CHAPTER 1
INTRODUCTION AND DESIGN OF THE STUDY

1.1 Introduction
1.2 Nature of the Company Form of Organisation
1.3 Corporate Governance
1.4 Definition of Corporate Governance
1.5 Importance of Corporate Governance
1.6 Consequences of Poor Governance
1.7 Principles of Corporate Governance
1.8 Why Corporate Governance Study Now?
1.9 Problem of the Study
1.10 Design of the Study
1.11 Objectives of the Study
1.12 Research Hypotheses
1.13 Importance of the Study
1.14 Scope of the Study
1.15 Operational Definitions
1.16 Review of Related Literature
1.17 Methodology and Tools
1.18 Construction of the Questionnaire
1.19 Collection of Items
1.20 Sampling Technique
1.21 Board Room Practices Model
1.22 Plan of the Analysis
1.23 Limitations of the Study
1.24 Scheme of the Present Report
"Much of the current economic difficulties in Asia could be viewed as failure of corporate governance". Linda Tsao Yang, US ambassador to the Asian Development Bank.

1.1 INTRODUCTION

This chapter gives a history about the evolution of the corporate form of business organisation. The role of corporate governance in the development of a country and principles of good corporate governance are outlined. An attempt is made to evaluate the consequences of the poor corporate governance. The present researcher attempts to explain why he has taken corporate governance for the study. The researcher also attempts to present the research design for the present study. The objectives of the study, hypotheses framed for the study, importance of the study and scope of the study are attempted to be projected.

1.2 NATURE OF THE COMPANY FORM OF ORGANISATION

In the world of institutions, commercial corporations are newcomers. The company form of organisation has been around for only 500 years – a mere blip in the course of human civilisation. At that time, as producers of material wealth, they have enjoyed immense success. They have sustained the world’s exploding population with the goods and services that make civilised life possible.

Separate legal identity, perpetual succession and democratic management are some of the salient characteristics of a joint stock company which have propelled the industrial revolution and distribution of wealth across the world’s population. A corporation represents an amalgam of disperse social interests. The interests belong not only to the present living generations but also to the living generations yet to come. It has and it wields enormous economic and social prowess. Those in control of the corporation, therefore, hold enormous

---

responsibility of multifarious dimensions - social, economic, ethical, scientific and technological.

The sheer complexity and economic vehemence of the corporate phenomenon of modern times are so baffling that the inevitable result is the collapse of legal, audit, and bureaucratic controls over corporate governance in almost all countries, whether it be the German model of supervisory boards or the Japanese model of shareholders' silence or the English model of permissive company law or the US model of shareholder vocalism.

A good portion of the nation's capital is tied up in listed companies; their success or failure is a matter of public interest, not simply private concern. The impact of corporate performance governance goes beyond shareholders. Listed companies have a value greater than GDP, and represent a significant part of the nation's capital, employment, and ultimately, tax base. There is therefore a wider and quite legitimate public concern with the accountability of such companies and the role of shareholders.

The corporation has a vital role to play in promoting economic development, and social progress. It is the engine of growth internationally, and increasingly responsible for providing employment, public and private services, goods and infrastructure. The efficiency and accountability of the corporation is now a matter of both private and public interest, and governance has thereby come to the head of the international agenda. The governance of the corporation is now as important in the world economy as the government of countries, observed the Chief of World Bank, James Wolfensohn.

The company whose purpose is survival is more like a river. Unlike a puddle, a river is a permanent feature of the landscape. Come rain, the river may swell. Come shine, it may shrink. But it takes a long and severe drought for a

---

river to disappear. From the point of view of the drops of water, the river is quite turbulent. No drop remains at the centre for long. From one moment to the next, the water, in one part of the river changes. New water drops succeed old ones, and they all re carried forward.  

The river lasts many times longer than the individual drops of water it comprises. The river is a self-perpetuating community with its own built-in guarantees for the continuity and motion of water within its banks. A company, by initiating rules for the continuity and motion of its people, can emulate the river’s longevity and power. The living company is a river company. 

If you look at them in light of what they could be, however most commercial corporations are underachievers. They exist at an early stage of evolution; they develop and exploit only a small fraction of their potential. Consider their high mortality rate. By 1983, one-third of the 1970 Fortune 500 companies had been acquired or broken into pieces, or had merged with other companies. Similar to this, in India also, many companies which were leaders in the early days of independence are now in oblivion because of a number of reasons, mainly because of ignoring the rules of corporate governance. One can cite many examples, where the corporations had a glorious history, now either vanished or reduced into a pigmy. One such example is Premier Automobile Ltd. The company was formed by one of the illustrious sons of India, Walchand Hirachand in the year 1944. The company with a market share of 40% during eighties, now no where in the market, because of poor governance including poor corporate governance. Apart from this type where the company was run and subsequently wound up due to sickness, there is another category where the mortality cannot be attributed to the governance factor. The death is quick in such cases, where dishonest promoters promoted the company utilising the law

---

5 www.cbc.to/Govemance/finalver
7 Ibid.
of the land and vanish away into thin air, leaving the innocent investors in quandary.

"The calendar 1994, 1995 and 1996 will go down as the most productive years in the history of Indian primary capital markets. Whereas the first four years of the nineties, that is 1990 to 1993, collectively saw a total of 1,193 public issues, the year 1994 alone witnessed as many as 1,130 public issues which was 69% higher than the previous year. The number of issues went further up to 1,445 in calendar 1995. In the next year, the number of issues dropped yet, the number was still impressive at 1,183. In all the three years between 1994 and 1996 witnessed 3,758 public offers that tapped Rs.36,180 crores from the market".

