2.1 Introduction

The term governance has been derived from the word “gubernare” which means “To rule of steer”. Though originally means to be a normative from work for exercises of power and acceptance of accountability, thereof in the running of kingdom; however it has found significant relevance in corporate words. With increase in the number of the companies there is also increase taken place in the shareholders For the sake of shareholders Interest the corporate governance is significant required in this fast growing corporate world.

The concept of corporate governance Which merged as a response to corporate failures and wide spread dissatisfaction with the way many corporate function, has become one of wide and deep discussions around the global recently, governance has assumed greater limelight with the public and private sectors, following Which the markets, the investors and the infallibility of these large systems.

Corporate Governance has been gaining momentum across the world due to miserable corporate failures unethical business practices, insufficient disclosure and transparency, inefficient management board and social concerns. As always, after a slew of scandals and corporate fraud there are cries of outrage, demand for bringing culprit to book, suggestions over how to improve corporate governance, setting up of another committee and corporate governance dominating the political and business agenda. Scams have almost become a regular feature; we had Harshad Mehta scam, Ketan Parikh scam, UTI scam, Bhansali scam and now Satyam Scam. The corporate frauds that we are witnessing today are of greater in frequency, intensity and magnitude. Thanks to the bubble of technology which has made these frauds more visible.

The legal and administrative environment in India provides excellent scope for corrupt practices in business. As a result unless a management is committed to be honest and observe the principles of prosperity, the atmosphere is to tempting to observe good corporate governance in practice. In response to recent corporate governance scandals, governments have responded by adopted a number of regulatory changes. One component of these changes has been increased disclosure requirements.

Recent financial scandals associated to accounting and other frauds allegedly blamed to top company managers (e.g. Satyam, Enron, Worldcom, Adelphia) have brought into public light the recurring question of whether companies are managed on the best interests
of shareholders and other company stakeholders such as workers, creditors and the general community. A point that has been made frequently is that top managers may possess too much power inside their companies and that a general lack of accountability and control of their activities is prevalent in companies with wide ownership diffusion.

On the other side globalization has increased the competition in which the corporate world operates, therefore, it has become increasingly important for the management to make the corporate business more transparent and institutionally sound. A company has an adopted set of practices for achieving its objectives through legal, regulatory and institutional environment. Further, the company intends to make business practices more and more transparent, and accountable to the stakeholders. It can be said that the relationship with the stakeholders’ create a social contract whereby the company is morally obliged to take account of the interest of these groups.

Ethics play a Very important role in the corporate governance but what is Ethics and what are ethical standards / guidelines? Not going anywhere else, if we look at the age-old Indian philosophical tradition and Indian shastras, we can derive certain values, which are also consistent with the value systems of other civilizations. The “Bhagwat Gita”, “Manu smruti” etc had provide a good code of conduct for the living being, It also helps in corporate governance

The pillars of the Indian philosophical tradition, which have explicitly provided for proper conduct, both in public and private life, needs to be incorporated in our dealings with other people, even though be of political or economic in nature. Corporate governance can be ethical only when it rests on the ‘core values’ of honesty, integrity, respect, fairness, purposefulness, trust, responsibility and citizenship. These values are not to be lost sight of by anyone and under any circumstances, irrespective of the goals that intended to be achieved. To achieve the ends of ‘good’ governance, the ‘means’ are as important as the ‘ends’. Infect we can say that corporate governance is important tool for better corporate management.

2.2 Meaning and Definition

To conceptualize corporate governance, we need to understand both the terms “governance” and “corporation”. Governance is a set of minimum framework or rules necessary to tackle problems guaranteed by a set if institutions. On the other hand
corporate means “a legal entity that exists independently of the person or people who have been granted the charter creating it, and is vested with many of the rights given to the individual.” Thus applying the concept of corporate governance comprises of formal and informal rules, along with accepted practice and enforcement mechanisms, both private and public.

Corporate governance is defined as the distribution of right and responsibilities among different participant in organization, such as, the board, managers, shareholders, and other stakeholders, and spell out the rules and procedures for making decisions on corporate affairs,

The Kumar Mangalam Birla committee constituted by SEBI has observed that:

“Strong corporate governance is indispensable to resident and vibrant capital market and is an important instrument of investor protection it is the blood that fills the veins of transparent corporate disclosure and high quality accounting practice, it is the muscle that moves a viable and accessible financial reporting structure.”

According to James D. Wolfensohn, President of the World Bank, “Corporate Governance is about promoting corporate fairness transparency and accountability.”

The World Bank defines corporate governance as “The blend of law, regulation and appropriate voluntary private sector practices which enables the corporation to attract financial and human capital, perform efficiently and there by perpetuate it by generating long term economic value for its shareholders, while respecting the interest of stakeholders and society as a whole.”

Cadbury committee U.K. has defined corporate governance as follows:

“The system by which companies are directed and controlled,”

“The concept of corporate governance primarily hinges on complete transparency, integrity and accountability at the management. This is also on increasingly greater focus on investor protection and public interests.”

According to Shleifer & Vishny. “Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting return on their investment.”
American Management Association has defined corporate governance as-

“Corporate governance is about how suppliers of capital get managers to return profits, make sure managers do not misuse the capital by investing in bad projects, and how shareholders and creditors monitor managers.”

International Chamber of Commerce has defined corporate governance as-

“Corporate governance is the relationship between corporate managers, directors and the providers of equity, people and institutions who save and invest their capital to earn a return. It ensures that the board of directors is accountable for the pursuit of corporate objectives and that the corporation itself conforms to the law and regulations.”

So, “corporate governance is the current buzzword in India as well as the world over, it is practicing at every stage of company affairs, now day’s good corporate governance is the expectation of shareholders in every lifestyle. These expectations are considered as their lights in corporate world.

Corporate Governance depends upon two factors. First is the commitment of the management for the principles of integrity and transparency in the business operations and the second are the legal and administrative framework created by the Govt. In the last few years, series of corporate governance codes and committees have been formed be it CII code, Birla Committee or Narayanmurthy Committee. Though such committees help in strengthening the internal process but what is required is the focus on values of the organization, its ethics, value for people, attitude towards excellence, quality as well as processes and understanding of the outcome.

With the Corporate Governance at the forefront of the corporate value means that corporate entity is looking at the issue from the point of view of organizational purpose, either in the isolation or in the competitive scenario, keeping the entire stakeholders in mind. The country like India which undergoes a transition period especially in the liberal and globalized scenario, weak Corporate Governance will be blamed for or has been blamed for the delay in the restructuring or not coping with the required changes. According to N.R. Narayanmurthy, Corporate Governance is no longer a luxury, but a necessity. There is a gap between percept and practice of Corporate Governance. Feudal mindset, manifold regulations, lack of concern for society, a sense of insecurity and greed are some of the reasons for it, he says.
2.3 Corporate Governance: A Historical Background

Public interest in corporate governance is nothing new. It dates back to 1970 when in the wake of the establishment, maintenance and review of internal controls was passed in the Trade-way commotion was formed following the saving and loan crises, In 1990 the Cadbury committee code of best practice in the U.K., the combined code of London stock exchange, the blue ribbon committee of U.S., the OECD to develop benchmarks in corporate governance have kept public interest kindling.

The historical development of Indian corporate laws has been marked by many interesting contrasts. At independence, India inherited one of the world’s poorest economies but one which had a factory sector accounting for a tenth of the national product. The country also inherited four functioning stock markets (predating the Tokyo Stock Exchange) with clearly defined rules governing listing, trading and settlements, a well-developed equity culture (if only among the urban rich), and a banking system replete with well-developed lending norms and recovery procedures.16 In terms of corporate laws and financial system, therefore, India emerged far better endowed than most other colonies. The 1956 Companies Act built on this foundation, as did other laws governing the functioning of joint-stock companies and protecting the investors’ rights.

Early corporate developments in India were marked by the managing agency system. This contributed to the birth of dispersed equity ownership but also gave rise to the practice of management enjoying control rights disproportionately greater than their stock ownership. The turn towards socialism in the decades after independence, marked by the 1951 Industries (Development and Regulation) Act and the 1956 Industrial Policy Resolution, put in place a regime and culture of licensing, protection, and widespread red-tape that bred corruption and stilted the growth of the corporate sector. The situation worsened in subsequent decades and corruption, nepotism, and inefficiency became the hallmarks of the Indian corporate sector. Exorbitant tax rates encouraged creative accounting practices and gave firms incentives to develop complicated emolument structures.

In the absence of a stock market capable of raising equity capital efficiently, the three all-India development finance institutions (the Industrial Finance Corporation of India, the Industrial Development Bank of India and the Industrial Credit and Investment Corporation of India), became the main providers of long-term credit to companies together with the state financial corporations. Along with the government-owned mutual
fund, the Unit Trust of India, these institutions also held (and still hold) large blocks of shares in the companies to which they lend and invariably have representations on their boards—though they traditionally play very passive roles in the boardroom.

Figure 2.1: Corporate Governance around the Globe
2.4 Recent development in Corporate Governance in India

The years since liberalization began in 1991 have witnessed wide-ranging changes in both laws and regulations, driving corporate governance as well as the general consciousness about it. Perhaps the single most important development in the field of corporate governance and investor protection in India has been the establishment of the Securities and Exchange Board of India in 1992 and its gradual empowerment since then. Established primarily to regulate and monitor stock trading, it has played a crucial role in establishing the basic minimum ground rules of corporate conduct in the country. Concerns about corporate governance in India were, however, largely triggered by a spate of crises in the early 1990’s—particularly the Harshad Mehta stock market scam of 1992--followed by incidents of companies allotting preferential shares to their promoters at deeply discounted prices, as well as those of companies simply disappearing with investors’ money.
These concerns about corporate governance stemming from the corporate scandals, coupled with a perceived need to opening up to the forces of competition and globalization, gave rise to several investigations into ways to fix the corporate governance situation in India. One of the first such endeavors was the Confederation of Indian Industry Code for Desirable Corporate Governance, developed by a committee chaired by Rahul Bajaj. The committee was formed in 1996 and submitted its code in April 1998. Later the SEBI constituted two committees to look into the issue of corporate governance—the first chaired by Kumar Mangalam Birla, which submitted its report in early 2000, and the second by Narayana Murthy, which submitted its report three years later. These two committees have been instrumental in bringing about far reaching changes in corporate governance in India through the formulation of Clause 49 of Listing Agreements (described below).

