparative corporate governance as a foundation author of the Company Directors' Diploma Course presented throughout Australia and internationally.


17 Bob Tricker is an expert in corporate governance who wrote the first book to use the title Corporate Governance in 1984\(^{[1]}\) based on his research at Nuffield College, Oxford. He was also the founder-editor of the research journal Corporate Governance - an international review (1993).
addresses the issues facing Board of Directors, such as the interaction with top management and relationship with the owners and others interested in the affairs of the company.”

VI. Monks\textsuperscript{19} and Minow\textsuperscript{20} have defined corporate governance as “relationships among various participants in determining the direction and performance of a corporation which include the primary participants such as the shareholders, the management and the board of directors”\textsuperscript{21}

Besides these definitions the term corporate governance has been defined by various committees and organizations in their respective reports as :-

VII. According to OECD, “Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance”\textsuperscript{22}

VIII. According to The Kumarmangalam Birla Committee, “Corporate Governance is the system by which companies are directed and


\textsuperscript{19} Robert A. G. Monks (born December 4, 1933) is a shareholder activist and co-founder of Institutional Shareholder Services, Lens Investment Management, Lens Governance Advisors and The Corporate Library (now part of GMI Ratings). He is the author of Corpocracy and The New Global Investors and, with Nell Minow, Watching the Watchers, Corporate Governance and Power & Accountability.

\textsuperscript{20} Nell Minow is an American film reviewer and writer who writes and speaks frequently on film, media, and corporate governance and investing. Ms. Minow was named one of the 20 most influential people in corporate governance by Directorship magazine in 2007. She was dubbed “the queen of good corporate governance” by Business Week Online in 2003 and has received Lifetime Achievement awards from both the International Corporate Governance Network \textsuperscript{21} and Corporate Secretary Magazine.


\textsuperscript{22} Organization for Economic Cooperation and Development April 1999. OECD’s definition is consistent with the one presented by Cadbury (1992).
controlled. Board of directors are responsible for the governance of their companies. The shareholder’s role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company’s strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The Board’s actions are subject to laws, regulations and shareholders in general meeting.”\(^\text{23}\)

IX. Report of Stock Exchange Board of India on Corporate Governance defines corporate governance as “the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making distinction between personal and corporate funds in the management of the company.

X. According to Cadbury Committee corporate governance is “the system by which companies are directed and controlled.”\(^\text{24}\)

Although the idea of corporate governance has received wide attention, there is considerable variation in the conceptual definition, even resulting in inconsistencies of the term.\(^\text{25}\) In its narrow sense, the term may describe the formal system of accountability of senior management to the shareholders. At its most expansive, the term is stretched to include the entire network of formal and informal relations involving the corporate sector and their consequences for the society in general. Corporate governance, however, as generally understood, includes the structure, processes, cultures and systems that engender the


\(^{24}\) Cadbury Committee, 1992.

successful operation of the organizations. “Governance is the process whereby people in power make decisions that create, destroy or maintain social systems, structures and processes. Corporate governance is therefore the process whereby people in power direct, monitor and lead corporations, and thereby either create, modify or destroy the structures and systems under which they operate. Corporate governors are both potential agents for change and also guardians of existing ways of working, as such, they are therefore a significant part of the fabric of our society. Different countries have different ideas and objectives as to what constitutes good corporate governance.

1.2 Objectives of Corporate Governance

Corporate Governance as well as good governance is integral to the very existence of a corporation. It inspires and strengthens investor’s confidence by ensuring company’s commitment to higher growth and profits. It seeks to achieve following objectives:

I. A properly structured Board in a corporation that is capable of taking independent and objective decisions whenever required besides this should have an effective machinery to sub-serve the concerns of stakeholders.

II. The Board should be balanced as regards the representation of adequate number of non-executive and independent directors who will take care of the interests and well-being of all the stakeholders. The Board should keep the shareholders informed of relevant developments impacting the company.

III. The Board adopts transparent procedures and practices and arrives at decisions on the strength of adequate information.

IV. The Board should effectively and regularly monitor the functioning of the management team and should remain in effective control of the affairs of the company at all times.

V. To align corporate goals with goals of its stakeholders (society, shareholders etc.).

VI. To specify responsibility of the board of directors and managers in order to insure good corporate performance and strengthen corporate functioning and discourage mismanagement.

VII. To achieve corporate goals by making investment in profitable investment outlets.

1.3 Importance of Corporate Governance

Corporate governance is important for the following reasons:

I. It shapes the growth and future of capital markets of the economy.

II. It helps in raising funds from capital markets. Sound governance practices contribute to investor’s confidence in corporations to attract long-term capital.

III. It links company’s management with its financial reporting system.

IV. It enables management to take innovative decisions for effective functioning of the enterprise within the legal framework of accountability. The effectiveness of legal and regulatory framework is indispensable to assess the impact of corporate governance on overall economic performance.

V. Good corporate governance enhances the structures through which objectives of the corporations are set, means of attaining such objectives are determined and performance is monitored.

VI. It supports investors by making corporate accounting practices transparent. Corporate enterprises disclose financial reporting structures.

VII. It provides adequate and timely disclosure reporting requirements, code of conduct etc. companies present material price sensitive information to outsiders and insure that till this information is made public, insiders abstain from dealing in corporate securities. It, thus, avoids insider trading.
VIII. It improves efficiency and effectiveness of the enterprise and adds to wealth of the economy. Corporate governance is, thus, an instrument of economic growth.

IX. It improves international image of the corporate sector and enables home companies to raise global capital.\textsuperscript{29}

1.4 Major Principles of Corporate Governance

Contemporary discussions on corporate governance tend to refer to principles raised in three important documents released since 1990: The Cadbury Report (UK, 1992), the Principles of Corporate Governance (OECD, 1998, and 2004), The Sarbanes-Oxley Act of 2002 (US, 2002). The Cadbury and OECD reports present general principles around which businesses are expected to operate to assure proper governance. The Sarbanes-Oxley Act is an attempt by the federal government in the United States to legislate several of the principles recommended in the Cadbury and OECD reports.

I. Right and Equitable Treatment of the Shareholders: Organizations should respect the rights of shareholders and help shareholders to exercise those rights. They can help shareholders exercise their rights by openly and effectively communicating information and by encouraging shareholders to participate in general meetings.

II. Interest of Other Stakeholders: Organizations should recognise that they have legal, contractual, social, and market driven obligations to non-shareholder stakeholders including employees, investors, creditors, suppliers, local communities, customers and policy makers.

III. Role and Responsibility of the Board: The board needs sufficient relevant skills and understanding to review and challenge management performance. It also needs adequate size and appropriate levels of independence and commitment.

IV. Integrity and Ethical Behaviour: Integrity should be a fundamental requirement in choosing corporate officers and board members.

\textsuperscript{29} Id. At 5.
Organizations should develop a code of conduct for their directors and executives that promotes ethical and responsible decision making.

V. Disclosure and Transparency: Organizations should clarify and make publicly known the roles and responsibilities of the board and management to provide stakeholders with a level of accountability. They should also implement procedures to independently verify and safeguard the integrity of company’s financial reporting. Disclosure of material matters concerning the organization should be timely and balanced to ensure that all investors have access to clear, factual information.