"During the mid-nineties’, unprecedented primary market boom, almost every Tom, Dick and Harry effortlessly floated public issues. In fact, most of the fly-by-night operators made good use of this opportunity to fill up their kitties. The market regulators too were happy as higher number of capital issues meant more revenue for them! Two years have now passed since the end of the last primary market boom. Where do those issuers stand today? After excluding the offers of bonds, convertible instruments, preferences shares and of course, the initial public offers (IPOs) valued at Rs.7,859 crores in 1994, 1,417 IPOs with an aggregate offer amount of Rs.12,601 crores in 1995 and 1,113 offers for an aggregate amount of Rs.5,325 crores in 1996. Of the 1994 IPOs, nine offers with an aggregate amount of Rs.31 crores are yet to be traced anywhere in the secondary market. The IPOs with an aggregate amount of around Rs.318 crores is yet to be traced. Though the number of IPOs dropped in 1996, the missing list' further lengthened with 177 IPOs that raised about Rs.543 crores finding no place in the official quotation list of their respective stock exchanges. This leaves 1,030 IPOs with an offer value of Rs.7,828 crores in 1994, 1,374 IPOs with an amount of Rs. 12,284 crores in 1995, and 936 IPOs accounting for Rs.
4,782 crores in 1996 for any worthwhile analysis.\(^8\) The death of such companies where the promoters entered the capital market in order to swindle the public money, utilising the loopholes in the existing law of the land cannot be attributed to corporate governance. Perhaps, it is the result of the law of the land. The absence of co-ordination between the various constituents of the administration, like SEBI, Registrar of Companies, ill-equipped legislation and political interference are instrumental in the above cited pre-matured death of companies. The attitude of the promoters is not to run the company. They want to utilise the existing mechanism to swindle money from the innocent public.

Apart from the above mentioned vanishing companies episode, in the normal circumstances, a number of companies are closed due to the negligence of the controlling group regarding corporate governance. The rise and fall of many business empires can be attributed to this factor. One such example is cited above, viz., PAL. However, the protected environment of the country has extended the life of many poorly managed companies. The real effect of poor corporate governance is yet to surface in India.

How do we know that many of the deaths are premature? Because we have evidence of much greater corporate longevity. Japan's Sumitomo has its origins in a copper-casting shop founded by Riemon Soga in 1590. And the Swedish company Stora, currently a major paper, pulp and chemical manufacturer, began as a copper mine in central Sweden more than 700 years ago. Examples such as these suggest that the natural life span of a corporation could be two or three centuries – or more.

The implication of the statistics is depressing. The gap between the endurance of a Sumitomo or a Stora and the fleeting life of the average corporation represents wasted potential. Individuals, communities, and

\(^8\) Ibid.
economies are all affected – even devastated – by untimely corporate deaths. The high corporate mortality rate seems to be unnatural. No living species suffers from such a discrepancy between its maximum life expectancy and the average span it realises. And few other types of institution – churches, armies, or universities – have the abysmal record of the corporations. Why do so many companies die young? Contrary to the academic boasting of a corporation having a perpetual succession, in reality it is not so. Why this discrepancy?

The high mortality rate, though it can be attributed to the freedom and competition, it is only partially true. As the medical science is able to increase the mortality rate of the natural persons, the corporate citizen’s life can similarly be increased by creating the proper environment as well as clean habits of corporate citizens, i.e., improving the corporate governance practices.

The company is a living social organisation. Therefore, the society’s culture as well as environment will also be the influencing variables in the evolution of the company form of organisation. In the case of Indian corporate history also, the above statement equally holds good. Indian corporate sector reflects our society. The corporate form of organisation is the gift of British legacy. India historically did not have the company form of organisation in the society. Though the Chanakya in his famous Artha Sasthra gave some details about partnership firm, the company form of organisation is totally a new concept. The concept of company form of organisation is borrowed from the Britain, which in turn from the Romans.

Though all the western countries have adopted the corporate form of organisation from the Roman law, the form of adoption varies from country to country. The reason being, as said earlier, the social organisation reflects the
socio-cultural environment. The western countries ruled their respective colonies in different ways. The British pattern was to govern the colony by a local council—a variation of executive directors—and a higher council (Board of Directors) residing in England and answering directly to the sovereign, had the final say on all policy matters. The vesting of authority in councils of peers was unique to British Governance System, even in the political arena, a concept derived from the Magna Carta during 1215 AD.¹²

The saga of Norman Invasion of Britain by William the Conqueror and the conquest in 1066 had sown the seeds of the principles of Anglo-Saxon model. Its effect led to the revolt of the barons and the signing of the Magna Carta at Runnymede two centuries later. This was the real beginning of modern checks and balances of governance in the political arena, which were extended in the corporate management.¹³

1.3 CORPORATE GOVERNANCE

The owners of a joint stock company, i.e., the shareholders are widely scattered and their number is limited to the number of shares issued by the company. The result is a large number of shareholders for each company. Hence all the shareholders of a company cannot participate in the day to day management of the Company. Hence, the Companies Act in India divorced the management from the owners. It provides a mechanism through which the managerial powers are entrusted to a separate committee specially created for this purpose, viz., Board of Directors and the management is carried on smoothly by them without involving all the shareholders.