Concurrent with these initiatives by the SEBI, the Department of Company Affairs, the Ministry of Finance of the Government of India also began contemplating improvements in corporate governance. These efforts include the establishment of a study group to operationalize the Birla Committee recommendations in 2000, the Naresh Chandra Committee on Corporate Audit and Governance in 2002, and the Expert Committee on Corporate Law (the J.J. Irani Committee) in late 2004. All of these efforts were aimed at reforming the existing Companies Act of 1956 that still forms the backbone of corporate law in India.

Further there are committees under the ministry of company affairs and the securities and exchange board of India (SEBI) which also brought out reports to supplement the emerging need for public policy on corporate governance. Then, the standing conference on public enterprises (SCOPE) came out with guidelines on the subject. For public enterprises. For the banking sector, the consultative group of RBI (reserve bank of India) gave recommendations for the strengthening the boards of banks, in particulars, in related areas of selection of directors, their training and contract. SEBI

Also amended section 49 (dealing with listing agreement with companies) to include conditions which will reinforce governance in corporate bodies. Besides these developments, the self-regulatory section of the institute of chartered accountants of India and the company secretaries took initiatives to raise the professional standards of the corporate bodies at par with the changing international levels. Besides, the Indian company law has been emended and is now under revision for meeting the exigencies of
business and industry in the contemporary competitive globalize market ambience, where effective corporate governance is inevitable for success. All these initiatives establish the emergent desire as well as the need at policy making and institutional levels to make improvements in the structure and the system for effective governance in corporate organizations. In addition, corporate bodies having international presence have voluntarily taken initiatives not only to meet the basics in good governance but have done excellently, and even exceeded the international expectations on disclosure and accounting reporting.

Indian institute of management, Bangalore and the management development Institute, Gurgaon, organize courses for the top management on corporate governance. The governance of India has set a national foundation for corporate governance.

Private companies like Wipro, ICICI Bank, Infosys, and the PSUs like ONGC, are making efforts to internationalize their business. This organization will have to observe the codes of corporate governance in the respective countries.

The International Monetary Fund (IMF) brought out its principle on transparency and OECD (Organization for Economic Cooperation and Development) has set forth its codes on governance, which are taken as global standards. The group of thirty member countries has adopted the revised version of the code in April 2004.

Y.R.K. Reddy, a very strong enthusiast on corporate governance, with his worldwide experience and knowledge of the subject set out give birth to an institute on corporate governance, called the academy of corporate governance, in November, 2001 at Hyderabad.

After issuance of the August’03 circular, SEBI received representations/suggestions from the corporate/public on various provisions of the said circular. Then SEBI decided to defer the implementation of the provisions of the August 26, 2003 circular and revisit Clause 49. The Narayana Murthy committee then considered and deliberated on the suggestions and comments received from corporate/public. Based on the revised recommendations of the committee, it was decided to further revise the provisions of clause 49 of the listing agreement vide circular dated 29th October’05, SEBI has again revised clause 49. This circulars a master circular and supersedes all other earlier circulars issued by SEBI on this subject.
2.5 Applying “DHARMA” in Corporate Governance

Globalization has increased the competition in which the corporate world operates, therefore, it has become increasingly important for the management to make the corporate business more transparent and institutionally sound. A company has an adopted set of practices for achieving its objectives through legal, regulatory and institutional environment. Further the company intends to make business practices more and more transparent, and accountable to the stakeholders. It can be said that the relationship with the stakeholders’ create a social contract where by the company is morally obliged to take account of the interest of these groups.

The recognition of issues related to corporate governance, at times, is appalling when we come across so many instances of well-regarded corporations ‘looting’ their shareholders for the personal gains of the managers or the owners. That brings us to the basic issue of what will be the ‘ethical’ issues in corporate governance. Honesty is the best policy. This means that there has to be absolute integrity in all operations. Corporate governance and ethical behaviour have a number of advantages: they help to build ‘good’ brand image for the company. Once there is a brand image there is a greater loyalty, greater commitment to the employees, and employees will become more creative. In the current competitive environment, creativity is vital to get a competitive edge. Another area where corporate governance and ethical issues may arise is at the time of the Annual Report, particularly preparing the financial statements and true reporting about business operations.

Thus, ethics has got a major role to play in realizing the value for your efforts. But what is ethics and what are ethical standards/guidelines? Not going anywhere else, if we look at the age-old Indian philosophical tradition and Indian shastras, we can derive certain values, which are also consistent with the value systems of other civilizations. Dr. Atheta, in his seminal paper titled as “Business Values for the 21st century,” has aptly summarized the concept of Dharma as enshrined in Indian shastras. We are very briefly illustrating below some of his perceptions for the benefit of our valued readers.

- **Dharma (Righteousness):** The right path, which will upload the family, organizational, and the social fabric.
- **Loka Sangraha (Public Good):** Work not just for private gain. But also for public good practice of Swartha Prartha (self plus others) seeking ones own gains and also catering to the welfare of others.
• **Kausalam (Efficacy):** optimum utilization of resources efficiently and productively. Judicious use of resources and preserving the resources for future generations.

• **Vividhta (Innovation):** Beyond survival, business has to be the ‘engine’ of innovation constantly seeking more effective solutions to meet economic and social expectations. Such innovation is required in processes, products, materials, machines, organization, strategies, systems and people.

• **Jigyasa (learning):** change and continuity will coexist. So the corporations have to keep learning from the feedback loop from society and through internal processes of question, challenges, debates and training.

Dharma has been explained to be that which helps the upliftment of living beings. Therefore, that which ensures welfare is surely dharma. Its origins can be traced as solution to eternal problems confronting the human race, originating from natural human instincts.

Manu says: Akasmay Kriya Kaschdrishayate Neh Kahinchit, Yadvati Kurute Kinchhit tattkamasse chestitam.

It means that there is no act of man, which is free from desire; whatever man does is the result of desire. The force behind every action of human begin is his desire, which is kama. There is natural desire to have enjoyment and wealth, i.e. material pleasure, which is Artha. But Artha and kama are, however subject to dharma. The propounders of dharma did appreciate that fulfillment of desires of human beings was an essential aspect of life but were of opinion that unless the desires were regulated by law, it is bound to give undesirable results. Therefore, all the propounders of dharma were unanimous that for existence of an orderly society, in this case and orderly market economy, the desires (kama) for material enjoyment, and pleasures (Artha) should always conform to Dharma.

**The Bhagwat Gita in 16-24**

Tsmachastrnm pramanam te karyakarvavyasthitao, Gyatva shastravidhanoktam karm kurtumihahirsi.

Which means let the shastras be your at thority in deciding what you should do and what you should desist from doing. In this case, the shastras are nothing else but the ‘codes’ of best practice developed by various institutions, however what is needed is ‘uniformity’ in
those codes. When we say that why we should observe Dharma than it is necessary to cite Manu where he explains the necessity of scrupulous practice of Dharma. He says: VIII-15

*Dharma aev hato hanti dharmo rakshati rakshita Tasmadharmo na hantavyo ma na dharmo hatividhit.*

Dharma protects those who protect it. Those who destroyed dharma get destroyed. Therefore, dharma should not be destroyed so that we may not be destroyed as a consequence thereof. The concept of dharma sankata is well-known in the Hindu religion. Narova Kunjarova (human or elephant) was the situation where Yudhistra in Mahabharat lied. For the sake of getting a short-term benefit resorting to lies or straying from the straight and narrow path ultimately leads to a long term failure. We would therefore, suggest that even at the cost of sacrificing short-term benefits, it is better for an enterprise to adopt healthy practices.

The pillars of the Indian philosophical tradition, which have explicitly provided for proper conduct, both in public and private life, needs to be incorporated in our dealings with other people, even though be of political or economic in nature. Corporate Governance can be ethical only when is rests on the ‘core values’ of honesty, integrity, respect, fairness, purposefulness, trust responsibility, citizenship and caring. These values are not to be lost sight of by anyone and under any circumstances, irrespective of the goals that intended to be achieved. To achieve the ends of ‘good’ governance, the ‘means’ are as important as the ‘ends’. There has been at length a debate over the corporate ethics and their implication over corporate governance. Safe and fair play is always ethical, so we believe that “do not do something that you would be ashamed of, it becomes public”.

### 2.6 Corporate Governance at Global Perspective

**Corporate Governance in USA**

The USA has given great importance to the modern private corporation. It has rarely doubted its legitimacy. It has assiduously nurtured the corporate form of organization as a bulwark of the free enterprise system in its fight against communism. American society has placed an abiding faith in the system by giving property rights to individuals and corporations in order to generate energy and initiative for enterprise and industry. At the same time, to avoid their excesses, it has depended on the checks and balances imposed by well functioning markets and competition. It has also evolved and elaborate and well-
enforced legal framework for handling disputes. The approach of the USA has been not to interfere with the functioning of corporations in the belief that those who govern least govern best.

It is not surprising, therefore, that some American economists argue that corporate governance is not an issue if complete contracts can be written between principals (owners) and agents (managers). But the problem with this argument is that comprehensive contract writing involves not only high transaction costs but also the need to know, in advanced, all possible contingencies. Therefore, corporate governance is an issue even in the USA.

The USA’s approach to corporate governance is minimizes conflicts of interest between owners and managers. This is attempted by giving managers profit-related incentives such as shares and stock options. Even than, issues such as how the members of the board of directors are selected, how they are compensated, their sense of rights and wrong. And the checks built in to their functioning have become issues for public debate from time to time. Oversight by outside directors is sought to be strengthened by devices such as the audit and other committees that go into the details of the corporation’s functioning.

Consistent with its preference for market-based solutions to corporate governance, including hostile takeovers, the US has welcomed the innovative methods of investment bankers to bring even the giant companies under the ambit of the market for corporate control. It has also taken in its stride the occasional destructive overtones of takeovers such as in the Kohlberg Kravis Roberts and company buy out of the giant RJR Nabisco in 1989. The threat of loosing corporate control is seen as preventing managements from settling down into an efficient equilibrium.

However, relating managers’ performance to the stock market has raised concern that it is leading to short-termism in corporate behaviour. Another long standing concern in the USA has to do with the asymmetry of information and knowledge between owners and managers. The solution to this has been to make insider trading illegal and to improve timely disclosures of information to shareholders. The growing importance of pension and unit trusts and mutual funds in the financing of corporations has been welcomed, as these institutional investors can ask for more information and use it more systematically.