1.5 Need For Corporate Governance in India

Although instituting corporate governance is clearly very beneficial for firms and countries, the rapid pace of globalization has made the need more urgent which requires that the firms and national governments make some fundamental changes. Companies must change the way they operate, while national governments must establish and maintain the appropriate institutional framework. What corporate governance is all about in larger terms is how a structure can be set up that allows for a considerable amount of freedom within the rule of law.30

Public attention through high profile corporate scandals and collapses has forced governments, regulators and boards of corporations to carefully reconsider fundamental issues of corporate governance as essential for public economic interest. In addition, the volatility and instability experienced in emerging markets in recent times has drawn attention to the implications of corrupt practices and maladministration in national and international financial systems and on public expenditure. Good corporate governance practices are now becoming a necessity for every country and business enterprise, and are no longer restricted to the activities of public-listed corporations in advanced industrial economies.31

It is clearly evident that inefficient management practices led to several financial crisis and business collapses around the world. These business failures forced the business world to think and stress upon the significance of sound concept of corporate management practices. The issue sighted serious consideration among the various professional bodies and makers of laws and regulations at international level and they considered the quality of corporate governance practices equally significant for decision making. Recently it was noticed that global investors have realized the significance of corporate governance practices on the financial performance of companies and also realized that the issue of corporate governance bears more importance while adopting investment decisions. It is also true that the investors are ready to pay higher premiums for companies having sound corporate governance practices. There are various advantages which can be reaped by companies of any nation through sound corporate governance framework. An effective and sound corporate governance policy in practice helps the companies to raise cheaper fund at low cost of capital, enhances financial soundness and liquidity position, provides capabilities to overcome and prevent any financial collapses and also improves the standing in the capital market. It also helps in improving country’s image and reputation by prevention of outflow of funds and increase in foreign capital flow. It also leads to efficient allocation of resources, increases the competitive power and strengthens the capital market and finally increases the chances of higher prosperity by preventing and reducing the occurrence of any financial crisis. Various significant studies of corporate governance have been undertaken and still being conducted to realize the importance and role of corporate governance in the current changing business scenario. The studies to a large extent have stated that their does not exist any single model of corporate governance which can be adopted uniformly in all the countries due the political, economic, legal and cultural and custom differences. Hence, there is an utmost need of a model to be developed which can be compatible to each country based on the principles of transparency, equality, accountability and responsibility which may be widely accepted for international corporate governance. The term equality can be defined
as equal treatment of stakeholders by the management to prevent any possible conflict as regard to their interest. Transparency can be expressed as providing all material financial and non-financial information within a reasonable time at low cost which should be accurate, reliable and valid for their decision making process. On the other hand accountability may be defined as laying down powers to the board so that the board of directors may be made answerable towards the company as a corporate entity and the stakeholders. Responsibility can be associated with compliance to all rules & regulations drafted under articles and in the operation & audit process. Thus to establish the corporate governance framework, various organizations viz; World Bank, Organization for Economic Cooperation and Development and Global Corporate Governance Forum were assigned the task to discuss the issue. Thus, a large number of countries in the developed and developing economy were in the process for reviewing and restructuring their legislation and some of them even came out with new laws & regulations.

A corporation is a congregation of various stakeholders, namely customers, employees, investors, vendor partners, government and society. In such situation and in the changed scenario of Indian corporation, as also a corporation elsewhere should be fair and transparent to its stakeholders in all its transactions.  

This has become imperative in today's globalized business world where corporations need to access global pools of capital, need to attract and retain the best human capital from various parts of the world. Unless a corporation embraces and demonstrates such type of ethical conduct, it will not be able to succeed.

Corporations need to recognize that their growth requires the cooperation of all the stakeholders; and such cooperation is enhanced by the corporations adhering to the best Corporate Governance practices. In this regard, the management needs to act as trustees of the shareholders at large and prevent asymmetry of benefits between various sections of shareholders, especially between the owner-managers and the rest of the shareholders.

32 Supra Note 1.
In *National Textile Workers’ Union v. P.R. Ramakrishnan*\(^{33}\) it was held that the workers are entitled to appear at the hearing of the winding-up petition whether to support or to oppose it so long as no winding up order was made by the court. The court was of the view that a corporation is not only responsible to the workers but also to the society.

Principles of corporate governance have become conventional wisdom with realization that it is a necessary tool for the economic health of a company and more importantly, for society at large. Implementation of governance practices however, continue to vary between companies, nations and across regions. The driving force for an increasing number of companies today is adopting voluntary initiatives that improve relationships with all constituents—customers, shareholders and all other stakeholders. But beyond a company’s direct web of relationships, the ‘corporate conscience’ has now taken centre stage wherein companies are differentiated on the basis of working conditions, environmental strategies and their response to community needs.\(^{34}\)

Governance norms have assumed greater significance in India with corporate having scaled up in size and ambition as they seek to establish a global footprint. The Indian regulatory framework has insured that the interests of stakeholders are well protected, though ultimately, the prime responsibility of good governance lies within an organization and not outside it.\(^{35}\)

An effective corporate governance framework needs to be flexible to respond to changing market dynamics, yet it must be unwavering as regards its values and ethics. While designing and implementing the governance processes, there is a need to insure an effective mechanism of checks and balances with transparency and accountability as the hallmark.

\(^{33}\) (1983) 53 Comp. Cas. 184.

\(^{34}\) Subhash Das, *Corporate Governance in India- An Evaluation* 77 (PHI Learning Pvt. Ltd., New Delhi, 2009).

\(^{35}\) *Ibid.*
1.5.1 Corporate governance is needed for following reasons

I. Separation of ownership from management: A company is run by its managers; corporate governance insures that managers work in the best interest of corporate owners (shareholders).

II. Global capital: In the globalised world of today, global capital flows in markets which are well regulated and have high standards of efficiency and transparency. Good corporate governance gains credibility and trust of global market players.

III. Investor protection: Investors are educated and enlightened of their rights. They want their rights to be protected by companies in which they have invested money. Corporate governance is an important tool for protecting investor’s interest by improving efficiency of corporate enterprises.

IV. Foreign investments: Significant foreign institutional investment is taking place in India. These investors expect companies to adopt globally accepted practices of corporate governance in well developed capital markets. The foreign investors demand international standards of corporate governance and greater professionalism in management of Indian corporate which in turn substantiates the need for good corporate governance.

V. Financial reporting and accountability: Good corporate governance ensures sound, transparent and credible financial reporting and accountability to investors and lenders so that funds can be raised from capital markets.

VI. Banks and financial institutions: Banks and financial institutions give financial assistance to companies. They are interested in financial soundness of companies. This can be done through good corporate governance.

VII. Globalization of economy: The economy today is globalized. Integration of India with the world economy demands that Indian
industries conform to the standards of international rules. Corporate governance helps in doing this.\textsuperscript{36}

1.6 Factors Influencing Quality of Corporate Governance

While corporate governance is an important element affecting the long-term financial health of companies, it is only part of the larger economic context in which companies operate. The corporate governance framework depends on the legal, regulatory and institutional environment, business ethics and awareness of the environmental and societal interests of the constituencies in which it operates. Quality of governance primarily depends on following factors:

I. Integrity of the management.
II. Ability of the Board.
III. Adequacy of the processes.
IV. Commitment level of individual Board members.
V. Quality of corporate reporting.
VI. Participation of stakeholders in the management.\textsuperscript{37}

The degree to which corporations observe basic principles of good corporate governance is an increasingly important factor for taking key investment decisions. International flow of capital enables companies to seek financing from a larger pool of investors. If companies are to reap the full benefits of the global capital market, capture efficiency gains, benefit by the economies of scale and attract long term capital, adoption of corporate governance standards must be credible, consistent, coherent and inspiring.\textsuperscript{38}

1.7 Global Emergence of Corporate Governance

The various financial scams, scandals and frauds emerged around corporate world raised various issues on the existing system of regulations and it was found that the prevailing system was unsatisfactory and it was strongly felt the need of substantial external regulations. There was a process thought of developing a regulation which could penalize and award to the wrong doers and

\textsuperscript{36} Dr. Neeru Vasishth and Dr. Namita Rajput, \textit{Taxmann’s Corporate Governance Values & Ethics} 4-5 (Taxmann Publications (P.) Ltd., New Delhi, 2010).


the abiders of rules and regulations of various market forces. The Government, the Shareholders, the players of mutual funds and financial institutional investors were of the view that the corporate in which they likely would like to make their investment should adopt to better corporate governance practices. It was also felt to form various committees to discuss the various issues of corporate governance and make recommendations from a corporate code of conduct and guidelines of corporate governance which can be implemented at global level. This process lead to bring about a serious notion in corporate world to realize that the investors and society at large are concern about corporate governance practices.