¹³ Ibid.
With the separation of ownership from the management, the primary responsibility for running a business with honesty and integrity lies with the Board of Directors, who are accountable to owners for their stewardship functions. The Companies Act has also stipulated a reporting mechanism through which the Board of Directors are expected to report the performance of the company to their appointing authority, i.e., shareholders. Though the managerial powers are delegated to the board of directors, they are watched by another external agency, viz., auditors. As a check to the enormous powers enjoyed by the board of directors, a supervisory mechanism is incorporated in the managerial process as formulated by the Companies Act. The Companies Act stipulates for the compulsory appointment of auditors by the shareholders in every annual general meeting. If a company fails to appoint auditor in an annual general meeting the central government will interfere and fill up that vacant position, i.e., auditor. The auditor so appointed will verify the accounts maintained by the board of directors and report to the shareholders about the authenticity of the accounts. Thus, the corporate governance mechanism consists of a number of checks and balances.

The shareholders’ responsibility is to select and appoint right persons as directors and auditors. The Board is responsible for proper governance in such a way that in the long run shareholders value is maximised. Auditor’s responsibility is to provide shareholders with an external and objective evaluation on the directors financial statements, which is the primary instrument in the reporting mechanism stipulated by the Companies Act.

1.4 DEFINITION OF CORPORATE GOVERNANCE

Corporate governance is concerned with the systems of law, regulation, and practice which will promote enterprise and ensure accountability. “From a corporation’s perspective, the emerging consensus is that corporate governance is about maximising value subject to meeting the corporation’s
financial and other legal and contractual obligations. This inclusiveness stresses the need for boards of directors to balance the interests of shareholders with those of other stakeholders—employees, customers, suppliers, investors, communities—in order to achieve long-term sustained value. From a public policy perspective, corporate governance is about nurturing enterprise while ensuring accountability in the exercise of power and patronage by firms. The role of public policy is to provide firms with the incentives and discipline to minimise the divergence between private and social returns and to protect the interests of stakeholders.14

These two definitions—from public and private perspectives—provide a framework for corporate governance which reflects this interplay between internal incentives (which define the relationship among the key players in the corporation) and external forces (notably policy, legal, regulatory, and market) that govern the behaviour and performance of the firm.”15

The World Bank defines "Corporate governance" as follows: Corporate governance refers to that blend of law, regulation and appropriate voluntary private sector practices which enable the corporation to attract financial and human capital, perform efficiently, and thereby perpetuate itself by generating long-term economic value for its shareholders, while respecting the interests of stakeholders and society as a whole.16

“Corporate governance ensures that long-term strategic objectives and plans are established and that the proper management structure (organisation, systems, and people) is in place to achieve those objectives, while at the same time making sure that the structure functions to maintain the corporation’s integrity, reputation, and responsibility to its various constituencies.”17

15 Ibid.
16 Ibid.
“It comprehends that structure of relationship and corresponding responsibilities among a core group consisting of shareholders, board members and corporate managers designed to best foster the competitive performance required to achieve the corporation’s primary objective.”

Corporate governance is the term used to describe the way in which companies are directed and controlled and encompasses issues such as the responsibilities of directors, and the relationships between shareholders, directors and auditors.

Corporate governance refers to the framework of rules and regulations that enable the stakeholders to exercise appropriate oversight of a company to maximise its value and to obtain a return on their holdings.

Corporate governance can be said to be a structural framework to make a healthy and competitive company which realises self-cleaning and competitiveness under such strategies, transparency, social orientation, and innovativeness.

1.5 IMPORTANCE OF CORPORATE GOVERNANCE

The concept of Corporate governance, has suddenly become international. A number of international agencies like OECD, the World Bank, and International Monetary Fund, besides more than a dozen of individual countries are busy in framing the corporate governance codes. A healthy corporate governance not only avoids accidental and temporary mishaps, but leads to excellent corporate management. In other words, discussion concerning

---

corporate governance should deal with topic “For whom, for what, and how should a company be run?” in a broad context.

The imperatives of corporate governance, flow from the concept of accountability for the safety and performance of assets and resources entrusted to the operating team. In a proprietary concern or a small business, the employees will be accountable for their actions to the proprietor or partners or in other words, owners of the business. Accountability, in such circumstances, is relatively easy and managed without any complication since the lines of communication and supervision are usually short and straightforward.

With a business growing in size and complexity, leading to organisational corporatisation, ownership and management are distanced from each other. Consequently, accountability and governance issues assume much greater significance. A board of directors is juxtaposed between the shareholders or owners and the executives, managers and other employees of the organisation. Therefore corporate governance basically has to do with power and accountability: who exercises power, on behalf of whom, and how the exercise of power is controlled. The corporation has become a more important political institution than the state and the business of government becomes even more dominated by corporate business.22

Although the need for good corporate governance has been acknowledged since corporations were first created, an awareness of this need has grown rapidly around the world during the recent years.

The corporation has a vital role to play in promoting economic development, and social progress. It is the engine of growth internationally, and increasingly responsible for providing employment, public and private services,

---

goods and infrastructure. "increasingly, transnational corporate power, not state 
power, constitutes the formative agent of change in world development."23

The efficiency and accountability of the corporation is no longer a matter of interest between the shareholders of a particular company and the Board. The entire society is interested. It becomes a matter of public interest. Governance has thus come to the head of the international agenda. Democratic reforms in the area of corporate governance offer our greatest hope for predictably enhancing wealth for corporations as well as for the broader society.