Another recent concern in the USA is whether directors are indulging in unreasonable increases in pay and perquisites even as corporate restructuring and downsizing take their
toll on employees and local communities. According to a study, chief executives officers of corporations in the USA earn 109 times the average base pay, compared to 35 times in the UK and 17 times for Japanese presidents.

The growing disparities in income have encouraged some economists to look for reforms in the system of corporate governance. They question the basic assumption that shareholders, as residual claimants to corporate income, should have total voting rights of the corporation. They argue that like shareholders, employees too make substantial firm-specific investments. Without such employee learning the company’s other investments in fixed capital assets would not be as valuable. Hence, employees too should have a say in the legal structure of corporate governance.

Such questions bring into the ambit of corporate governance, the larger socio-economic framework that guides the sharing of the risks and rewards of wealth creation. Not all societies have been as averse as the USA to involve other stakeholders than the shareholders into corporate governance.

**Corporate Governance in Germany**

Germany has built statutory a statutory role for its employees in its corporate governance system, even though the shareholding in Germany is far more concentrated than in the USA. In a majority of the companies listed on the German stock exchange, a single owner held more than 50 percent shares. The corresponding figure in the USA was 5 percent. At the end of 1993, private households held only 17 percent of outstanding equity shares of joint stock companies listed on the German stock exchange Compared to 49 percent in the USA.

Unlike in the USA, ownership of property in Germany is seen as imposing concomitant duties for its use for the public weal. There is an instance when the board of a company in Germany did not permit the management to use the insurance money from a plant which caught fire for improving production in another place. The board successfully got the money deployed for the community which suffered on account of the fire in the plant. The involvement of German industry in creating educational infrastructure through technical apprenticeships is another instance of government-industry co-operation in practice.

Unlike in the USA, where banks cannot trade in securities, banks in Germany not only provide long-term finance but also hold stocks of companies. Although their shareholding
in companies is small, banks have significant voting rights on the bearer-form shares deposited with them by shareholders. German banks are required to consult the shareowners, give them advice, and take their instructions on voting.

Banks also have position on the top tier of the two-tiered board system of governance. The two-tiers – the supervisory board and the management board – are both decision making bodies. The supervisory board is responsible for the company’s accounts, major capital expenditures, strategic acquisitions and closures, dividends, and most importantly, for appointments to the management board. The management board is responsible for running the company.

While the emphasis in the accounting system in the USA is on providing a true and fair view of the company’s performance, the German accounting and auditing practices allow companies to make provisions for various short-term and long-term risks. Such provisioning has the approval of the employee representatives on the supervisory board.

The system of corporate governance in Germany is much less driven by the stock market than that of the USA. It runs by consensus in the supervisory and management boards than by an all-important chief executive officer. The two-tier board structure institutionalizes some checks and balances. The information asymmetry among the various stakeholders in decision making position is less much than in the USA. Justifying strategic proposals to knowledgeable boards that get relevant information not only from inside but also from outside the corporation, is quite different from releasing selective information through various media and letting the market judge the developments on an ongoing basis.

The German corporate governance system is not, however, free from concern. Questions are raised about whether the supervisory board is serving any practical purpose. Does it depend too much on the management board, given that nominations for appointments to the management board usually come from the management board itself. How does the supervisory board handle mistakes in its appointments. Is threat of hostile takeover needed? While managements can works with a long-term perspective in a stable environment, is the system flexible enough for adoption in fast changing industries such as computers? Is there structural rigidity?

Thus as we can see, although both USA and Germany are market-based system and compete aggressively across the globe, their systems of corporate governance differ markedly. Each system is based on the assumptions and the beliefs of its people.
Corporate Governance in France

The French believe in strong leadership. It is reflected in the absolute power given to a president director-general in each company. This position is considered stronger than that of the chief executive officer in the US. The French government plays an important but informal role. Besides, it holds 15 to 20 percent of the shares of major companies, in the national interest. The strong old-boy network of the ruling class, mostly graduates of the famed grandes ecoles, and a strong president director-general give France, according to experts, a pragmatic and personality-oriented system of governance. Only nationalized industries have employee representatives on the board while private ones do not.

The French system of corporate governance scores high on initiative and enterprises, although the stock market plays a minor role. Families control 60 percent of top 200 companies. Nearly 99 percent of the private shares are held in bearer form. Companies do not know who their shareholders are. Unlike in Germany, where banks at intermediaries have to vote on behalf of the shareholders, intermediaries in France cannot vote on behalf of the shareholders. Shareholders have to vote personally at shareholders meetings. The French system strengthens the institutional shareholders, who can access the information they need from the company.

French concerns in corporate governance have to do with relative competitiveness of its industries, Developing technological trust areas, and globalisation.

Corporate Governance in Japan

Corporate governance in Japan is not focused on the board of directors of the company. The Japanese concept of obligation to company, country, family and their willingness to follow a consensus, make the system’s accountability easier and one based on trust. The system’s dynamism is derived from cross holdings and networks among companies in the group. The ministry of international trade and industry and the ministry of finance provide useful information and impetus for strategizing for world markets.

The Japanese concerns with corporate governance have to do with the appreciation in the value of the yen and to reduce the risks born by the banking system. The heavy reliance of corporations on the banking system for equity and loans has been reduced from about 63 percent in 1977 to 23 percent in 1990.
Jonathan Charkham, who evaluated the corporate governance systems in the US, the UK, Germany, France and Japan, concluded that although all five were advanced market economies, each had evolved a system from its own assumptions about how best to promote the entrepreneurial and innovative talents of its people for the development of society and how best to hold them accountable.

**Corporate Governance in Pakistan**

Corporate Governance (CG) reforms, initiated in the last few years by the Securities and Exchange Commission of Pakistan (SECP), are a vital component of the growth revival strategy being pursued by the government. Pakistan’s economic performance during the 1990s has been quite dismal compared to its own historical economic growth record and to the economic performance of other South Asian countries, who have been pursuing similar policies of structural adjustment and economic liberalization during the 1990s. In view of growth-financing needs of the economy, a lot of emphasis has been placed on the reform of capital markets in order to increase the depth and efficiency of capital markets by mobilizing domestic savings and attracting foreign direct investment. One of the most important features of the growth revival strategy is the introduction of Code of Corporate Governance 2002, aiming at improvement in existing corporate governance practices and system. The rationale behind all these reform measures has been to introduce a corporate governance system that has the ability to efficiently raise external capital, increase corporate competitiveness, and stimulate organizational growth.

Many local corporations in Pakistan use cross-shareholdings and inter-locking directorships to retain majority control. Family controller find cross-shareholdings, pyramid structures and inter-locking directorships extremely beneficial as it allows them to make cash transfers across family companies. These cash transfers can take various forms ranging from companies extending subsidized lending, transfer price manipulations, and sale of assets at prices different from market prices.

**Corporate Governance in United Kingdom**

Although more recently corporate governance seems far more the ‘hot’ issue in the US, one cannot ignore the importance of the corporate governance developments in Britain since the beginning of the 1990s. As nowadays in the US, the urge for corporate governance regulations in the UK was also mainly triggered by a series of corporate ‘accidents’. (BCCI, Maxwell Group)
The first committee established to deal with the financial aspects of corporate governance was the Cadbury Committee. This committee was particularly concerned with the ‘perceived’ low level of confidence in financial reporting. Although their report was preceded several years by the reports of the Tread-way Commission, the Cadbury Report (Dec. 1992) is generally believed to be the foremost cornerstone of modern corporate governance. Its findings and recommendations leading to the present day evolutions of corporate governance worldwide had quite an effect on the corporate world. The three basic principles included: openness, integrity and accountability. One of the most controversial and revolutionary requirements and at the same time the one that had the potential of having an impact on internal auditing, was the requirement that ‘the Directors should report on the effectiveness of a company’s system of internal control.’

A less known report was the Rutteman Report or ‘Internal Control and Financial Reporting: Guidance for directors of Listed Companies Registered in the UK’ (Dec. 1994). It is worth mentioning because it was the ‘predecessor’ of the ‘Turnbull Report’ and was based on the COSO principles on internal control.

Chronologically, the next event was the establishment of the Greenbury Committee which was in its turn followed by the Hampel Committee. The Hampel Committee was responsible for drawing up the ‘Combined Code’ (June 1998). The Combined Code broadened the importance of corporate governance and included, next to elements of accountability, also elements of prosperity. The final report of the Hampel Committee starts as follows: ‘The importance of corporate governance lies in its contribution both to business prosperity and to accountability.’ In fact, the Combined Code, as the term itself suggests, was a combination of the recommendations of the Cadbury Committee, the Greenbury Committee and the Hampel Committee. On the one hand, the committee decided that accountability was important and thereby endorsed the contribution made by the Cadbury Committee, but on the other hand it also decided that the emphasis put on accountability by the Cadbury Report tended to draw too much attention away from the primary responsibility of the board: to enhance the performance and the profit of the business.

The last report that had significant implications on corporate governance but also on internal auditing is the ‘Turnbull Report’ (September 1999). The purpose of the Turnbull Report is to provide guidance on certain aspects of the combined code, especially those dealing with internal control. Since this is the most recent report and since it takes
into account the recommendations of the others, it may be interesting to have a look at some of the fundamental recommendations.

- Listed companies are expected to have a sound system of internal control to safeguard shareholders’ investment and the company’s assets.
- Management needs to review the effectiveness of internal controls on an annual basis, at least.
- The risk facing the business should be regularly evaluated.
- The review should include risk management, operation and compliance, as well as financial controls.
- Risk management is the collective responsibility of the whole board.
- The board is ultimately responsible for internal control, but may delegate aspects of the review work.
- The need for an internal audit department needs to be kept under review.

This report pays particular attention to aspects of risk management and internal auditing! This does by no means imply that since the Turnbull report no further efforts were made to enhance and promote good corporate governance. On the contrary, similarly to the US scenario, a great number of guidelines, reports and codes were (re)written in the past years. It can however not be denied that some of them are merely ‘updates’ of previous reports and codes or that some of them elaborate on a particular aspect of corporate governance in general such as audit committee guidance or guidance for non-executive board members.

Contrary to the ‘American’ developments, there remains a large degree of ‘voluntary compliance’ and the ‘comply or explain’ principle is still explicitly present in these ‘English’ documents. This is also valid with regard to the internal audit function; companies that do not have an internal audit function are recommended to review the need for one ‘from time to time’ and they should explain why they do not have one.