The term corporate governance gained importance after the Watergate debacle. After a series of investigation the regulatory and legislative bodies of U.S. noticed the drawbacks of control failures as the major cause of the scandals which allowed several corporations to make unethical and illegal financial practices backed by political forces. The scandals in united state force the regulator to develop a mechanism to counter such issues. Thus, Foreign and Corrupt Practices Act (1977) was formulated which contained provisions as regard to review, establish and maintain internal control system. This also forced to follow the proposals for mandatory review and reporting on internal financial control by the Securities and Exchange Commission's (SEC’s 1979). The noticeable high profile business failure in 1985 in regard to savings and loans collapse led to the formation of Tradway Commission to focus on misappropriations in financial report and state measures for minimizing the act of misappropriations. Tradway Commission in its report focused on need of effective control process, development of independent audit committees and recommended for publication of internal control report and their effectiveness.

The banking scandals which took place in England provided the gateway of corporate governance. The corporate failures in England brought about in notice about improper structure and objectives of the top management. Absence of effective regulatory mechanism and multiple corporate failures led to the development of the Committee of Sponsoring Organizations (COSO), which was made responsible to provide adequate response to check the business failure. The
committee recommended for a control framework endorsed through its subsequent report viz; Cadbury, Ruthman, Hampel and Turnbull. The Hampel Report (1998) on Combined Code on corporate governance recommended significant areas of corporate governance in which changes were to be brought about. The committee on corporate governance analyzes various business issues and problem of the business crises among the corporate sector and financial market and sought out guidelines for effective corporate management.

1.8 Global Corporate Governance Models

It is pertinent to note that there are many different models of corporate governance around the world. These differ according to the variety of capitalism in which they are embedded. The Anglo-American “model” tends to emphasize the interests of shareholders. The coordinated or multi-stakeholder model associated with Continental Europe and Japan also recognizes the interests of workers, managers, suppliers, customers, and the community.

Some continental European countries, including Germany and Netherlands, require a two-tiered Board of Directors as a means of improving corporate governance. In the two-tiered Board, the executive Board made up of company executives, generally runs day-to-day operations while the supervisory board, made up entirely of non-executive directors who represent shareholders and employees, hires and fires the members of the executive board, determines their compensation, and reviews major business decisions.

The so-called “Anglo-American model” (also known as “the unitary system”) emphasizes a single-tiered Board of Directors composed of a mixture of executives from the company and non-executive directors, all of whom are elected by shareholders. Non-executive directors are expected to outnumber executive directors and hold key posts, including audit and compensation committees. The United States and the United Kingdom differ in one critical respect with regard to corporate governance. In United Kingdom, the CEO generally does not also serve as the chairman of the Board, whereas in the US having the dual role is the norm, despite major misgivings regarding the impact on corporate governance.
In the United States, corporations are directly governed by state laws, while the exchange (offering and trading) of securities in corporations (including shares) is governed by federal legislation. Many US states have adopted the Model Business Corporation Act, but the dominant state law for publicly-traded corporations is Delaware, which continues to be the place of incorporation for majority of publicly-traded corporations. Individual rules for corporations are based upon the corporate charter and, less authoritatively, the corporate bylaws.

India’s SEBI Committee on corporate governance defines corporate governance as the “acceptance by management of the inalienable rights of shareholders as the true owners of corporation and of their own role as trustees on behalf of shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the management of a company.” It has been suggested that the Indian approach is drawn from Gandhian principle of trusteeship and the Directive Principle of the Indian constitution, but this conceptualization of corporate objectives is also prevalent in Anglo-American and most other jurisdictions.39

1.9  Mechanisms and Controls of Corporate Governance

In fact, corporate governance mechanisms and controls are designed to reduce the inefficiencies that arise from moral hazard and adverse selection. For example, to monitor manager’s behaviour, an independent third party (the external auditor) attests the accuracy of information provided by the management to investors. An ideal control system should regulate both motivation and ability.

1.9.1  Internal Corporate Governance Controls

Internal corporate governance controls monitor activities and then take corrective action to accomplish organizational goals. Examples include:

I. Monitoring by the board of directors: The board of directors, with its legal authority to hire, fire and compensate top management, safeguards invested capital. Regular board meetings allow potential problems to be identified, discussed and avoided. Whilst non-executive directors are thought to be more independent, they may

not always result in more effective corporate governance and may not increase performance. Different board structures are optimal for different firms. Moreover, the ability of the board to monitor the firm’s executives is a function of its access to information. Executive directors possess superior knowledge of the decision making process and therefore evaluate top management on the basis of the quality of its decisions that led to financial performance outcomes, *ex ante*. It could be argued, therefore, that executive directors look beyond the financial criteria.

II. Internal control procedures and internal auditors: Internal control procedures are policies implemented by an entity’s board of directors, audit committee, management, and other personnel to provide reasonable assurance of the entity achieving its objectives related to reliable financial reporting, operating efficiency, and compliance with laws and regulations. Internal auditors are personnel within an organization who test the design and implementation of the entity’s internal control procedures and the reliability of its financial reporting.

III. Balance of power: The simplest balance of power is very common; require that the president be a different person from the treasurer... This application of separation of power is further developed in companies where separate divisions check and balance each other’s actions. One group may propose company-wide administrative changes, another group review and can veto the changes and a third group check the interests of people (customers, shareholders, employees) outside the three groups are being met.

IV. Remuneration: Performance-based remuneration is designed to relate some proportion of salary to individual performance. It may be in the form of cash or non-cash payments such as shares and share options, superannuation or other benefits. Such incentive schemes, however, are reactive in the sense that they provide no
mechanism for preventing mistakes or opportunistic behaviour, and can elicit myopic behaviour.

V. Monitoring by large shareholders and/or monitoring by banks and other large creditors: Given their large investment in the firm, these stakeholders have the incentives, combined with right degree of control and power to monitor the management.

1.9.2 External Corporate Governance Controls

External corporate governance controls encompass the controls external stakeholders exercise over the organization. Some of them are:

I. Competition
II. Debt covenants
III. Demand for and assessment of performance information (especially financial statements)
IV. Government regulations
V. Managerial labour market
VI. Media pressure
VII. Takeovers

1.10 Corporate Governance and Corporate Social Responsibility

Corporate social responsibility and corporate governance are inextricably intertwined. Today there is a growing perception among enterprise that sustainable business success and shareholder value control cannot be achieved solely through maximizing short-term profits, but instead through market oriented yet responsible behaviour. Companies are aware that they can contribute to sustainable development by managing their operations in such a way as to enhance economic growth and increase competitiveness whilst ensuring environmental protection and promoting social responsibility.

Business governance or corporate governance is a phenomenal set of systems and processes to ensure that a company is managed to safeguard the interest of all the stakeholders. Corporate governance and Corporate Social Responsibility are both extremely important to a company.

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40 Id. At 57-60.
We cannot see good CSR practices without good corporate governance practices. Corporate governance depends on managerial performance as well as a consideration of social responsibility, the socio-cultural-environmental dimension of business procedure, legal and ethical practices with a focus on customers and other stakeholders of an organization. Therefore we can say the corporate governance and corporate social responsibility are interrelated.\(^\text{42}\)

1.11 Regulatory Framework of Corporate Governance in India

In India, the question of corporate Governance has come up mainly in the wake of economic liberalization and de-regularization of industry and business. Various committees set up by the industry, reports and recommendations made by the Securities and Exchange Board of India and the Ministry of Corporate Affairs covered every subject of importance to corporate governance. In India, the development of corporate laws has been marked by interesting contrasts.