In the beginning, the Governors of Central Banks and Finance Ministers considered the stock market as a nuisance and gave a scant respect to it only as a place of speculative business. However, Dow Jones, the founder author of Wall Street Journal, identified the link between the performance of the corporate sector and the economy. Thus he was able to declare, the arrival of the Great Depression in thirties well in advance of some six months. The share market that is the business of the businesses has the necessary mechanism to forecast the economical environment. There is a direct link between the economy and the performance of the corporate sector.

"The link between the corporate sector and the macro economy are two-way. First, macroeconomic developments can affect the health of the corporate sector, especially if corporations are highly leveraged (that is, if they carry large amounts of debt relative to equity) and do business in an environment that does not promote sound corporate governance.

- Changes in world interest rates and country risk premiums can sharply alter the cost of borrowing for corporations burdened by foreign debt.

• Rapid change in the rate of depreciation can increase the debt-servicing costs of firms with large foreign debts, destabilise the corporate sector, and even threaten the viability of many firms.

• A high level of short-term corporate debt dominated in foreign currency increases the vulnerability of the macro economy to exchange rate depreciation and sudden capital outflows.

• The adverse impact of tight monetary policy and high interest rates on domestic demand and bank lending, which have been used to stem rapid exchange rate depreciation, is amplified by high corporate debt and can therefore worsen the corporate sector’s financial situation.

Second, the corporate sector can affect the macro economy through the following links:

• The restructuring of over leveraged corporations struggling to stay afloat financially can magnify an economic downturn by triggering the rapid disposal of assets at “fire-sale” prices and prompting large investment contractions. In post-crisis Asia, the contribution of investment to real GDP in the highly leveraged countries is negative and very large.

• A squeeze on credit to corporations arising from a short-fall of bank capital can force governments to divert their fiscal resources to bank recapitalisation.

• If the corporate sector is tipped into insolvency, lower investment and the prolonged period needed for corporate restructuring can significantly impair growth.24

Before the Asian crisis, analysis of the links between corporate balance sheets and the macro economy received relatively little attention. The Asian crisis proved, beyond doubt, the link between the corporate sector financial
position and the macro economical condition. In future, the policy makers should design and introduce policies that can reduce the risk of crisis and destabilisation. Such policies include better insolvency frame-works, improved corporate governance and the like at the micro and macro level.\textsuperscript{25}

"Power corrupts and absolute power corrupts absolutely" is an old saying. The keys to creating wealth and maintaining a free society lie primarily in the same direction. Both require that broad based systems of accountability be built into the governance structures of corporations themselves.\textsuperscript{26}

\textbf{1.6 CONSEQUENCES OF POOR CORPORATE GOVERNANCE}

The movement to more democratic forms of corporate governance by empowering owners is important not only for creating wealth, from the point of view of the shareholders but also important from the society’s point of view. It cuts directly one's ability to maintain a free society. It has enormous powers. If unchecked, gradually it becomes a monster and the society has to struggle at a later stage. As Monks and Minow have noted, "Corporations determine far more than any other institution the air we breathe, the quality of the water we drink, even where we live. Yet they are not accountable to anyone."\textsuperscript{27} That managers and entrepreneurs were constantly trying to escape or control competition, not engage in it...the rules of the market could be changed by powerful corporate actors and the government."\textsuperscript{28}

Economic activity came to represent the realm of freedom and the pursuit of self-interest. The coercive powers of the state were limited to preserving the realm of freedom and social efficiency. The ideological precept of corporate

\textsuperscript{25} Ibid
\textsuperscript{26} www.corpgov.net
\textsuperscript{27} Ibid.
autonomy grew out of legal doctrines which reified the corporation as a citizen, thus, serving both to legitimise and to disguise corporate power as an inviolable part of the natural order. Corporate liberalism rose as an alternative to laissez-faire liberalism and states socialism.\(^{29}\)

“Jurists moved from thinking of the corporation as an artificial construct of the sovereign to a regulated citizen. The rights of due process aided corporate power by providing constitutional rights that could be invoked against state attempts to regulate. With the rights of legal persons, came an expectation of corporate social responsibility, consistent with the ideological concept of citizenship. The western frontier and the "invisible hand" gave way to faith in technological advance and a pragmatic role for government support and regulation.”\(^{30}\)

“Each wave of populism was marked by pushing regulation of corporations to a more abstract level”. Bowman speculates on the future of the adoption of an international companies act or a supranational corporate charter. Behind the political decisions of corporations, Bowman sees the work of a dominant class. His is not the simple class warfare of Marx; the owners of the means of production pitted against the masses. Instead, control lies with the corporate executives and board members of the top 200 industrial and 50 financial corporations. Power based on relationships of control over the corporate bureaucracy superseded power based on property ownership, as the corporation developed into a political institution.”\(^{31}\)

As a corporation has unrestricted power to influence the society at large, if unchecked, it will harm the universe. “That large corporations must be held


\(^{30}\) Bowman, Scott R. The Modern Corporation and American Political Thought, The Pennsylvania State University Press.

accountable for policies that affect society as a whole and that increasingly, corporate accountability will have to be defined in global terms.”

Probing into the functioning of many corporate houses, which either decimated in India or abroad proves that corporate management is not an exception to the above rule. The collapse of a single economic unit does not end there. It has so many repercussions. The globalisation is likely to bring a series of chain reaction in the event of closure of some companies. Though nothing was wrong in the economy of Singapore, the collapse of companies in Indonesia and Thailand reverberated the entire East Asian countries, including Singapore. Its exchange rate also suffered and depreciated. It also affected even India, not because of the fact that the companies in India was misgoverned. It is the impact of globalisation of trade. It affects the entire universe. Such is the magnitude of the failure of companies. The failure of companies has both socio-economic and political dimensions.