In the case of the revised ‘Combined Code on Corporate Governance’ of 2003, even listed companies are merely expected to comply with the Code’s provisions most of the time. Moreover, the same document suggests a number of company specific factors which may offer an acceptable reason why the company does not have an internal audit function. These include the scale, diversity and complexity of the activities, the number of employees and the cost/benefit considerations.
Corporate Governance in Belgium

In January 1998, ‘the Association of Belgian Enterprises (FEB-VBO) released a set of corporate governance recommendations based on the Cadbury Code and the Brussels Stock Exchange issued a set of ‘benchmark’ guidelines for good corporate conduct.’


However, the Belgian Banking & Finance Commission and the Brussels Stock Exchange decided to incorporate their respective codes in one single document: ‘the Dual Code of the Brussels Stock Exchange and the Belgian Banking & Finance Commission’.

To complete the set, suffice it to add that in January 2000 ‘the Director’s Charter’ was drawn up by the ‘Foundation-Administrators’.

Unlike the situation in the USA and the UK, however, there was no apparent immediate cause for the development of corporate governance in Belgium at that time. The Belgian Code for corporate governance puts a slightly different emphasis on different aspects of corporate governance. As it seems, the primary purpose was not to enhance the accountability of corporate executives but rather to call for a greater managerial independence from dominant shareholders.

Nevertheless, the three ‘original ‘codes are all based on the Cadbury Report, be it with due consideration for the Belgian situation. It is interesting to learn that during the preparation of the three original codes, there was ample consultation among the different parties involved. Fortunately this has led to the fact that there are no actual contradictions to be found between them.

These Belgian codes mainly deal with a number of aspects pertaining to the board: role, composition, working and reporting.

Realizing that different codes hardly contributed to a uniform interpretation of good governance principles, a new effort for a single code of best practice on corporate governance for listed companies was launched in 2004. A joint initiative was taken by the three ‘organizations’ involved to form a Corporate Governance Committee whose task it
was to draw up a new Corporate Governance Code, taking into consideration the principles of the 3 original codes. Following the U.K. model, the committee opted for a principle-based approach instead of rule-based and kept the ‘comply or explain’ principle.

The final result is the Belgian Corporate Governance Code dealing with 9 basic principles and offering supplementary provisions and guidelines. This code is initially only applicable for listed companies.

Since the code is basically meant for listed companies and only recommends that non-listed companies should follow the Code whenever possible, a reaction by non-listed SME (Small and Medium sized Enterprise) professional organizations lead to the drawing up of a draft corporate governance code for non-listed enterprises, the Buysse Code. Next to a number of recommendations which are equally valid for listed companies, this code also includes a number of ‘specific’ recommendations for non-listed companies. These specific recommendations deal with particular aspects such as:

- Family owned businesses and the advantages of a family forum, a family charter, etc.
- Best practices for SME in the field of banking relations, supplier relations, client relations, personnel relations, etc.

Both the UK and Belgian Codes are ‘principle based’ while the US codes are ‘rule based’.

**Corporate Governance in India**

**Corporate Governance in Public Sector in India**

- The equity shares are owned wholly or substantially (meaning 51% or more) by the government. Technically, of course, the shares of the central public sector undertakings are held in the name of the president of India.
- The boards of public sector undertakings, appointed for all practical purposes by the controlling administrative ministry, comprise three categories of directors (1) functional directors (2) government directors and (3) outside directors.
- There is, in general, a good deal of political and bureaucratic influence over the management of public sector undertakings. As a result, the autonomy of the management of the public sector undertakings is often eroded. Of late, however, things have improved.
These undertakings are constrained by various regulations and administrative guidelines. Further, they are subject to the CAG audit and are accountable, to parliament. This leads to an excessive emphasis on observing rules, regulations, and guidelines. Efficiency and performance are often sacrificed at the altar propriety.

Chief executives of these undertakings have short-term tenures, as chairman and MD, often one to five years. It is rare to find a chief executive who has been at the helm of affairs for more than 5 years. Such a short tenure, coupled with limited freedom, leads to a myopic outlook. It is, therefore, rare to find a visionary leader guiding the destiny of a public sector undertaking with a long planning horizon. Most of the CEOs seem to be concerned with fulfilling short-term targets emanating from the MOU’s. Incidentally, the MOU does themselves appear to be the outcome of an elaborate budgetary game between the management and the government.

In general, performance standards are soft, compensation levels low, incentives for performance poor, and 'real' accountability weak.

In summary, the corporate governance system in the public sector may be characterized as the 'transient system' with the key players, viz., politicians, bureaucrats, and managers taking a myopic view of things.

### Corporate Governance in Private Sector in India

Here in the private sector there are 3 broad categories of shareholders: promoters, financial institutions and retail investors. On an average, the 3 categories are more or less equally important, though there are wide variations across companies.

For electing the directors, the majority rule voting system is typically followed. The proportionate rule voting system is rarely followed.

Company boards generally comprise 3 types of directors: promoter directors, professional directors and institutionally nominated directors.

In general, institutional investors have been supportive of promoters. They seem to implicitly subscribe to what P.L. Tandon has referred as the "Management by Chromosomes" principle. They interfere only when a crisis develops or when there is clear evidence of malafide behaviour and performance of the management seriously. Of late, however, institutional investors have become more assertive. IDBI and ICICI, for example, have forced companies to undertake restructuring initiatives aimed at
protecting the interest of institutional investors. Similarly UTI has started the practice of asking companies to make regular presentations and even give board position.

- Individual investors have, by and large, been benign, tolerant, and ignorant. Though there are some knowledgeable shareholders who raise sensible queries in the AGMs, they are not able to accomplish much because the management enjoys an informational advantage and knows how to retain the support of most the shareholders by offering sops here and there and portraying a glowing picture that enthuses them. Scattered and ill-organised, individual shareholders are not in a position to play a meaningful role in electing directors. Further, the majority rule voting system prevents even a well-organised substantial minority to have any say in the election of board of directors.

- Family managed companies, in general, seem to display greater entrepreneurial vigor, act more proactively, and exercise stricter control. However, the virtually unchallenged control of the family provides enormous scope for self-dealing and facilitates personal enrichment at the expense of the company. The degree to which these aberrations occur depends on the level of integrity of the controlling family.

- Professionally managed companies, in general, react somewhat slowly to new opportunities and challenges, put together greater emphasis on systems, favour the interest of incumbent management over that of shareholders, and set relatively easy performance targets.

- The corporate governance system in the private sector may therefore be characterized as the 'entrenched system', given the firm hold of the promoters over the companies managed by them and disinclination and / or inability of others to challenge them.

- Hence the principal conflict in India is not between the interests of shareholders on the one hand and the interest of managers on the other. Rather, it is between the interests of dominant shareholders (promoters) on the one hand and the interests of the remaining shareholders on the other. This seems to be true of companies controlled by families or multinationals parents or even the government.

2.7 Objectives of Corporate Governance

Sheridan and Kendall believe that good corporate governance consists of a system of structuring, operating and controlling a company in order to achieve the following objectives.
• To fulfill the long-term strategic goals of the owners, which may consist of building the shareholder value, or establishment a dominant market share, or maintaining a market lead in a chosen sphere

• To consider and care for the interest of the employees (past, present and future) including planning future needs, recruitment, training and working environment, severance and retirement procedures through to looking after pensioners.

• To maintain good relations with customers and suppliers in matters such as quality of service, considerate ordering and account settlement procedures.

• To take account of needs of the environment and the local community in terms of the physical effects of the company’s operation on the surrounding area, and the economic and cultural interaction with the local population.

• To maintain proper compliance with all the applicable legal and regulatory requirements under which the company is carrying out its activities.

In 1992, the Cadbury committee on the financial aspects of corporate governance considered the concept of corporate governance and defined it as “the system whose aim is to align as nearly as possible the interest of individuals, corporation and society.” The board of directions is responsible for the governance of the companies. Moreover, the shareholders’ role in governance is to appoint the directions and the auditors to satisfy themselves that an appropriate governance structure is in place.

2.8 Need for Corporate Governance

Modern day corporations raise capital through investment by stakeholders whose interests are to be protected by the company management. Corporate governance is thus ‘concerned with ways of bringing the interests of investors and manager into line and ensuring that firms are run for the benefit of investors’

The era of corporate governance in America was ushered in due to the Enron and WorldCom scams that made it imperative for the Government to set up mechanisms such as the corporate Fraud Task Force and adopt legislative measures such as the corporate Accountability Act passed by the America Congress in 2002. In comparison, India has the largest number of listed companies and scams such as UTI, Ketan Parekh have jeopardized small time investors. Thus as urgent need was felt to articulate policies for corporate governance.
In India as informal attempt was made by CII to codify principle that would bring about corporate transparency and accountability. The securities and Exchange Board of India vide its circular dated feb21 2000 for the first time specified principle of corporate governance and introduced a new clause 49 in the listing agreement of the stock exchange. However many f the provisions were diluted when in exercise of its power conferred by section II 1) of the securities and Exchange Board of India Act 1992 read with section 10 of the Securities Contract Act 1956 SEBI revised clause 49.

2.9 Importance of Corporate Governance

The Birla Committee Report has highlighted the significance and need for good corporate governance. The salient points are reproduced here. It is almost a truism that the adequacy and the quality of corporate governance shape the growth and the future of any capital market and economy. The concept governance is no longer confirmed to the hall of academia and is increasingly finding acceptance for its relevance and underlying important in the industry and capital markets. Progressive firms in India have voluntarily put in place systems of good corporate governance.

Internationally also, while this topic has been accepted for a long time, the financial crisis in emerging market has led to renewed discussion and inevitably focus them on the lack of corporate as well as governmental oversight. The same applies to recent high profile financial reporting failures even among firms in the developed economies. Focus on the corporate governance and related issues is an inevitable outcome of process, which leads firms to increasingly shift to financial markets as the pre-eminent source for capital. In the process more and more people are recognizing that corporate governance is an indispensable to effective market discipline. This growing consensus is both an enlightened and a realistic view. In an age where capital flows worldwide, just as quickly as information, a company that does not promote a culture of strong, independent oversight, risks its very stability and future health. As a result, the link between a company’s management, directors and its financial reporting system has never been more crucial. As the board provides stewardship of companies, they play a significant role in their efficient functioning.

Studies of firm in India and abroad have shown that markets and investors take notice of well manage companies, respond positively to them, and reward such companies, with higher valuation. A common failures of such companies is that they have system in place,
which allow sufficient freedom to the boards and management to take decisions towards the process of their companies and to innovate, while remaining within a framework of effective accountability. In other words they have a system of good corporate governance.