In terms of corporate laws and financial system, India emerged far better endowed than most other colonies. The years since liberalization, have witnessed wide-ranging changes in both laws and regulations driving corporate governance as well as general consciousness about it.\(^\text{43}\) It is evident from the various legal and regulatory frameworks and Committees set up for the corporate functioning. Such laws, regulatory framework and recommendations of the committees are as follows:

1.11.1 List of regulators

II. The Ministry of Corporate Affairs (MCA), Government of India-MCA regulates corporate affairs in India through the Companies Act, 1956, 2013 and other allied acts, bills and rules. It also protects investors and offers many important services to stakeholders. It also prevents adverse competition through Competition Act, 2002 and also promotes and sustains competition.


\(^{43}\) Priya Sharma, Corporate Governance in India, Available at: www.DehradunLawReview.com (Visited on June 05, 2013).
III. The Serious Fraud Investigation Office – It is multi-disciplinary organization to investigate serious financial frauds. It normally takes up investigations which are multi-disciplinary in nature and involve substantial public interest and many other factors.

IV. The Company Law Board – It is a quasi-judicial body established under the Companies Act of 1956. It has power to regulate its own procedure.

V. The Registrar of Companies – It is formed under The companies Act 1956. It is vested with the primary duty of registering companies and ensuring that such companies comply with the statutory requirements under the act.

VI. Securities Contract 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.

VII. Securities and Exchange Board of India – Its basic function is to protect the interest of investors in securities. It promotes the development of securities market. It also regulates the securities market and matters connected with it. It also prohibit fraudulent and unfair trade practices relating to securities market, promoting investor education and training of intermediaries of securities market, regulating substantial acquisition of shares and takeovers of companies and also promotes and regulates self-regulatory organizations.

VIII. Enforcement Directorate – It is a specialised investigating agency under the Ministry of Finance which enforces Foreign Exchange and Management Act (FEMA) and Prevention of Money Laundering Act (PMLA). Foreign Exchange and Management Act is a civil law having quasi-judicial powers for investigating suspected contraventions of exchange control laws and regulations
with the powers to impose penalty. Prevention of Money Laundering Act is a criminal law, whereby the officers are empowered to conduct enquiries to locate, provisionally attach/confiscate assets.

1.11.2 **Principle Laws and Regulations**

I. The Indian Companies Act, 1956

II. The Depositories Act, 1996: This established share and securities depositories, and created the legal framework for dematerialization of securities.

III. Securities and Exchange Board of India 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.

IV. Arbitration and Conciliation Act, 1996;

V. SEBI Code on Corporate Governance, 1998

VI. Clause 49: Clause 49 of the Equity Listing Agreement consists of mandatory as well as non-mandatory provisions. Those which are absolutely essential for corporate governance can be defined with precision and which can be enforced without any legislative amendments are classified as mandatory. Others, which are either desirable or which may require change of laws are classified as non-mandatory. The non-mandatory requirements may be implemented at the discretion of the company. However, the disclosures of the compliance with mandatory requirements and adoption (and compliance) / non-adoption of the non-mandatory requirements shall be made in the section on corporate governance of the Annual Report;

VII. Foreign Exchange Management Act, 2000;

VIII. The Competition Act, 2002.

Apart from these Acts many committees have been set up for drafting the concept of ‘corporate governance’.

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1.11.3 Initiatives on Corporate Governance in India

I. Cadbury Report and CII initiatives,
II. Kumar Managlam Birla Committee report and SEBI initiatives,
III. Naresh Chandera Committee,
IV. N.R. Narayana Murthy Committee,
V. The Companies Act, 1956,
VI. The Companies Act, 2013.

1.11.4 Desirable Code of Corporate Governance (1998)

Corporate governance has been a buzzword in India since 1998. On account of the interest generated by Cadbury Committee Report (1992) in UK corporate governance initiatives in India began in 1998 with the Desirable Code of Corporate Governance – a voluntary code published by the Confederation of Indian Industry (CII), and the first formal regulatory framework for listed companies specifically for corporate governance, established by the Stock Exchange Board of India. The CII Code on corporate governance recommended that the key information to be reported, listed companies to have audit committees, corporate to give a statement on value addition, consolidation of accounts to be optional. Main emphasis was on transparency. Despite the code being voluntary in nature, a large number of listed companies, accounting for over 25% of India’s market capitalisation, adopted this code.  

1.11.5 Committee on Corporate Governance under the Chairmanship of Shri Kumar Mangalam Birla (1999)  

The Kumar Mangalam Committee made mandatory and non-mandatory recommendations. Based on the recommendations of the Committee, the SEBI

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45 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.

had specified principles of Corporate Governance and introduced a new clause in the Listing agreement of the Stock Exchanges in the year 2000.

1.11.6 Naresh Chandra Committee (2002)

The Department of Company Affairs in the Ministry of Finance on 21 August 2002, appointed a high level committee, popularly known as the Naresh Chandra Committee, to examine various corporate governance issues and to recommend changes in the diverse areas involving the auditor-client relationships and the role of independent directors. The Committee submitted its Report on 23 December 2002. Naresh Chandra Committee recommendations relate to the Auditor-Company relationship and the role of Auditors. Report of the SEBI

Mandatory and non-mandatory recommendations

The committee divided the recommendations into two categories, namely, mandatory and non-mandatory. The recommendations which are absolutely essential for corporate governance can be defined with precision and which can be enforced through the amendment of the listing agreement could be classified as mandatory. Others, which are either desirable or which may require change of laws, may, for the time being, be classified as non-mandatory.

Mandatory Recommendations:

- Applies To Listed Companies With Paid Up Capital Of Rs. 3 Crore And Above
- Composition Of Board Of Directors – Optimum Combination Of Executive & Non-Executive Directors
- Audit Committee – With 3 Independent Directors With One Having Financial And Accounting Knowledge.
- Remuneration Committee
- Board Procedures – Atleast 4 Meetings Of The Board In A Year With Maximum Gap Of 4 Months Between 2 Meetings. To Review Operational Plans, Capital Budgets, Quarterly Results, Minutes Of Committee's Meeting. Director Shall Not Be A Member Of More Than 10 Committee And Shall Not Act As Chairman Of More Than 5 Committees Across All Companies
- Management Discussion And Analysis Report Covering Industry Structure, Opportunities, Threats, Risks, Outlook, Internal Control System
- Information Sharing With Shareholders

Non-Mandatory Recommendations:

- Role Of Chairman
- Remuneration Committee Of Board
- Shareholders’ Right For Receiving Half Yearly Financial PerformancePostal Ballot Covering Critical Matters Like Alteration In Memorandum Etc
- Sale Of Whole Or Substantial Part Of The Undertaking
- Corporate Restructuring
- Further Issue Of Capital
- Venturing Into New Businesses

47 Mandatory and non-mandatory recommendations

The committee divided the recommendations into two categories, namely, mandatory and non-mandatory. The recommendations which are absolutely essential for corporate governance can be defined with precision and which can be enforced through the amendment of the listing agreement could be classified as mandatory. Others, which are either desirable or which may require change of laws, may, for the time being, be classified as non-mandatory.

48 The Naresh Chandra Committee was appointed as a high level committee to examine various corporate governance issues by the Department of Company Affairs on 21 August, 2002.