Corporate governance was lent new urgency by the global financial crises which unleashed unprecedented volatility in markets, led to devaluation, default and capital flight, with the brunt borne by the poor. Reform on governance can no longer be viewed as a national or local issue for any corporation: globalisation has brought in its wake the need for international co-ordination of effort to ensure that growth is sustained and shared: sustained in that it is robust and can withstand shocks – and shared in that it brings prosperity to the many, rather than the few.

Poor corporate governance is the main culprit behind the East Asian crisis in the late nineties. In Indonesia and Korea, as well as Malaysia and Thailand, many sectors of their economies are dominated by conglomerates controlled by a small group. Non transparent accounting practices, interlocking ownership between the corporate and financial sectors, and weak minority

---

32 Ibid.
shareholder rights are instrumental in accelerating the reverse trend. Once considered to be the tigers, these countries were tamed by poor corporate governance practices. The domestic and international financial markets are still reacting negatively, especially to the lack of transparency in the Indonesian banking and corporate sectors.\textsuperscript{33}

It is estimated that the top 10 families in Indonesia in 1997 controlled corporations worth more than half the country's market capitalisation. Comparable figures are one-half in Thailand, one-fourth in Korea and Malaysia but only 2-3 per cent in Japan.\textsuperscript{34} Investor confidence was undermined during the crisis and remains weak, not just in certain companies but in the entire Indonesian market. A cursory look at the corporate sector in the Indonesia reveals the following features:

- Corporate governance has been seen primarily as a compliance issue rather than a means of enhancing corporate performance.
- In common with many other parts of Asia, Indonesian corporates are predominantly family-owned, even when they are listed companies.
- Fraud and insider transactions have been common, disclosure has been weak and the disclosure and disciplinary mechanisms of the capital market have been ineffective.
- Minority shareholders and other stakeholders have had a few means of protecting themselves against the abuses of majority shareholders. Although mechanisms for addressing abuses do exist in Indonesian Law they are little used and the weak judiciary has limited their effectiveness.
- Managers and directors has been largely immune from stakeholder accountability.

\textsuperscript{34} Magdi Iskander, Gerald Meyerman, Dale F. Gray, and Scan Hagan, "Corporate Restructuring and Governance in East Asia", Finance and Development, March 1999.
• Banks have been ineffective monitors of corporate managers.

• A weak bankruptcy and judicial system has left creditors with little leverage over their debtors.

• State enterprises have been subject to significant intervention by government in business decisions, and SOE performance monitoring has been almost non-existent.

• The role of the regulators BAPEPAM and JSX has not been strong enough to compensate for the weak judiciary. As a result, the once admired hero is now in the corridors of World Bank and IMF.

Corporate governance reforms will become one of the most important items on Indonesia’s medium term economic reform agenda. Its successful implementation will be one of the prerequisites for sustained economic growth, which in turn is the key to reducing poverty and the vulnerability of the poor. Good corporate governance will also be an important element in ensuring a more transparent, fair and just society.

Now the affected countries are utilising this opportunity, as the U.S.A., utilised the Great Depression to reform its financial sector from “relation based” finance to a modern financial structure”, to lay the foundation for a new system of corporate governance that brings in sizeable outside shareholders and encourages transparency, strengthens minority shareholders rights broader capital markets and sound financial system.

One of the International Monetary Fund’s prescriptions for tackling the East Asian crisis is to improve the corporate governance System. Governance must be improved in the corporate sector and transparency and accountability

---

36 Ibid.
Corporate governance reform will become one of the pillars of Indonesia's medium term economic reform agenda. Its successful implementation will be one of the prerequisites for sustained economic growth, which in turn is the key to reducing poverty and the vulnerability of the poor. Good corporate governance will also be an important element in ensuring a more transparent, fair and just society.

Corporate governance is a buzzword universally. Till seventies, the term corporate governance was unheard of in many parts of the world, leave alone the communist block countries. With the advent of Cadbury's Committee and the East Asian Crisis, the countries all over the world started appointing committees to examine their system of corporate governance. The forms of joint stock companies are new to communist block countries, as the means of production are owned by the State so far. With the disintegration of USSR and the collapse of communism in the East European nations, these economies started embracing capitalism. As a result, the term corporate governance occupies a prominent position even in the Central and East European countries. The Republic of China too is in the race for devising ways and means for promoting standards of corporate governance. The corporate sector is at the infant stage as far as China is concerned. In spite of the fact, the country is in the fast track in developing accounting standards at par with the international standard. The term corporate governance now has become a holy word. It is an omnipresent concept, cutting across the political ideology. Even China and Russia are trying their level best to improve the quality of corporate governance realising its importance, in spite of the fact that their corporate sector is at the nascent stage. The erstwhile champions of communism are now vigorously attempting to promulgate laws to

facilitate the formation of joint stock companies and compel promoters of joint
stock companies to follow sound principles of corporate governance.