Strong corporate governance is thus indispensable to resilient and vibrant capital market and is important instrument of investor protection. It is the blood that fills the veins of transparent corporate disclosure and high quality accounting practices. It is a muscle that moves a viable and accessible financial reporting structure. Without financial reporting premised on sound, honest number, capital markets will collapse upon themselves.

Another important aspect of corporate governance relates to issues of insider trading. It is important that insides do not used that position of knowledge and access to inside information about the company, and take unfair advantage of the resulting information asymmetry. To prevent this from happening, corporate are expected to disseminate the material price sensitive information in a timely and proper manner and also ensure that till such information is made public, insiders abstain from transacting in the securities of the company. The principle should be ‘disclose or desist’. This, therefore, calls for companies to devise and internal procedure for adequate and timely disclosures, reporting requirements, confidentiality norms, code of conduct and specific rules for the conduct of its directors and employees and other insiders. However, the need for such procedures, reporting requirements and rules also goes beyond corporate to other entities in the financial markets such as stock exchange, intermediaries, financial institutions, mutual funds and concerned professionals who may have access to inside information.

Good corporate governance, besides protecting the interest of shareholders and all other stakeholders, contributes to the efficiency of business enterprise, to the creation of wealth and to the country’s economy. In a sense both these points of view are related and during the discussion at the meeting of the committee, there was a clear convergence of both points of view.

According to Charkham, good corporate governance is consider vital from medium and long term perspective to enable firms to compete internationally in sustained way and make them flourish and grow so as to provide employment, wealth and satisfaction, not only improve standard of living materially also to enhance social cohesion.
2.10 Prerequisites of Corporate Governance

A review of the literature on corporate governance, including the reports of various committees, suggests that there are some pre-requisite for good corporate governance. They are:

- A proper system consisting of clearly defined and adequate structure of roles, authority and responsibility.
- Vision, principles and norms which indicates development path., normative consideration, and guidelines and norms for performance.
- A proper system for guiding, monitoring, reporting and control.

2.11 Elements of Good Corporate Governance

1. Role and Powers of Board

Good governance is decisively the manifestation of personal beliefs and values which configure the organizational values, beliefs and actions of its Board. The Board as a main functionary is primary responsible to ensure value creation for its stakeholders. The absence of clearly designated role and powers of board weakens accountability mechanism and threatens the achievement of accountability of board, CEO, and the chairman of the Board. The role of the board should be clearly documented in board Charter.

2. Legislation

Clear and unambiguous legislation and regulations are fundamental to effective corporate governance. Legislation that requires continuing legal interpretation or is difficult to interpret on a day-to-day basis can be subject to deliberate manipulation or inadvertent misinterpretation.

3. Management Environment

Management environment includes setting-up of clear objectives and appropriate ethical framework, establishing due processes, providing for transparency and clear enunciation of responsibility and accountability, implementing sound business planning, encouraging business risk assessment, having right people and right skill for the jobs, establishing performance evaluation performance and sufficiently recognizing individual and group contribution.
4. Board Skills

To be able to undertake its functions efficiently, the board must possess the necessary blends of qualities, skills, knowledge and experience:

- Operational or technical expertise, commitment to establish leadership;
- Financial skills;
- Legal skills; and
- Knowledge of Government and regulatory requirement.

5. Board Appointments

To ensure that the most competent people are appointed in the board, the board position should be filled through the process of extensive search. A well defined and open procedure must be in place for reappointments as well as for appointment of new directors. Appointment mechanism should satisfy all statutory and administrative requirements. High on the priority should be an understanding of skill requirements of the Board particularity at the time of making choice for appointment setting out in detail their duties and responsibilities.

6. Board Induction and Training

Directors must have a broad understanding of the area of operation of the company’s business, corporate strategy and challenges being faced by the board, attendance at continuing education and professional development programmes is essential to ensure that directors remain abreast of all developments, which are on may impact on their corporate governance and other related duties.

7. Board Independence

Independence board is essential for sound corporate governance. This goal may be achieved by associating sufficient number of independent directors with the board. Independence of directors would ensure that there are no actual or perceived conflicts of interest. It also ensures that the board is effective in supervising and, where necessary, challenging the activities of management. The board needs to be capable of accessing the performance of managers with an objective perspective. Accordingly, the majority of board members should be independent of both the management team and any commercial dealings with the company.
8. Board Meetings

Directors must devote sufficient time and give due attention to meet their obligations. Attending Board meetings regularly and preparing thoroughly before entering the boardroom increases the quality of interactions at Board meetings. Board meeting are the forums for board decision making. These meetings enable directors to discharge their responsibilities. The effectiveness of board meetings is dependent on carefully planned agendas ad providing board papers and materials to directors sufficiently prior to board meetings. Also, in the present scenario, board meetings through modern means of communication like teleconferencing, videoconferencing may be expressly allowed under law.

9. Board Resources

Board members should have sufficient resources to enable to discharge their duties effectively. It includes an access for director to independence legal and professional advice at the company expenses. The costs of supporting the board should be transparent and reported.

10. Code of Conduct

It is essential that the organization’s explicitly prescribed norms of ethical practices and code of conduct are communicated to all stakeholders and are clearly understood and followed by each member of the organization. Systems should be in place to periodically measure adherence to code of conduct and the adherence should be periodically evaluated and if possible recognized.

11. Strategy Setting

The objectives of the company must be clearly documented in a long term corporate strategy and an annual business plan together with achievable and measurable performance targets and milestones.

12. Business and Community Consultation

Though basic activity of a business entity is inherently commercial yet it must also take care of community’s obligations. Commercial objectives and community service obligations should be clearly documented after approval by the board. The stakeholders must be informed about the proposed and on going initiatives taken to meet social responsibility obligations
13. Financial and Operational Reporting

The board requires comprehensive, regular, reliable, timely correct and relevant information in a form and of quality that is appropriate to discharge its function of monitoring corporate performance. For this purpose, clearly defined performance measures – financial and non-financial should be prescribed which would add to the efficiency and effectiveness of the organization.

The reports and information provided by the management must be comprehensive but not as extensive and detailed as the hamper comprehension of the key issues. The reports should be available to board members well in advance to allow informed decision-making. Reporting should include status report about the state of implementation to facilitate the monitoring of the progress of all significant board approved initiatives.

14. Monitoring the Board Performance

The board must monitor and evaluate its combined performance and also that of individual directors at periodic intervals, using key performance indicators besides peer review. The board should establish an appropriate mechanism for reporting the results of board’s performance evaluation results.

15. Audit Committees

The audit committee is inter alia responsible for liaison with the management; internal and statutory auditors, reviewing the adequacy of internal control and compliance with significant policies and procedures, reporting to the board on the key issues. The quality of Audit Committee significantly contributes to governance of the company.

16. Risk Management

Risk is an important element of corporate functioning and governance. There should be clearly established process of identifying, analyzing and treating risks, which could prevent the company from effectively achieving its objectives. It also involves establishing a link between risk-return and resource priorities. Appropriate control procedures in the form of risk management plan must be put in place to manage risk throughout the organization. The plan should cover activities as diverse as review of operating performance, effective use of information technology, contracting out and outsourcing.
The board has the ultimate responsibility for identifying major risks to the organization, setting acceptable levels of risks and ensuring that senior management takes steps to detect, monitor and control these risks. The board must satisfy itself that appropriate risk management systems and procedure are in place to identify and manage risks. For this purpose the company should subject itself to periodic external and internal risk reviews.

### 2.12 Ten ways for a CEO to Improve Corporate Governance

1. **Schedule regular meetings of the non-executive board members from which you and the other executives are excluded**

   Non-executives are there to exercise “constructive dissatisfaction” with the management team. They need to discuss collectively and frankly their views about the performance of the executives, the strategic direction of the company and worries about areas where they feel inadequately briefed.

2. **Explain fully how discretion has been exercised in compiling the earnings and profit figures**

   These are not as cut and dried as many would imagine. Assets such as brands are intangible and with financial practices such as leasing common, a lot of subtle judgments must be made about what goes on or off the balance sheet. Don’t hide these, but use disclosure to win trust.

3. **Initiate a risk-appetite review among non-executives**

   At the root of most company failures are ill-judged management decisions on risk. Non-executives need not be risk experts. But it is paramount that they understand what the company’s appetite for risk is—and accept, or reject, any radical shifts.

4. **Check that non-executive directors are independent**

   Weed out members of the controlling family or former employees who still have links to people in the company. Also raise awareness of “soft” conflicts. Are there payments or privileges such as consultancy contracts, payments to favourite charities or sponsorship of arts events that impair non-executives’ ability to rock the boat?
5. **Audit non-executives’ performance and that of the board**

The attendance record of non-executives needs to be discussed and an appraisal made of the range of specialist skills. The board should discuss annually how well it has performed.

6. **Broaden and deepen disclosure on corporate websites and in annual reports.**

Websites should have a corporate governance section containing information such as procedures for getting a motion into a proxy ballot. The level of detail should ideally include the attendance record of non-executives at board meetings. If you have global aspirations, an English-language version must be available.

7. **Lead by example, reining in a company culture that excuses cheating**

Don’t indulge in sharp practice yourself—others will take this as a green light for them to follow suit. If the company culture has been compromised, or if you are in an industry where loose practices on booking revenues and expenditure are sometimes tolerated, take a few high-profile decisions that signal change.

8. **Find a place for the grey and cautious employee alongside the youthful and visionary one**

Hiring thrusting MBAs will skew the culture towards an aggressive, individualist outlook. Balance this with some wiser, if duller heads—people who have seen booms and busts before, value probity and are not in so much of a hurry.

9. **Make compensation committees independent**

Corporate bosses should be prevented from selling shares in their firms while they head them. Share options should be expensed in established companies—cash-starved start-ups may need to be more flexible.

10. **Don’t avoid risk**

No doubt corporate governance would be a lot simpler if companies were totally risk averse. But in the words of Helmut Maucher, honorary chairman of Nestlé, “You have to accept risks. Those who avoid them are taking the biggest risk of all.”
2.13 Different Models for Corporate Governance

1. The simple finance model

“In the finance view, the central problem in corporate governance is to construct rules and incentives (that is, implicit or explicit 'contracts') to effectively align the behaviour of managers (agents) with the desires of principals (owners)”, (Hawley & Williams 1996). However, the 'rules' and 'incentives' considered, are generally only those within the existing US system of publicly traded firms with unitary boards.