49 On 21 August 2002, the Department of Company Affairs (DCA) under the Ministry of Finance and Company Affairs appointed this High Level Committee to examine various corporate governance issues. Among others, this Committee has been entrusted to analyse and recommend changes, if necessary, in diverse areas such as:
Committee on Corporate Governance recommended that the mandatory recommendations on matters of disclosure of contingent liabilities, CEO/CFO Certification, definition of Independent Director, independence of Audit Committee and independent director exemptions in the report of the Naresh Chandra Committee, relating to corporate governance, be implemented by SEBI.50

1.11.7 Committee on Corporate Governance under the Chairmanship of Shri N. R. Narayana Murthy (2002)51

Narayana Murthy Committee recommendations52 to clause 49 of the Listing Agreement include role of Audit Committee, Related party transactions,

- the statutory auditor-company relationship, so as to further strengthen the professional nature of this interface;
- the need, if any, for rotation of statutory audit firms or partners;
- the procedure for appointment of auditors and determination of audit fees;
- restrictions, if necessary, on non-audit fees;
- independence of auditing functions;
- measures required to ensure that the management and companies actually present ‘true and fair’ statement of the financial affairs of companies;
- the need to consider measures such as certification of accounts and financial statements by the management and directors;
- the necessity of having a transparent system of random scrutiny of audited accounts;
- adequacy of regulation of chartered accountants, company secretaries and other similar statutory oversight functionaries;
- advantages, if any, of setting up an independent regulator similar to the Public Company Accounting Oversight Board in the SOX Act, and if so, its constitution; and
- the role of independent directors, and how their independence and effectiveness can be ensured.


The SEBI Committee on Corporate Governance (the “Committee”) was constituted under the Chairmanship of Shri N. R. Narayana Murthy, Chairman and Chief Mentor of Infosys Technologies Limited. • The Committee met thrice on December 7, 2002, January 7, 2003 and February 8, 2003, to deliberate the issues related to corporate governance and finalize its recommendations to SEBI.

Key Issues Discussed and Recommendations-

1. Audit Committees: Mandatory recommendation: Audit committees of publicly listed companies should be required to review the following information mandatorily: • · Financial statements and draft audit report, including quarterly / half-yearly financial information; • · Reports managing discussion and analysis of financial condition and results of operations; • · Reports relating to compliance with laws and to risk management; • · Management letters / letters of internal control weaknesses issued by statutory internal auditors; and • · Records of related party transactions. All audit committee members should be “financially literate” and at least one member should have accounting or related financial management expertise.

2. Audit Reports and Audit Qualifications: • Mandatory Recommendation: In case a company has followed a treatment different from that prescribed in an accounting standard, management should justify why they believe such alternative treatment is more representative of the underlying business transaction. Management should also clearly explain the alternative accounting treatment in the footnotes to the financial statements.
3. Related Party Transactions: • Mandatory recommendation A statement of all transactions with related parties including their bases should be placed before the independent audit committee for formal approval / ratification. If any transaction is not on an arm’s length basis, management should provide an explanation to the audit committee justifying the same.

4. Risk Management • Mandatory recommendation Procedures should be in place to inform Board members about the risk assessment and minimization procedures. These procedures should be periodically reviewed to ensure that executive management controls risk through means of a properly defined framework. Management should place a report before the entire Board of Directors every quarter documenting the business risks faced by the company, measures to address and minimize such risks, and any limitations to the risk taking capacity of the corporation. This document should be formally approved by the Board.

4.1 Training of Board members: • Non-mandatory recommendation: Companies should be encouraged to train their Board members in the business model of the company as well as the risk profile of the business parameters of the company, their responsibilities as directors, and the best ways to discharge them.

5. Proceeds from Initial Public Offerings (“IPO”): • Mandatory recommendation Companies raising money through an Initial Public Offering (“IPO”) should disclose to the Audit Committee, the uses / applications of funds by major category (capital expenditure, sales and marketing, working capital, etc), on a quarterly basis. On an annual basis, the company shall prepare a statement of funds utilized for purposes other than those stated in the offer document/ prospectus. This statement should be certified by the independent auditors of the company. The audit committee should make appropriate recommendations to the Board to take up steps in this matter.

6. Code of Conduct: • Mandatory recommendation 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. 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.

7. Non-Executive Director Compensation: • Mandatory recommendation All compensation paid to non-executive directors may be fixed by the Board of Directors and should be approved by shareholders in general meeting. Alternatively, this may be put up on the company’s website and reference drawn thereto in the annual report. Non-executive directors should be required to disclose their stock holding (both own or held by / for other persons on a beneficial basis) in the listed company in which they are proposed to be appointed as directors, prior to their appointment. These details should accompany their notice of appointment.

8. Independent Directors: The term “independent director” is defined as a non-executive director of the company who: • Apart from receiving director remuneration, does not have any material pecuniary relationships or transactions with the company. • Is not related to promoters or management at the board level or at one level below the board; • Has not been an executive of the company in the immediately preceding three financial years;

8.1 Independent Directors: Cont..... The term “independent director” is defined as a non-executive director of the company who: • Is not a partner or an executive of the statutory audit firm or the internal audit firm that is associated with the company, and has not been a partner or an executive of any such firm for the last three years. • Is not a supplier, service provider or customer of the company. • is not a substantial shareholder of the company, i.e. owning two percent or more of the block of voting shares.

9. Whistle Blower Policy: • Mandatory recommendation Personnel who observe an unethical or improper practice (not necessarily a violation of law) should be able to approach the audit committee without necessarily informing their supervisors.
Risk management, compensation to Non-Executive Directors, Whistle Blower Policy, Affairs of Subsidiary Companies, Analyst Reports and other non mandatory recommendations.  

1.12 Corporate Governance under Companies Act, 1956

The Companies Act, 1956 is the central legislation in India that empowers the Central Government to regulate the formation, financing, functioning and winding up of companies. It applies to whole of India and to all types of companies. The Companies Act, 1956 has elaborate provisions relating to the Governance of Companies, which deals with management and administration of companies. It contains special provisions with respect to the accounts and audit, director’s remuneration, other financial and nonfinancial disclosures, corporate democracy, prevention of mismanagement, etc.

Disclosures on Remuneration of Directors: The specific disclosures on the remuneration of directors regarding all elements of remuneration package of all the directors should be made as a part of Corporate Governance. Section 299 of the Act requires every director of a company to make disclosure, at the Board meeting, of the nature of his concern or interest in a contract or arrangement (present or proposed) entered by or on behalf of the company. The company is also required to record such transactions in the Register of Contract under section 301 of the Act.

10. Real Time Disclosures: It was suggested that SEBI should issue rules relating to real-time disclosures of certain events or transactions that may be of importance to investors, within 3-5 business days. These would include events such as • (a) a change in the control of the company, • (b) a company’s acquisition / disposal of a significant amount of assets, • (c) bankruptcy or receivership, • (d) a change in the company’s independent auditors, and • (e) the resignation of a director.

11. Analyst Reports: • Mandatory recommendation: SEBI should make rules for the following: Disclosure in the report issued by a security analyst whether the company that is being written about is a client of the analyst’s employer or an associate of the analyst’s employer, and the nature of services rendered to such company, if any; and Disclosure in the report issued by a security analyst whether the analyst or the analyst’s employer or an associate of the analyst’s employer hold or held (in the 12 months immediately preceding the date of the report) or intend to hold any debt or equity instrument in the issuer company that is the subject matter of the report of the analyst.

1.12.1 Requirements of the Audit Committee

Audit Committee has a critical role to play in ensuring the integrity of financial management of the company. This Committee add assurance to the shareholders that the auditors, who act on their behalf, are in a position to safeguard their interests. Besides the requirements of Clause 49, section 292-A of the Companies Act, requires every public having paid up capital of Rs 5 crores or more shall constitute a committee of the board to be known as Audit Committee.