"The (Russian) government is developing twelve new laws aimed at
protecting investors. In March, Parliament adopted one of these laws, which
protects investors in the securities markets. We also need to improve our joint
stock company law in order to reduce share dilution and asset stripping, as well
as to allow shareholders to dismiss management and stop asset theft. We also
want to change the criminal code and make nondisclosure to investors a crime. I
believe that we can learn from other countries’ experiences, including the United
States, in this area."^{41}

In the early 1990s, international capital flowed to emerging markets in
record levels. As long as returns remained spectacular, few investors paid
attention to the behind-the-scenes manner in which companies went about their
business. The Asian financial crisis, however, has led investors to attach new
importance to corporate governance. All over the world, the conclusion drawn
for the sudden calamity in the erstwhile East Asian Tigers is the lack of respect
for the corporate governance principles.

Today, “corporate governance”, “disclosure,” “transparency” and
“shareholder value” are the mantras at the World Bank, the IMF and the OECD
corridors. These institutions regard improved corporate governance standards as
critical in helping emerging markets rebuild competitiveness, restore investor
confidence, and promote sustainable economic growth. The World Bank and the
IMF are implementing governance reform in those still-ailing markets, and they
are developing policies to stem the possibility of future financial crises in other
countries on this line.

^{41}“Interview with Dmitry Vasilyev, Chairman of the Federal Commission for the Securities Market in
Russia – Safeguarding Russian Investors: Securities Chief Speaks Out,” Economic Reform Today,
Number one 1999.
As democracy is needed for a society, the joint stock companies are needed for a vibrant economy. In turn, good corporate governance system is needed for the joint stock companies to flourish. Otherwise, the country will be at a disadvantageous position in attracting long term capital for development. The apathy of investors will cast the shadow upon the ability of the company to mobilise funds. Unless the corporate governance system is toned up in an era of capital convertibility, investors from the homeland will neglect the local companies and go for companies with good corporate governance standards even in other countries. "Not only are foreigners reluctant to invest in Russia, but Russians do not trust it either. People are putting their savings into dollars because other forms of investment don’t offer enough protection."^2

Russia is losing billions of dollars in investments because of poor investor safeguards, both in corporate and government securities. This is reflected in the lower value of Russian stock prices as compared with those of other emerging market countries. Better protection of investors’ rights will attract more investors and allow companies to raise more capital and lead to the development of new technologies and more production^3.

Like democratic governments, business must be governed by a set of rules that reflect the interests of their shareholders and the public at large. These rules of the game for businesses are an important dimension of reform efforts in developed and transition economies alike. Countries that ignore or lag behind in corporate governance reforms will find themselves at a competitive disadvantage position in attracting long-term capital for development^4.

---

^2 Ibid.
^3 Ibid.
1.7 PRINCIPLES OF CORPORATE GOVERNANCE

The principal characteristics of effective corporate governance are: transparency (disclosure of relevant financial and operational information and internal processes of management and control); protection and enforceability of the rights and prerogatives of all shareholders; and, directors capable of independently approving the corporation's strategy and major business plans and decisions, and of independently hiring management, monitoring management's performance and integrity, and replacing management when necessary.

Corporate governance emphasises the values of fairness, accountability, transparency and responsibility. And it involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Effective corporate governance revolves around strong, active and independent board of directors and laws and regulations that guarantee shareholder rights. The presence of accepted standards of financial accountability and transparency within firms ensure sound corporate governance principles. Sound corporate governance principles can create safeguards against corruption and mismanagement, while promoting democracy and transparency in economic life. Thus, corporate governance lifts private sector issues into the broader context of democratic development.

It is a well accepted theory that the only way to improve corporate governance is to maximise 'contestability'. Contestability refers to a 'competitive pressure in an apparently non-competitive arrangement'. A corporate governance system aims to build 'contestability' within the organisation. The underlying principles of an ideal corporate governance system are:
• It should be effective in protecting shareholders interests, yet should leave managers free to run and develop business and to take risks and show entrepreneurship:

• It should provide transparency in terms of full disclosure of information to enable shareholders to evaluate managers in their stewardship functions and to be decisive if managers are not performing as per expectations;

• It should not adversely affect investor's liquidity and must allow shareholders to buy and sell shares freely;

• It should not encourage insiders trading.

• It should not impair the competitiveness of the organisation.

Thus, the essence of good corporate governance is to achieve the right balance between shareholders interest and management interest.

1.8 WHY CORPORATE GOVERNANCE STUDY NOW?

“Corporate history of the United States from the mid-1960s to late 1970s is littered with cases of large companies setting the stage to systematically destroy shareholder value. Armed with free cash flows generated by a global boom that continued up to 1979, many US CEOs went into a compulsive acquisition spree and bought a host of companies that had little or nothing to do with core business. These purchases certainly lacked up turnover and created empires where CEOs donned the mantle of later day Caesars. Little did the corporate chiefs realise that they were sowing the seeds of destruction. By the time the second oil shock of 1979 gripped industrialised economies, many US mega-corporations were facing dwindling bottomline. The growth had petered out and, in the process, cruelly exposed these conglomerates to the downside of unrelated, group-turnover driven acquisitions. Soon, the asset value of many of these widely held corporations vastly exceeded their market capitalisation – a
This phenomenon opened the discussion of corporate governance in the U.S.A. during the eighties, for the first time in the corporate history of the world.