The rules and incentives in the finance model refer to those established by the firm rather than to the legal/political/regulatory system and culture of the host economy or the nature of the owners. The finance view represents a sub-section of the political model of corporate governance. The political model interacts with the 'cultural', 'power' and 'cybernetic' models raised in the following section.

It is the nature of the owners, which exacerbates corporate control problems found in Anglo countries like the US, Canada, UK and Australia. In each of these countries, institutional investors may own the majority of the shares in most of the largest publicly traded firms unlike in continental Europe and Japan (Analytica 1992; ECGN 1997). Institutional investors, such as pension and mutual funds, collectively owned more than 57% of the top US 1,000 firms in 1994 (Hawley & Williams 1996). The problem with institutional ownership is that their investment managers are fiduciary agents of the beneficial owners and so the situation is created of agents representing agents. Hence the term 'Fiduciary Capitalism' or what Peter Drucker (1976) more provocatively described as 'Pension Fund Socialism'.

The problem of agents being responsible to agents is that it compounds the agency costs identified by Jensen & Meckling (1976). A basic assumption is that managers will act opportunistically to further their own interests before shareholders. Jensen and Meckling showed how investors in publicly traded corporations incur costs in monitoring and bonding managers in best serving shareholders. They defined agency costs as being the sum of the cost of monitoring management (the agent); bonding the agent to the principal (stockholder/ 'residual claimant'; and residual losses. Their analysis also showed: why firms use a mixture of debt and equity; why it is rational for managers not to maximize the value of a firm; why it is still possible to raise equity; why accounting reports are provided
voluntarily and auditors employed by the company; and why monitoring by security analysts can be productive even if they do not increase portfolio returns to investors.

A basic conclusion of agency theory is that the value of a firm cannot be maximized because managers possess discretions, which allow them to expropriate value to themselves. In an ideal world, managers would sign a complete contract that specifies exactly what they could do under all states of the world and how profits would be allocated. “The problem is that most future contingencies are too hard to describe and foresee, and as a result, complete contracts are technologically unfeasible” (Shleifer & Vishny 1996).

As a result, managers obtain the right to make decisions, which are not defined or anticipated in the contract under which debt or equity finance is contributed (Grossman & Hart 1986; Hart & Moore 1990). This raises the “principal's problem” (Ross 1973) and “agency problem” (Fama & Jensen 1983). How can publicly traded firms with such incomplete contracts with their managers be effective in efficiently raising funds?

The “agency problem” is particularly acute in Anglo cultures with dispersed ownership where corporations do not have a supervisory board or what Monks (1994) describes as a “relationship investor”. When all shareholders own small minority interests to create diverse ownership it is not rational for any investor to spend time and incur costs to supervise management as this provides a 'free ride' for other investors. In any event, small shareholders may lack the power and influence to extract information, which could reveal expropriation or mismanagement.

In many Anglo countries, the law may limit the ability of shareholders to become associated together to form a voting block to influence or change management unless they make a public offer to all shareholders. Insider trading laws may also inhibit or prohibit shareholders from obtaining the necessary information to monitor and supervise management. Monks (1996), an Assistant Secretary of Labour in the Reagan Administration describes how US corporate managers have influenced law making to protect themselves from shareholder interventions.

2. The stewardship model

In the stewardship model, 'managers are good stewards of the corporations and diligently work to attain high levels of corporate profit and shareholders returns' (Donaldson &
Davis 1994). Both Lex Donaldson and Davis teach in business schools. Their arguments support the investment of business schools and their students in the development of management skills and knowledge. It also reinforces the social and professional kudos of being a manager.

Donaldson & Davis note that “Managers are principally motivated by achievement and responsibility needs” and “given the needs of managers for responsible, self-directed work, organizations may be better served to free managers from subservience to non-executive director dominated boards”. According to Donaldson & Davis, “most researchers into boards have had as their prior belief the notion that independent boards are good” and “so eventually produce the expected findings”. There are influential and powerful sources who recommend the need for independent non-executive directors such as the Council of Institutional Investors in the US, Cadbury (1992) in the UK, Australian Institutional investors (AIMA 1995), existing professional directors, and all those would like to become non-executive directors.

However, supporting stewardship theory are the individuals who contribute their own money and other resources to non-profit organizations to become a director. In analyzing the welfare distributed to stakeholders through introducing a division of powers, Persson, Roland & Tabellini (1996) had provisions in their equations to include the welfare contributed by controllers.

In commenting on stewardship theory, Hawley & Williams (1996) state that “The logical extension is either towards an executive-dominated board or towards no board at all”. Donaldson & Davis point out “the non-executive board of directors is, by its design, an ineffective control device” and cite evidence to support the view that “the whole rationale for having a board becomes suspect”. Brewer (1996) reported that “One of Canada's best-known business leaders suggested last month that boards of directors should be abolished and replaced by a formal committee of advisers”. This view arose from the businessman in question being sued as a director of an insurance company for over a billion dollars from actions taken by management.

Boards can become redundant when there is a dominant active shareholder, especially when the major shareholder is a family or government. One could speculate that some
boards are established from cultural habit, blind faith in their efficacy, or to make government or family firms look 'more business like'.

However, research by Pfeffer (1972) has shown that the value of external directors is not so much how they influence managers but how they influence constituencies of the firm. He found that the more regulated an industry then the more outsiders were present on the board to reassure the regulators, bankers, and other interest groups.

Tricker (1996) points out “underpinning company law is the requirement that directors show a fiduciary duty towards the shareholders of the company”. Inherent in the idea of directors having a fiduciary duty is that they can be trusted and will act as stewards over the resources of the company. Thus in Anglo law, directors duties are based on stewardship theory. This duty is higher than that of an agent as the person must act as if he or she was the principal rather than a representative.

Many writers, and especially the proponents of stewardship and agency theory, see each theory contradicting the other. Donaldson & Davis raise the possibility that there is some deficiency in the methodologies of the numerous studies they cite which provide support for both theories. Some possibilities are that the studies did not separate out the affect of firms being in a regulated industry as analysed by Pfeffer (1972) or possessing a dominant shareholder acting as a supervisory board or 'relationship investor' as discussed earlier.

Ghosal & Moran (1996) raise the possibility that the assumption of opportunism on which agency theory is based, “can become a self-fulfilling prophecy whereby opportunistic behaviour will increase with the sanctions and incentives imposed to curtail it, thus creating the need for even stronger and more elaborate sanctions and incentives”.

Likewise, stewardship theory could also become a self-fulling. This would appear to be the situation in firms around Mondragón, which have no independent directors. All board members are either executives or stakeholders (Turnbull 1995). However, each firm and each group of firms in the Mondragón system is controlled by three or more boards/councils or control centres which introduces a division of power with checks and balances to manage conflicts.

The inclination of individuals to act as stewards or self-seeking agents may be contingent upon the institutional context. If this is the case, then both theories can be valid as indicated by the empirical evidence. Stewardship theory, like agency theory, would then
be seen as sub-set of political and other broader models of corporate governance. Psychological analysis supports both theories. Wearing (1973), a professor of psychology states that: “differences between individuals are significant and important”. The need for money and approval, etc. is “determined and limited by the necessity of maintaining the organism in a state of dynamic equilibrium”. People stand “in an interactive cybernetic relationship to his/her community and environment, and is changed as a result of any interaction” and individuals are “sometimes competitive, sometimes collaborative: usually both”.

The inclination of individuals to act as selfless stewards may be culturally contingent. The 'company man' in Japan may place his employer before family. The voluntary resignation of executives is not uncommon when a firm is disgraced and instances of suicide are still reported.

3. The stakeholder model

In defining 'Stakeholder Theory' Clarkson (1994) states: “The firm’ is a system of stakeholders operating within the larger system of the host society that provides the necessary legal and market infrastructure for the firm's activities. The purpose of the firm is to create wealth or value for its stakeholders by converting their stakes into goods and services”. Blair (1995) supports this view and stated:

“The goal of directors and management should be maximizing total wealth creation by the firm. The key to achieving this is to enhance the voice of and provide ownership-like incentives to those participants in the firm who contribute or control critical, specialized inputs (firm specific human capital) and to align the interests of these critical stakeholders with the interests of outside, passive shareholders.”

Consistent with this view to provide “voice” and “ownership-like incentives” to “critical stakeholders”, Porter (1992) recommended to US policy makers that they should “encourage long-term employee ownership” and “encourage board representation by significant customers, suppliers, financial advisers, employees, and community representatives”. Porter (1992) also recommended that corporations “seek long-term owners and give them a direct voice in governance” (ie. relationship investors) and to “nominate significant owners, customers, suppliers, employees, and community representatives to the board of directors”.
All these recommendations would help establish the sort of business alliances, trade related networks and strategic associations which Hollingsworth & Lindberg (1985) noted had not evolved as much in the US as they had in continental Europe and Japan. In other words, Porter is suggesting that competitiveness can be improved by using all four institutional modes for governing transactions rather than just markets and hierarchy. This supports the need to expand the theory of the firm as outlined by Turnbull (1994).

However, the recommendations of Porter to have various stakeholder constituencies appoint representatives to a unitary board would be counter-productive for the reasons identified by Williamson (1985), Guthrie & Turnbull (1995) and Turnbull (1994, 1995). Williamson (1985) states: “Membership of the board, if it occurs at all, should be restricted to informational participation”. Such information participation is provided for in Table 3, which is achieved in Japan through a Keiretsu Council and in continental Europe through works councils and supervisory boards. These examples provide the model for establishing “stakeholder councils” as described by Guthrie & Turnbull (1995) and Turnbull (1994, 1997).

Hill & Jones (1992) have built on the work of Jensen & Meckling (1976) to recognise both the implicit and explicit contractual relationships in a firm to develop “Stakeholder–Agency Theory”. The interdependence between a firm and its strategic stakeholders is recognised by the American Law Institute (1992). The Institute states: “The modern corporation by its nature creates interdependences with a variety of groups with whom the corporation has a legitimate concern, such as employee, customers, suppliers, and members of the communities in which the corporation operates”.

Both stakeholder voice and ownership, as suggested by Porter and Blair, could be provided by “re-inventing” the concept of a firm as proposed by Turnbull (1973, 1975, 1991, 1994, 1997). This proposal is based on tax incentives providing higher short-term profits to investors in exchange for them gradually relinquishing their property rights in favour of strategic stakeholders. Control of the firm is likewise shared between investors and stakeholders through a compound board to remove conflicts of interest and so agency costs in a manner similar to that found in continental Europe and especially in Mondragón.