1.12.2 Number of Directorships Restricted

Section/s 275, 276 and 277 have been amended to provide that no person shall hold office as director in more than 15 companies (excluding private company, unlimited company, etc., as defined in section 278) instead of 20 companies. This shall enable the director concerned to devote more time to the affairs of company in which he is a director.54

1.12.3 Corporate Democracy

Wider participation by the shareholders in the decision making process is a pre-condition for democratizing corporate bodies. Due to geographical distance or other practical problems, a substantially large number of shareholders cannot attend the general meetings. To overcome these obstacles and pave way for introduction of real corporate democracy, section 192-A of the Act and the Companies (Passing of Resolution by Postal ballot), Rules provides for certain resolutions to be approved and passed by the shareholders through postal ballots.

1.12.4 Appointment of Nominee Director by Small Shareholders

Section 252 has been amended to provide that a public company having paid-up capital of Rs. 5 crore or more and one thousand or more small shareholders can elect a director by small shareholders. “Small shareholders” means a shareholder holding shares of nominal value of Rs. 20,000 or less in a company. However, this provision is not mandatory and small shareholders have option to elect a person as their representative for appointment as director on the Board of such company.

54 Dr. G.K. Kapoor, Corporate laws 406 (Taxmann Allied Services (P.) Ltd., New Delhi, 2006).
1.12.5 Directors’ Responsibility Statement

Sub-section (2-AA) in section 217-A has provided that the Board’s report shall include a directors’ responsibility statement with respect to applicable accounting standards having been followed, consistent application of accounting policies selected so as to give a true and fair view of state of affairs and of the profit and loss of the company, maintenance of adequate accounting records with proper care for safeguarding assets of company and to prevent and detect fraud and other irregularities, and the preparation of annual accounts on a going concern basis. A corporation should be fair and transparent to its stakeholders in all its transactions. This has become imperative in today’s globalized business world where corporations need to access global pools of capital, need to attract and retain the best human capital from various parts of the world, need to partner with vendors on mega collaborations and need to live in harmony with the community. Unless a corporation embraces and demonstrates ethical conduct, it will not be able to succeed.

1.13 Corporate governance under The Indian Companies Act, 2013

The Indian Companies Act, 2013, is significantly changing the way companies are governed. It has made sweeping changes in the corporate governance system of the country and indicates the intention of the government to move from control and command regime to placing the onus on those entrusted with the governance of the company. Indian companies have a long way to go before adhering to the best governance practices. The Act, amongst other things, focuses on good corporate governance practices by increasing the roles and responsibilities of the Board, protecting shareholders’ interest, bringing in a disclosure based regime and built in deterrence through self-regulation.

In the following section, we look at the corporate governance changes effected by the present Act.

1.13.1 Independent Directors

Under 1956 Act, there was no requirement to have Independent Directors. However, under the Listing Agreement, the Board of listed entities having non-executive chairman and executive chairman should comprise of at least one-third
and one-half of the Board as Independent Directors respectively. The 2013 Act proposes that the Board of listed entities should comprise at least one-third of the Board as independent directors as opposed to Clause 49, which requires at least 50% independent directors in case the chairperson is in an executive capacity or a promoter or related to a promoter, and hence this represents a dilution from the existing position.

The definition of an independent director has been considerably tightened. The definition now includes positive attributes of independence, which was excluded from Clause 49 by stating that the candidate must be “a person of integrity and possess the relevant expertise and experience” in the opinion of the board. Every independent director is also required to declare that he or she meets the criteria of independence.

One of the key criticisms of the current regime for independent directors is that they are appointed like any other director, thereby leaving promoters with tremendous influence in determining the identity of the independent director. That has been partially addressed by making a nomination and remuneration committee mandatory (a departure from clause 49 that does not mandate a nomination committee). The committee is required to consider candidates for appointment as independent director and to recommend them to the board. The Act contemplates the establishment of a data bank of independent directors, from which persons may be chosen by companies.

In order to ensure that independent directors maintain their independence and do not become too familiar with the management and promoters, minimum tenure requirements have been prescribed. The initial term shall be 5 years, following which further appointment of the director would require a special resolution of the shareholders. However, the total tenure shall not exceed 2 consecutive terms.

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55 Section 149 (4), Companies Act, 2013.
56 Section 2(47), 149(5), Companies Act, 2013 Act.
57 Section 150, Companies Act, 2013.
58 Section 149 (10), Companies Act, 2013.
59 Section 149 (11), Companies Act, 2013.
Under the Act, independent directors are entitled only to fees for attending meetings of the board, and possibly commissions within certain limits. The Act expressly disallows independent directors from obtaining stock options in companies. 60 The Schedule IV61 of the Act contains a code that sets out the role, functions and duties of independent directors and incidental provisions relating to their appointment, resignation and evaluation.

In order to balance the extensive nature of functions and obligations impose on independent directors, the Act seeks to limit their liability to matters directly relatable to them. The Act limits the liability of an independent director “only in respect of acts of omission or commission by a company which had occurred with his knowledge, attributable through board processes, and with his consent or connivance or where he had not acted diligently.”62

The Companies Act mentions that performance evaluation of independent directors shall be done by the entire Board of Directors, excluding the director being evaluated. The Act also provides for separate meetings of Independent Directors at least once a year. In these meetings, Independent Directors would be expected to examine internal controls and general governance practices prevailing in the company and bring out any inefficiency to the attention of shareholders and their report in this regard may form part of the annual report. Independent directors are also required to disclose reasons for their resignation in the form of notice to the Board. Independent Directors have been excluded from retiring by rotation.

1.13.2 Board Functioning

The 2013 Act provides that the company shall have a maximum of 15 directors on the Board and appointing more would require approval of shareholders through a special resolution. 63 The Act aims at ensuring effective functioning and wider perspectives on Board by bringing in diversity. The Act provides for appointment of at least one woman director on the Board for such

60 Section 197 (5), Companies Act, 2013.
61 Section 149 (8), Companies Act, 2013.
62 Section 149 (12), Companies Act, 2013.
63 Section 149 (1), Companies Act, 2013.
class or classes of companies as may be prescribed. Accompany should have at least one director who has stayed in India for a total period of not less than hundred and eighty two days in the previous calendar year. The 1956 Act did not prescribe any academic or professional qualifications for directors. The 2013 Act provides that majority of members of Audit Committee including its Chairperson shall be persons with ability to read and understand the financial statements. For the first time, duties of the directors are defined under the 2013 Act.

1.13.2.1 Disqualification of directors

The 2013 Act includes the following additional grounds of disqualification: A person who has been convicted of an offence dealing with related party transactions at any time during the past five years. The directorship in private companies has also been brought under the ambit of disqualification on ground for non-filing of annual financial statements or annual returns for any continuous period of three years, or failure to repay deposits for more than a year. This makes scrutiny of directions more stringent and checks on related party transactions.

1.13.2.2 Number of Directorships

The 1956 Act provided for maximum directorship of not more than 15 companies excluding Private companies, Unlimited companies, Section 25 Companies, alternate directorship and Foreign companies. The 2013 Act provides that a person cannot have directorships (including alternate directorships) in more than 20 companies, including 10 public companies.

1.13.2.3 Restriction on power of Board

The Board can act on certain prescribed matters only after obtaining the consent of the members by a special resolution. This has been made applicable to private companies also which was not the case under 1956 Act.

1.13.2.4 Board reports and responsibility statement

The 2013 Act seeks to make the board's report more informative with extensive additional disclosures to bring transparency in the functioning of the

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64 Ibid.
65 Section 149 (3), Companies Act, 2013.
66 Section 166, Companies Act, 2013.
Board. Report and disclosures include: a statement indicating development and implementation of a risk management policy for the company; internal financial controls to be followed by the listed company and they are whether they are adequate and operating effectively; Related party transactions not in the ordinary course of business and not at arm’s length basis etc. The Board shall disclose the composition of an Audit Committee and where the Board had not accepted any recommendation of the Audit Committee, the same shall be disclosed along with the reasons.