The corporate governance system has been the subject of review since the early eighties in the United States and the topic occupied the centre stage during the nineties. The United States witnessed a number of corporate takeovers and reconstruction. That process initiated and as a result we had the Jenkins Report. Canada had its own version of code, Australia has its own version during the year 1995, AIMA report. In the early nineties, some corporate scandals rocked the U.K., corporate sector, which led to the appointment of Cadbury Committee. The Cadbury Committee was set up by the London Stock Exchange, the Financial Reporting Council (which is responsible for accounting standards in Britain) and the accountancy profession. The sponsors were concerned at the lack of confidence in reports and accounts and the audit statements attached to them, following the collapse of some prominent UK companies. The reputation of the U.K. banking system collapsed with the collapse of BCCI. The Maxwell group company and some other corporate failures cast a shadow upon the credibility of the financial reporting system. The cause of their anxiety was not so much that these companies had failed. But their reports and accounts, just prior to their failure, appeared to give no forewarning of the true state of their financial affairs. The sponsors feared that if no action was taken to improve standards of financial reporting, this could affect London’s reputation as a financial centre and the reputation of British accounting firms. The irony is that the terms of reference to the Cadbury Committee did not include the corporate governance. However, as the Committee itself found that the members themselves unexpectedly in the public eye, they were compelled to deal with corporate governance as a whole and not

just its financial aspects as suggested by the original terms of reference. Cadbury committee was followed by Greenbury Committee which looked upon the remuneration to the Board members. To review the impact of the above two committees and to evaluate the extent of the compliance to the suggestions of various committees, the Hamphel Committee was appointed.

Given the need for some measure of societal expectations, countries with developed capital markets have documented the minimum requirements appropriate to their needs and possibly also limited by the compliance capabilities of the subject companies. All these reports reflect the need and mood of their respective countries around the time the committees were appointed and the reports were published. Often, they are in the nature of a reactive responses to some event that shook that particular society. They are also country-and culture-specific documents and it is neither possible nor desirable to wholly adopt another country's norms without suitable adaptation to local needs. Nevertheless, with the long association that India has had and continues to have with the UK, and also given that the country's corporate laws and practices have been adapted or evolved from those in the UK, a study of the recent developments such as the Cadbury Committee Report are instructive.

Although the need for good corporate governance has been acknowledged since corporations were first created, an awareness of this need has grown rapidly around the world in recent years. Initiatives for improvement started to accelerate in the US in the early 1990s. The governance issue has gone global. There is barely a country left in the world that has not issued its own best practice governance code. The Government in UK, sensing the inadequacies of the coverage of Cadbury Committee, appointed two more committees, viz. Hamphel Committee and Greenbury Committee to formulate the best code. In

---

46 Sir Adrian Cadbury, “Development in Corporate Governance”, Chartered Secretary, May 1997.
47 "World over only reactive responses vis-a-vis Corporate Governance: Corporate Practices", The Chartered Accountant, April 1998.
addition to a thorough review of the problem in UK, throughout the world a number of countries either have promulgated an Act to promote best corporate practices or in the process of formulating the corporate governance codes.

In November 1994, South Africa’s King Committee, chaired by Mervyn King, issued a report recommending some board room practices.

A December 1994 Toronto Stock Exchange report, “Where Were the Directors?” encouraged listed Canadian firms to disclose additional Corporate Governance information in their annual reports. The report also spurred many Canadian firms to restructure their boards.

In June 1995, the Australian Association of Investment Managers issued “Statement of Recommended Corporate Practice,” which established stringent board standards regarding the disclosure of the selection process of corporate directors.

In 1995, in order to ensure that Corporate Governance strategies would be shared across markets, an association of global institutional investors, stock exchanges and governance experts formed the International Corporate Governance Network (ICGN). During its July 1998 conference, the ICGN adopted the world’s first best practice standards for cross-border share voting.

In 1995, the Centre for European Policy Studies, a Brussels-based think tank with ties to the European Commission, published a path-breaking study, “Corporate Governance in Europe”. The report recommended that independent directors be filled at the top slots of European corporate boards.

In 1995 in France, the Vienot Committee, a private sector group formed to assess French Corporate Governance, concluded that boards should institute audit and compensation committees and appoint a minimum number of independent outside directors. In 1998, the Association Financiere Gestion (AFG-ASFFI) group, representing fund managers, proposed, even tougher steps,
such as stricter standards of independence for directors, greater disclosure, and an end of poison pill-style take-over defences.

Besides countries like United Arab Republic, Spain, Belgium, Holland, Italy, Russia, Japan have also taken steps to strengthen the corporate governance system. These flurry of activities, in an era of globalisation, shows that universally both business community and Government realised the need for transparency in order to attract investors to invest in their country.48

At a recent conference of the International corporate governance Network, Philippe Jaffré, the chairman and chief executive of Elf Aquitaine said that "most companies are beginning to practise and believe in corporate governance". Further he said that "managers in Europe speak very often about corporate governance and the subject has become a must at French annual general meetings".49

1.9 PROBLEM OF THE STUDY

An ideal system of corporate governance will function in the following manner:

(i) The system empowers shareholders, as the owners of the company, to elect directors and constitute the Board of Directors. If the board fails to deliver the expected results, they should be capable of reshuffling the board.

(ii) The Board of Directors is an independent organ which runs the company by appointing a Chief Executive Officer, called ‘Managing Director’ (MD). The MD in turn constitutes a second-tier management team. The board entrusts the necessary authority to MD, to run the affairs of the company. If the second-tier fails to deliver the results, the board shall be

---

empowered to replace the managing director with a suitable candidate i.e., the Board of Directors should be independent of the management team headed by managing director.