4. The political model

The political model recognises that the allocation of corporate power privileges and profits between owners, managers and other stakeholders is determined by how governments
favour their various constituencies. The ability of corporate stakeholders to influence allocations between themselves at the micro level is subject to the macro framework, which is interactively subjected to the influence of the corporate sector.

According to Hawley & Williams (1996: 29): “the political model of corporate governance has had immense influence on corporate governance developments in the last five to seven years”. However, Hawley & Williams focus their discussion only on the micro aspects of how shareholders can influence firms. Firms have also been influential in moulding the US political/legal/regulatory system over the last few centuries. According to Justice Felix Frankfurter of the US Supreme Court, the history of US constitutional law is “the history of the impact of the modern corporation upon the American scene”, quoted in Miller (1968).

Roe (1994) provides an elaboration of the historical evolution of the political model and like Black (1990) and others, argues that the finance model's nearly exclusive reliance on the market for corporate control, was primarily the result of the political traditions of federalism/decentralization dating back to the American Revolution. However, these traditions have been subject to substantial changes.

After the Revolution, there was concern that newly won political freedoms could be lost through foreigners gaining control of corporations (Grossman & Adams 1993: 6). As a result, all corporate charters were limited to a life of 50 years or less up until after the Civil War. Nor did these charters provide limited liability for the owners. Most states adopted a ten-year sunset clause for bank charters and sometimes they were as short as three years. “Early state legislators wrote charter laws and actual charters to limit corporate authority, and to ensure that when a corporation caused harm, they could revoke the charter”.

However, “During the late 19th century, corporations subverted state governments” and according to Friedman (1973: 456), corporations “bought and sold governments”.

In 1886 the US Supreme Court ruled that a private corporation was a natural person under the US constitution, sheltered by the Bill of Rights and the 14th Amendment. “Led by New Jersey and Delaware, legislators watered down or removed citizen authority clauses. They limited the liability of corporate owners and managers, then started handing out charters that literally lasted forever” (Grossman & Adams 1993: 21). “Political power
began flowing to absentee owner’s intent upon dominating people and nature”. Grossman & Adams (1993: 26) went on to say “No Corporation should exist forever”.

As a reaction to the corporate power extant at the end of the 19th century, a number US States introduced cumulative voting to allow minority interests to elect directors (Gordon 1993). Gordon describes how this initiative was subverted by competition between states to attract corporate registrations or what Nader, Green & Seligman (1976: 44) describes as “charter mongering”. Monks (1996) describes this as “the race to the bottom” and explains how contemporary corporations are influencing the determination of accounting and legal doctrines and promoting a management friendly political/legal/regulatory environment. Monks (1996) states that “The hegemony of the BRT (Business Round Table) is not a sustainable basis for corporate governance in America”.

During the beginning of the 20th century, at the federal level, laws were introduced in the US to limit bank ownership of corporations and related party transactions between corporations. This forced both the pattern of ownership and control of US firms and the pattern of trading relationships to diverge from that found in continental Europe and Japan. Kester (1992) describes the latter patterns as “contractual governance” as analysed by Coase and Williamson while limiting the term corporate governance to the problem of coordination and control as analysed by Jensen & Meckling (1976) and Berle & Means (1932).

Hawley & Williams (1996: 29) focused on the micro level of the political model as articulated by Gundfest (1990) and Pound. Pound (1993b) defined the “political model of governance” as an approach, “... in which active investors seek to change corporate policy by developing voting support from dispersed shareholders, rather than by simply purchasing voting power or control...”. Pound (1992: 83) states: “this new form of governance based on politics rather than finance will provide a means of oversight that is both far more effective and far less expensive than the takeovers of the 1980's”.

Gundfest (1993) points out that “an understanding of the political marketplace is essential to appreciate the role that capital-market mechanisms can play in corporate governance”. For example, Gordon & Pound (1991) showed that corporations with fewer anti takeover provisions in their constitutions out performed those with anti-takeover measures in place.

While the political form of governance is new to many US scholars, the importance of “political procedures” (Jensen & Meckling 1979) have been recognised in worker
governed firms by Bernstein (1980), Turnbull (1978), and many others, including stakeholder-controlled firms (Turnbull 1995).

While recognising the cultural and contextual contingencies of the US system, the current political model focuses on contemporary issues such as the US proclivity for market liquidity over institutional control (Coffee 1991). The political model is also concerned with the related issue of trading off investor voice to investment exit, and institutional agents monitoring corporate agent, ie. *Watching the Watchers* (Monks & Minow 1996). All these issues are influenced by government laws and regulations and so subject of public policy debate for changes and reform. Black & Coffee (1993) state that:

“According to a new 'political' theory of corporate governance, financial institutions in the U.S. are not naturally apathetic, but rather have been regulated into submission by legal rules that—sometimes intentionally, sometimes inadvertently—hobble American institutions and raise the costs of participation in corporate governance.”

Bhide (1994) develops details of this position. Hawley & Williams (1996: 32) state:

“The political model of corporate governance (whether Pound's or Gundfest's version) places severe limits on the traditional economic analysis of the corporate governance problem, and locates the performance-governance issue squarely in a broader political context. Political does not mean necessarily imply a government role, merely that it is non-market.”

In other words, the analysis of economists needs to be truncated and integrated into the insights of Ben-Porath (1978) and Hollingsworth & Lindberg (1985) to understand how both economic transactions and their coordinating institutions are governed. An aspect also neglected by economists is that national income can be distributed without work or welfare by spreading corporate ownership directly to individuals rather than through institutional intermediaries (Kelso & Adler 1958; Kelso & Hetter 1967, 1986; Turnbull 1975, 1988, 1991, 1994).

5. **Emerging political issues**

On the suggestion of Louis Kelso, Senator Russell Long began introducing tax and other incentives into the US Congress from 1974 onwards to promote universal share ownership. Largely as a result of these incentives, “of the approximately 7,000 companies
listed on American stock exchanges, about 1,000 firms are at least 10% employee held” (Tseo, 1996: 66). Blasi (1988) documents the growing spread and size of employee ownership in both private and publicly traded companies in the US. Ironically, the extent of employee ownership in publicly traded firms in Russia is higher (Blasi & Gasaway 1993). “In 1988, more than 90% of all firms listed on Japanese stock markets had an ESOP” (Jones & Kato 1993). The Confederation of British Industry (CBI 1990: 7) found that “60 fund managers could determine the ownership of British companies” and concluded, “concentration of power in any democracy is to be discouraged”.

Without universal individual ownership, problems arise from “universal owners” as pointed out by Monks (1996). A 'universal owner' is an institution, which effectively owns a small proportion of the entire economy. The raises the problem of the same owners participating in the governance of competing firms. It also raises the possibility that universal owners may seek to maximise profits in their corporations through transferring the costs of maintaining the environment, education and health care to the taxpayers whom they also represent.

Universal ownership avoids the problems of universal owners. There is also much evidence that ownership by individual stakeholders can improve performance (Turnbull 1997). Corporate governance scholars such as Blair (1995), Monks (1996), Porter (1992), and Denham & Porter (1995) support employee ownership, in particular. Porter (1992) recommended that all strategic stakeholders participate in ownership and control. Turnbull (1973, 1975, 1991, 1994, 1997) describes alternative mechanisms to those proposed by Kelso for achieving this objective to promote what Porter refers to as 'expanded ownership'. Turnbull describes how Porter's proposals could be implemented to provide operating advantages and a basis for improving corporate self-governance.

2.14 Model for Successful Implementation of Corporate Governance

It has now been empirically established that corporate governance is necessity of companies. Companies are required to publish a report on corporate governance along with their annual report on corporate governance along with their annual report. In order to get listed on any of the prominent stock exchanges apart from the financial requirement, fulfillment of corporate governance stipulations are also mandatory. For the concept of
The first party that has to play a significant role in successful implementation of corporate governance is the State.

2.15 Clause 49 of Listing Agreement on Corporate Governance

Clause 49 of the Listing Agreement, which deals with Corporate Governance norms that a listed entity should follow, was first introduced in the financial year 2000-01 based on recommendations of Kumar Mangalam Birla committee. After these recommendations were in place for about two years, SEBI, in order to evaluate the adequacy of the existing
practices and to further improve the existing practices set up a committee under the Chairmanship of Mr. Narayana Murthy during 2002-03. The Murthy committee, after holding three meetings, had submitted the draft recommendations on corporate governance norms. After deliberations, SEBI accepted the recommendations in August 2003 and asked the Stock Exchanges to revise Clause 49 of the Listing Agreement based on Murthy committee recommendations. This led to widespread protests and representations from the industry. There by forcing the Murthy committee to meet again to consider the objections.

The committee, thereafter, considerably revised the earlier recommendations and the same was put up on SEBI website on 15th December 2003 for public comments. It was only on 29th October 2004 that SEBI finally announced revised Clause 49, which will have to be implemented by the end of financial year 2004-05. These revised recommendations have also considerably diluted the original Murthy Committee recommendations. Areas where major changes were made include:

- Independence of Directors
- Whistle Blower policy
- Performance evaluation of nonexecutive directors
- Mandatory training of non-executive directors, etc.

The changes in corporate governance norm as prescribed in the revised Clause 49 are as follows:

**A. Composition of Board**

The revised clause prescribes six tests, which a non-executive director needs to pass to qualify as an Independent Director. The existing requirement is that to qualify as an Independent Director, the director should not have, apart from receiving director's remuneration, any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the judgment of the Board may affect independence of judgment of the director. This requirement finds place in the revised clause also except that the relationship will now extend to its management, its holding company and its associates in addition to the existing list. Further the Board is no longer required to judge the independence status of a director as at present. Five new clauses have been added to determine independence of a director. These are:
(i) He is not related to promoters or persons occupying management positions at the board level or at one level below the board;

(ii) He has not been an executive of the company in the preceding three financial years;

(iii) He is not a partner or an executive or was not partner or an executive during the preceding three years of (a) the statutory audit firm or the internal audit firm that is associated with the company; and (b) the legal and consulting firms that have a material association with the company.

(iv) He is not a material supplier, service provider or customer or a lessor or lessee of the company, and

(v) He is not a substantial shareholder of the company owning two percent or more of the block of voting shares.