1.13.3 Committees of the board

1.13.3.1 Nomination and Remuneration Committee

The 1956 Act did not provide for the constitution of a Nomination and Remuneration Committee. Under the Listing Agreement listed entities have an option to constitute a Remuneration Committee under non mandatory clause. The 2013 Act requires that Board of Directors of every listed company shall constitute the Nomination and Remuneration Committee consisting of three or more non-executive directors out of which not less than one half shall be independent directors. Such committee shall identify persons who are qualified to become directors and recommend to the Board their appointment and removal, carry out their performance evaluation and ensure that the pay comprises of an optimum balance between fixed and variable component. As per the Act, listed companies need to disclose in the Board’s report, the ratio of the remuneration of each director to the median employee’s remuneration and such other details as may be prescribed. This will bring about transparency in disclosure of remuneration policies.

1.13.3.2 Stakeholder Relationship Committee

The 1956 Act did not require the constitution of Stakeholders Relationship Committee. Presently, Clause 49 requires constitution of 'Shareholders/Investors Grievance Committee', under the chairmanship of a non-executive director for

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67 Section 134 (3), Companies Act, 2013.
68 Section 177 (5), Companies Act, 2013.
69 Section 178, Companies Act, 2013.
70 Section 178 (5, 6,7), Companies Act, 2013.
specifically looking into the redressal of investors' complaints like transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends etc.. Clause 178 of the 2013 Act mandates that a company with more than 1000 shareholders, debenture holders, deposit holders and other security holders at any time during the financial year shall constitute a Stakeholders Relationship Committee to consider and resolve the grievances of security holders of the company. This will protect the interest of other stakeholders apart from equity investors.

1.13.3.3 Audit Committee

The 1956 Act required public companies having paid-up capital of more than Rs 5 crore to constitute audit committee, consisting of minimum three directors and two-third of total members to be directors other than Managing Director ("MD") or Whole Time Director ("WTD") of the company. Further, Clause 49 requires listed entities to constitute audit committee with two-third of the members to be independent directors. As per the 2013 Act, audit committees have been made mandatory for listed companies and other prescribed classes of companies. The Act provides that audit committee should consist of minimum of three directors with IDs forming majority. The role of the audit committee includes the following activities as per the 2013 Act: a) the recommendation for appointment, remuneration and terms of appointment of auditors of the company; b) review and monitor the auditor's independence and performance, and effectiveness of audit process; c) examination of the financial statement and the auditors' report thereon; d) approval or any subsequent modification of transactions of the company with related parties; e) scrutiny of inter-corporate loans and investments; f) valuation of undertakings or assets of the company, wherever necessary; g) evaluation of internal financial controls and risk management systems; h) monitoring the end use of funds raised through public offers and related matters. Risk management and pre approval of related party transactions by the Audit Committee are significant changes to ensure good governance. Presently, the audit committee reviews RPTs on a periodic basis after such transactions have taken place. Such reviews are of limited use as the

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71 Section 177, Companies Act, 2013.
transaction could not be undone even if the Audit Committee expresses negative opinion on the transactions.

1.13.3.4 Corporate Social Responsibility Committee

India has become the first country in the world to make corporate social responsibility a statutory requirement by mandating specified companies to spend at least two percent of its average net profits made in the preceding three financial years on government approved categories of corporate social responsibility. This move is expected to go a long way in improving the social welfare of the country and is heralded as a significant corporate governance move. The 1956 Act did not mandate a company to spend on corporate social responsibility activities and consequently, there is no requirement to constitute a corporate social responsibility Committee. The 2013 Act provides that every company having net worth Rs. 500 crore or more, or a turnover of Rs. 1000 crore or more or a net profit of rupees five crore or more during any financial year should constitute a Corporate Social Responsibility Committee of the Board, consisting of minimum of three directors (at least one independent director) that will devise, recommend, and monitor corporate social responsibility activities, and the amounts spent on such activities, to the rest of the board. The committee shall prepare a report containing the corporate social responsibility activities undertaken and if not, the reasons for failure to comply.

1.13.4 Audit and Auditors

Auditors play an important role in lending credibility to the financial statements and dubious role of auditors has been the common link in all the accounting scandals over the world. In order to tighten the grip on auditors, the Act lays down stringent rules for their practice and their liabilities.  

1.13.5 Related Party Transactions

A third of Indian Companies are family owned giving rise to possibility of channeling of funds to related parties. In Case of Satyam also, its downfall began with the promoter's intention to buy two of its family controlled companies. This

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72 Section 135, Companies Act, 2013.
73 Section 139,140 Companies Act, 2013.
74 Section 188, Companies Act, 2013.
erodes investor’s confidence and undermines the integrity of capital formation mechanism to curb abusive Related party transactions, the Act lays down stringent provisions. The 2013 Act as against the term “relative” defined under the 1956 Act, the 2013 Act defines the term “related party” for the first time. The 1956 Act and the Listing Agreement do not require specific approval of the related party transactions by the Board/shareholders. However, Listing Agreement requires listed entities to present list of related party transactions and other related information to the audit committee. The 2013 Act proposes that all related party transactions which are not in the ordinary course of business or not at arm's length basis should be approved by the Board. The Act also proposes that for the companies with the prescribed share capital, no contract or arrangement or transactions exceeding prescribed amount, shall be entered into with its related party, unless, approved by the shareholders of the company by way of a special resolution. However, the related party shareholders are not permitted to exercise their voting rights, in such special resolution. The Act also proposes that a company shall not make investments through more than two layers of investment companies, unless the investments are in an overseas company and the company has overseas subsidiaries and such layers are permitted under the local law of the company being acquired or under the law of the acquiring company. Every contract or arrangement entered into with related party shall be referred to in the Board’s report along with the justification for entering into such contract or arrangement.

1.13.6 Class Action Suit\textsuperscript{75}

Though there were provisions for oppression and mismanagement, there is no express recognition of class action suits in Companies Act, 1956. Indian corporate laws were not equipped to deal with the aftermath of scandals i.e. compensating the aggrieved investors. However, Clause 245 of the Companies Act, 2013 expressly provides for class action suits and Clause 125 provides for reimbursement of expenses incurred in class action suits from the Investor Education and Protection Fund.

\textsuperscript{75} Section 245, Companies Act, 2013.
Class action suits, allow a requisite number of members or depositors with common interest, in a matter, to file an application in the National Company Law Tribunal (‘NCLT’) against the company/its management/its auditors or a section of its shareholders for damages or compensation if they are of the opinion that the management or conduct of the affairs of the company are being conducted in a manner prejudicial to their interest. This will empower minority shareholders and protect their interests. However, to prevent misuse of this provision would be a challenge.

1.13.7 Separating the position of Chairman and MD/CEO

Holding of two positions by the same person leads to unfettered power of decision making. In most of the developed jurisdiction like US, UK, France it is a requirement to segregate the role of Chairman and CEO. According to the Act, chairperson of the company, in pursuance of the articles of the company, as well as the managing director or Chief Executive Officer of the company at the same time unless, (a) the articles of such a company provide otherwise; or (b) the company does not carry multiple businesses.

1.13.8 Making installation of Whistleblower Mechanism compulsory

Till date, The Companies Act, 1956, contained no guidelines for protection of whistleblowers. Clause 49 requires listed companies to develop and communicate a mechanism to channelize employee complaints to the Board, under non mandatory provisions. Looking at the growing number of scams in the country and international legislations in place, it is imperative that India also has a well laid out whistleblower mechanism in place. The 2013 Act fills this gap and provides every listed company or such class or classes of companies, as may be prescribed, shall establish a vigil mechanism for directors and employees to report genuine concerns in such manner as may be prescribed. The vigil mechanism shall provide for adequate safeguards against victimization of persons who use such mechanism and make provision for direct access to the chairperson of the Audit Committee in appropriate or exceptional cases.
1.13.9 E-Governance Initiatives

In order to ensure good governance and participation of all shareholders in voting matters, the 2013 Act specifically recognizes electronic voting by members. Participation in Board meeting through video conferencing has been recognized. Maintenance and allowing inspection of documents by companies in electronic form Registration process has been made faster and compatible with e-governance.