The new tests of ‘independence’, the readers would recall, were mostly included in the Companies (Amendment) Bill, 2003. The important and practical change that has now been made is addition of the word ‘material’ in item (iv) Above. Without use of the word ‘material’, technically even a single supply or purchase by the director to or from the company would have taken away independence status if he/she was otherwise eligible. However, the word ‘material’ has not been defined. Nominee directors of Institutions are now to be considered as ‘Independent Director’. While on the subject of Independent Director one must remember that no one is invited to join a board to act as a non-executive director unless he/she is well known to the Promoters or the Chairman or the Managing Director. All non-executive directors, whether or not independent, need support of Promoter Group for their reelection. If the purpose or objective of having a specified number of independent directors on the boards of listed companies is to ensure that boards are not packed with ‘yes-men’ or to ensure constructive criticism one needs to ponder how many independent directors can freely raise questions at board meetings. Is it right that a vast majority of them invariably support every proposal of management? Only a few persons who are eminent in their own fields may ask right questions, even if they look inconvenient, at board meetings but the majority may not muster enough courage to do so. It may therefore appear that no amount of regulation can ensure how an independent director should behave at board meetings. After all independence is a matter of attitude and a director who is conscious about his responsibilities, will always raise right questions at board meetings, whether or not he holds the independent status. The original
recommendation of the Murthy Committee for mandatory training and updating of knowledge of directors has now been shifted to non-mandatory requirement, most probably in the face of strong opposition from industry. This indeed is sad as a vast majority of directors are in need of training in the business model of the company and for updating of knowledge. I do believe that a beginning in this regard was immediately necessary. It may not be out of place to mention here that under the Listing requirements of UK all directors are mandatory required to regularly update and refresh their skills and knowledge. From the point of view of listed companies, a declaration should be obtained annually from all independent directors confirming compliance with all six conditions of independence.

B. Non-Executive Directors’ Compensation & Disclosures

A new requirement has been provided for obtaining prior approval of shareholders for payment of fees/compensation to non-executive directors. If there is stock option, the limit for the maximum number that can be granted to non-executive directors in any financial year and in aggregate should be disclosed. According to the Companies Act, 1956 fees paid to directors do not form part of Managerial remuneration and hence no approval of shareholders for payment of fees to directors is required. Listed companies will now need to obtain prior approval of shareholders for payment of sitting fees to directors.

Unless the Government is contemplating to change the law and bring sitting fees within the ambit of Managerial remuneration this contradiction should have been avoided.

C. Other Provisions relating to Board

(i) Gap between two meetings has been reduced to three months from four months ruling at present.

(ii) A code of Conduct for Board members and senior management has to be laid down by the Board which should be posted on the website of the company. All Board members and senior management should affirm compliance with the code on annual basis and the annual report shall contain a declaration to this effect signed by the CEO.

D. Audit Committee

Following are the changes with regard to Audit Committee:
(i) Two-third of the members of Audit committee shall be independent directors as against the present requirement of majority being independent;

(ii) Earlier, only non-executive directors could be members of Audit committee. The revised clause has omitted this requirement.

(iii) All members of the Audit committee shall be financially literate (As defined in the revised clause) as against the existing requirement of at least one member having financial and accounting knowledge.

(iv) Minimum number of Audit committee meetings in a year increased to 4 from 3.

(v) Role of the Audit committee has been enlarged to include

   (a) Matters required being included in Directors’ Responsibility statement;

   (b) To review the functioning of Whistle Blower mechanism if the same exists and

   (c) review of performance of statutory and internal auditors.

(vi) The Audit committee will also mandatorily review

   (a) Management Discussion and Analysis of Financial condition and results of operations;

   (b) Statement of significant related party transactions;

   (c) Management letters/letters of internal control weaknesses issued by the statutory auditors;

   (d) Internal audit reports relating to internal control weaknesses, and

(vii) To review the appointment, removal and terms of remuneration of the Chief Internal Auditor. The Audit committee will no longer be required to review the company’s financial and risk management policies. Risk assessment and minimization procedures will now be reviewed by the Board. Listed companies should now ascertain from their respective Audit committees the frequency of reporting related party transactions, frequency of discussing Management letters issued by the statutory auditors etc.

### E. Subsidiary Companies

These are new requirements, which provide for the following:

(i) At least one independent director on the Board of the holding company shall be a director on the board of a material non-listed Indian subsidiary company;

(ii) The audit committee of the holding company shall review the financial statements, in particular, the investments made by the unlisted subsidiary company;
(iii) The minutes of board meetings of the unlisted subsidiary company shall be placed at the board meeting of the holding company. The management should periodically bring to the attention of the holding company a statement of all significant transactions and arrangements entered into by the unlisted subsidiary company.

Attention of the readers is drawn to the following:

(a) Material non-listed Indian subsidiary has been mentioned only for Board representation. In respect of review of financial statements of unlisted subsidiary by the audit committee of holding company and placing of minutes and significant transactions entered into by subsidiary, it is significant that the words ‘material’ and ‘Indian’ have not been used. It can therefore be interpreted that board meeting minutes, financial statements and significant transactions of all unlisted subsidiaries whether incorporated in India or abroad are to be placed before the board of the holding company or to be reviewed by the audit committee of the holding company. Is this the intention?

(b) Material non-listed Indian subsidiary shall mean an unlisted subsidiary, incorporated in India, whose turnover or net worth exceeds 20% of the consolidated turnover or net worth respectively of the listed company and its subsidiaries. This definition is likely to exclude most of the unlisted subsidiaries as they are not likely to meet the turnover or net worth test.

(c) Significant transaction or arrangement shall mean any individual transaction that exceeds 10% of the total revenues/ expenses/assets/liabilities of the subsidiary. It is difficult to understand the logic of excluding subsidiaries incorporated abroad from the purview of representation on the board by an independent director.

F. Disclosures

Following new disclosure requirements have been specified in the revised clause 49:

(i) Statement on transactions with related parties in the ordinary course of business shall be placed before the Audit committee periodically;

(ii) Details of material individual transactions with related parties which are not in the normal course of business shall be placed before the Audit committee; and

(iii) Details of material individual transactions with related parties or others, which are not on arm’s length basis, should be placed before Audit committee together with
management’s justification for the same. Here also, the word ‘material’ has not been defined. Listed companies should ascertain from their respective audit committees the frequency of reporting such transactions.

(iv) Financial statements should disclose together with management’s explanation any accounting treatment different from that prescribed in Accounting Standard.

(v) The company will lay down procedures to inform board members about the risk assessment and minimization procedures which shall be periodically reviewed by the Board.

(vi) The company shall disclose to the Audit committee on a quarterly basis the use of funds raised through public/ rights/preferential issues. Annually a statement showing use of funds for purposes other than those stated in Offer document/prospectus should be placed before the Audit committee. Such statement should be certified by the statutory auditors.

(vii) Under ‘Remuneration of Directors’ new disclosure requirements have been prescribed, which include criteria of making payments to non-executive directors, shares and convertible instruments held by non-executive directors and shareholding (both own and held on beneficial basis) of non-executive directors to be disclosed in the notice of general meeting called for approving appointment of such director.

G. CEO/CFO Certification

This is a new requirement and is based on the Sarbanes Oxley Act of USA. This had also been recommended by the Naresh Chandra Committee set up by the Centre in 2002-03. The revised Clause only requires CEO and CFO to certify to the Board the annual financial statements in the prescribed format. While this certification will certainly provide comfort to the non-executive directors and will indeed act as the basis for the Board to make Directors’ Responsibility Statement in terms of section 217(2AA) of the Companies Act, 1956, it is not clear why SEBI did not require the listed companies to include such certification in the Annual Report.

H. Compliance Report

The format of quarterly report to be submitted to the Stock Exchanges has been revised and the new format follows the revised requirements of Clause 49. The CEO or the Compliance officer can now sign the compliance report. The annual corporate governance report should disclose adoption or non-adoption of non-mandatory requirements.
I. Non-Mandatory Requirements

Five new items have been added under non-mandatory requirements and the existing item on Postal ballot has been deleted. The first new item states that Independent directors may not have tenure not exceeding in the aggregate a period of nine years on the Board of the company. The next item relates to companies moving towards a regime of unqualified audit report. The third item deals with training of board members in the business model of the company as well as risk profile of the business parameters of the company and responsibilities of directors and how best to discharge it. The fourth item deals with performance evaluation of non-executive directors by a peer group comprising the entire Board. The fifth item relates to setting up of a whistle blower policy in the company. While the new corporate governance norms are more stringent than the existing requirements it must be appreciated that while regulations in these areas are necessary, regulations per se cannot and will not ensure good corporate governance. Attention of readers is drawn towards the Report on Observance of Standards and Codes carried out under a joint programmed of World Bank and IMF. This report benchmarks the observance of corporate governance in India against the benchmark Principles of Corporate Governance lay down by the Organization for Economic Cooperation and Development (OECD). The assessment team had extensively interviewed issuers, institutional investors, financial institutions, market analysts, lawyers, accountants and auditors. The report was also discussed by Government of India and cleared by the DEA for publication in June 2004. Following are the areas identified for reform in the World Bank report:

a. Sanctions and enforcements should be credible deterrents to help align business practices with the legal and regulatory framework, in particular with regard to related party transactions and insider trading.

b. The current framework places the oversight of listed companies partly with DCA, partly with SEBI and partly with Stock exchanges. This fragmented structure gives rise to regulatory arbitrage and weakens enforcement.

c. If boards are to move away from simply ‘rubber stamping’ the decisions of management or promoters they must have a clear understanding of what is expected from them. They should know their duties of care and loyalty to the company and all shareholders. They should know their responsibilities and should be familiar with the
changes in this regard arising from changes in laws and regulations. A key missing ingredient is a strong focus on professionalism of directors. Director training institutes can play a key capacity building role and expand the pool of competent candidates.

d. Institutional investors acting in a fiduciary capacity should be encouraged to form a comprehensive corporate governance policy including voting and board representation.

It will be observed that the World Bank report has stressed the need of training and updating of knowledge of directors. Unfortunately the recommendation of Murthy Committee in this regard has now been shifted as non mandatory requirement. The rationale of industry’s objection to mandatory training, etc. of directors is not readily understandable. Hopefully, when the governance norms are reviewed next the training and knowledge updating would be made mandatory requirement.

A new requirement has been provided for obtaining prior approval of shareholders for payment of fees/compensation to non-executive directors. If there is stock option, the limit for the maximum number that can be granted to non-executive directors in any financial year and in aggregate should be disclosed.
## Key Requirements of Clause 49

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<td>Number of independent directors in the committee</td>
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