1.13.10 Prohibition of Insider Trading

Companies Act, 1956, did not contain any clause relating to insider trading. SEBI has prescribed Insider trading Rules in India. New clause has been introduced with respect to prohibition of insider trading of securities under the 2013 Act. The definition of price sensitive information has also been included. No person including any director or KMP of a company shall enter into insider trading except any communication required in the ordinary course of business or profession or employment or under any law. This is a step towards harmonization between the 2013 Act and the SEBI Act; more specifically for listed companies; any person who violates the clause will be punished with a cash fine or imprisonment or both.

1.13.11 Penalties

The 2013 Act proposes significant penalties for directors for defaults in discharging his duties. It is noted that the instances for levying penalties have increased substantially too. Apart from the above provisions the bill also contains provisions like new definitions for Associate Company, One Person Company, Small Company, Related Party, Turnover, matters relating to securities, dividend, incorporation, mergers and acquisition, accounts etc have been provided but are not being discussed in the present paper due to the scope of the paper.

The Companies Act, 2013 is a step in the right direction. Many provisions pertaining to independence of directors, auditors, strict disclosure norms and protection of investors will have far reaching implications in order to bring in greater transparency and accountability in the working of the company and at the same time, minimize the incidents of corporate frauds. Companies and
stakeholders should start evaluating their position vis-à-vis that required under the
new regime and make strategies accordingly. The Act is forward looking in nature
and is on par with international best practices. However, the effectiveness of this
legislation, like all other, will depend on its implementation. The Ministry of
Corporate Affairs should issue circulars and clarifications to ensure smooth
implementation of the provisions. Corporate should ensure that they follow the
law not just in letter but in spirit also as the true value of Corporate Governance
lies beyond compliance.

The genesis of the corporate governance lies in the business scams and
failures in India and around the world. From time to time several committees have
been appointed and each of the reports recommended some code of practice
targeted towards avoiding similar incidences in future.76 A primary goal of
prevailing corporation laws is to promote honest and efficient markets and
informed investment decisions through full and fair disclosure.

Transparency in financial reporting plays a pivotal role in making our
markets the most resilient and efficient in the world. It enables investors, creditors
and the market to evaluate an entity thereby helps investors make better decisions
and, naturally, increases confidence in the fairness of the market.77

“Joint–stock company” is one of the greatest inventions of mankind. It is
this very invention which is playing a major role in eroding the geographical
boundaries of nations across the globe. As the mankind is making strides with the
help of this invention, care is also being taken that these organisations fulfil their
objectives in the best possible manner.78 Today the corporate organizations have
grown into huge sizes, characterised by separation between control and
ownership, their internal organisational problems and their external relation to the
society, have acquired new dimensions, not envisaged in the early era of the
corporations. Corporations today affect the average citizen’s life both directly and

76 Dr. Onkar Nath Dutta, “Corporate Governance–Codes and Ethics,“ 33 Growth 10( 2006).
p. 17 available at http://aaahq.org/audit/midyear/03midyear/papers/Session%2011-
Jerry%20Turner.pdf (Visited on October 31, 2013).
78 Yogesh Upadhyay and Shive Kumar Singh, “Corporate Governance: Role of Corporate Laws”
3 Pranjana (2000).
indirectly, in many ways—he may be its shareholder, employee, supplier, dealer, customer and even if none of these, his life may still be affected by what the corporation does, e.g. by the pollution that its plant may create and by the company’s impact on the general economy. Thus major concern of both developed and developing countries is proper governance of the modern companies.79

The recent past has seen a marked enthusiasm and interest in the subject of corporate governance. There is common consensus that Indian companies need to become more transparent and accountable to its shareholders. Corporate Governance is a voluntary ethical code of business of companies. Philosophical traditions in West and East may be reviewed to know the bed rock of ethical standards. A business should benefit from the business like a honey bee which suckles honey from the flower without affecting its charm and beauty reflecting wisdom from Vedas.80

The western thought on the other hand views ethics from the angle of sectoral interests. Values system is an important factor and plays a significant role, in successful management of a business. The very essence of corporate governance is based upon principles of transparency, accountability, fairness and responsibility. Their application is universal in nature. The concept may be complex but the principles are essentially simple and straightforward stimulating a fine fusion of legislative and ethical frame work.81

The concept of “corporate governance” is multi faceted and involves lot of dimensions. Therefore, it covers several principles such as rights and equitable treatment of shareholders, interest of stakeholders, role and responsibility of board, integrity and ethical behaviour, and disclosure and transparency. By the adoption of such principles the corporate business is expected to operate to insure good governance.82

81 These words have been extracted from one of the speech of Sir Adrian Cadbury delivered in India during his visit in Year 2000.
Firstly, the organization should respect rights of shareholders and help shareholders to exercise those rights. They can help shareholders exercise their rights by communicating information openly and effectively and by encouraging shareholders to participate in general meetings. Secondly, organization should recognize that they have legal, contractual, social, and market driven obligation of non-shareholder stakeholders, including employees, investors, creditors, suppliers, local communities, customers, and policy makers.\textsuperscript{83}

In addition, the board needs to possess sufficient relevant skills and understanding to receive and challenge management performance. It also needs adequate size and appropriate levels of independence & commitment. Besides this, integrity should be a fundamental requirement in choosing corporate officers and board members. Organizations should develop a code of conduct for their directors and executives that promotes ethical and responsible decision making. And finally, organization should clarify and make publicly known the roles and responsibilities of board and management to provide stakeholders with a level based on accountability. They should also implement procedures to independently verify and safeguard the integrity of the company’s financial reporting. Disclosure of material matters concerning the organization should be timely and balanced ensuring that all investors have access to clear and factual information. All these principles are universal in application and try their level best to provide comprehensive coverage along with complete protection.

\textbf{1.14 Problem Profile}

Corporate governance has become one of the most commonly used phrases in the current business vocabulary. The notorious corporate failures have focused international attention on the role of corporate governance in prevention of these failures. The problem of Indian corporate legal framework is its enforcement and implementation in letter as well as spirit. There are loopholes and drawbacks in the Indian Corporate laws dealing with ‘Corporate Governance’. Corporate governance has assumed crucial role

\textsuperscript{83} \textit{Ibid.}
in the Indian context because of the scams that occurred since liberalization from 1991, for e.g. the UTI scam, Ketan Parekh scam, Harshad Mehta scam & the latest & the biggest of them all the Satyam Fraud scam. The failure of the corporate communication structure, therefore, has made the financial community realize that there is a great need for skilled professionals that can identify, expose, and prevent structural weaknesses in three key areas: poor corporate governance, flawed internal controls, and fraudulent financial statements. In addition, the corporate governance framework needs to be first of all strengthened and then implemented in “letter as well as in right spirit. The increasing rate of white-collar crimes, without doubt, demands stiff penalties and punishments. Comprehensive legislation combined with strong enforcement can be a big deterrent to fraud.

**Research Hypothesis:**

In India the concept of corporate governance is not provided in a comprehensive manner and the laws, rules, regulation etc. do not provide standard norms or code for the establishment and development of good corporate governance.

**Research Methodology:**

The present research study is doctrinal in nature. For the fulfillment of the research work will include primary and secondary sources. The study material will include case laws, reports of the commissions, rules, regulations, orders, by-laws, text books, laws journals and commentaries.

**Tools Applied**

4. Reports of Committees etc.: Use of reports of various committees like The Kumarmangalam Birla Committee, Report of Stock Exchange Board of India, Naresh Chandera Committee, N.R. Narayana Murthy Committee etc.