(iii) Another organ in the corporate governance mechanism is auditor, who is appointed by the shareholders. His function is to attest the genuineness of the accounts submitted by the board to the shareholders. If the accounts fail to reflect the true and fair view of the business of the company, the auditor should disclose the fact to their appointing authority, viz., shareholders. In short, the auditors should be independent of the board as well as the second-tier of management headed by the managing director.

If one goes by the reports in the magazines and journals, it is hard to believe that an ideal system of corporate governance to prevail. The prevailing scenario in Indian corporate sector does not impress one that the shareholders are empowered to shuffle the board, as they are supposed to do, whenever the board fails to deliver the results.

Similarly, the managing director is supposed to be appointed by the Board of Directors. The Board of Directors is supposed to change the managing director, whenever he fails to deliver the results. In reality, it is doubtful whether the board has such independence.

Similarly, the auditor is supposed to be independent of the Board of Directors as well as management. Again, if one watches the Indian corporate scenario, it is doubtful, whether the auditor is as independent, as one expects. Hence, the present researcher is in the process of identifying whether an ideal corporate governance system prevails in the listed companies of Tamil Nadu. The present researcher makes an attempt to evaluate the issue of corporate

\[49 \text{Ibid.}\]
governance from this angle i.e., the prevailing relationship between the three parties viz., shareholders, Board of Directors and auditors.

1.10 DESIGN OF THE STUDY

The research is of descriptive study in nature. The present study aims to describe the prevalent corporate governance practices in India. The study attempts to study corporate practices in India from the governance point of view. The study describes the position of board of directors, auditors as well as shareholders vis-à-vis corporate governance.

The study is synchronic in nature in which the data were collected from the secretaries of the listed companies with the help of the prepared questionnaire. The study is of survey type in nature in which the data were collected by applying random sampling technique from the respondents selected for the study. The collected data were analysed with the help of percentage analysis and the results of the data were discussed in the analysis chapters. A Model is also constructed to measure the board room practices from the data collected through the survey. The present researcher uses a five point Likert Scale to measure the attitude of the company secretaries towards the independence of the board members as well as the auditors.

1.11 OBJECTIVES OF THE STUDY

The main objectives of the study are:-
1. To identify the different corporate governance models in practice around the world.
2. To study the composition of Board of Directors of the listed companies in Tamil Nadu.
3. To assess the independence of the board.

---

4. To ascertain the functions of the board.
5. To ascertain how the board meeting is being conducted.
6. To assess the role played by the shareholders in the corporate governance.
7. To assess the shareholders' activism.
8. To assess the role of the auditors in corporate governance.
9. To assess the independence of the auditors.

1.12 RESEARCH HYPOTHESES

The following research hypotheses were framed by the present researcher.
1. The board is independent.
2. The job of consultancy offered to auditor affects his independence.
3. The average number of shareholders attending the annual general meeting is 250.
4. The average duration of the annual general meeting is one hour.
5. The average number of executive directors in the listed companies of Tamil Nadu is 3.
6. The average number of non-executive directors is in the listed companies of Tamil Nadu is 5.

1.13 IMPORTANCE OF THE STUDY

The term corporate governance is a new mantra in the corporate circle. It is the agenda in most of the forums of management association, Institute of Chartered Accountants of India, Institute of Company Secretaries of India, Institute of Cost and Works Accountants of India. The topic is so hot, that it is at the centre stage of many seminars and workshops. All of a sudden, one can sense the active shareholders participation in the annual general meeting, compared to their activity till the end of eighties. Shareholders are lately much more interested in their rights compared to the individual shareholders who were there in the pre-LPG era. Financial institutions which were silent spectators of
the misdeeds of promoters now have surprisingly started reacting. They react for the failures and violations on the part of the promoters. Though the Cadbury Committee's recommendations were submitted and had been a hot topic throughout the world in the early nineties, the topic did not attract the attention of the corporate circle. Subsequent Hamphel Committee and Greenbury Committee reports even did not disturb the mental attitude of Indian corporate constituents. The ITC episode all of a sudden attracted the attention of all the segments connected with corporate governance. The individuals who had so far enjoyed the directorship as a right without any responsibility, started realising the responsibilities attached to the post. Similarly, the Government came to know the large scale violation and concealment of facts in spite of the fact that the accounts of the entity had been certified by the Chartered Accountants that they reflect the true and fair view of profit and loss account as well as balance sheet. The shareholders so far ready to gave a premium to professionally managed companies. ITC episode exploded the myth that professionally managed companies will be different from the companies managed by local business community. The entire corporate arena revolves around this topic since 1997. The Indian business community conducted a soul-searching exercise. As a result, came the Desirable code of corporate governance, released by the Confederation of Indian Industries. Subsequently, SEBI appointed a committee under the Chairmanship of Kumar Mangalam Birla to review the corporate governance practices. It also submitted a report which had a subject of discussion in the corporate sector. The SEBI also has accepted the same and implemented many of the recommendations through the listing requirements and some are implemented through the amendment to the Companies Act, 1956.

The successive Governments in the post-LPG era are trying to enact a new legislation for replacing the existing Companies Act, 1956 as it fails to reflect the requirement of the current need. Unfortunately, the political instability prevents the successive Governments in getting the legislation passed.
in the Parliament. They are bringing out the necessary reformations in a piece-meal manner. Hence, the present researcher feels that this is the ripe time to study the existing system of corporate governance. The corporate sector never witnessed such a busy period after the Companies Act, 1956 is passed in the parliament. The press comes daily with some scandals or other as a result of loop-holes and lacuna in the prevailing legal environment. The lethargic bureaucracy also started reacting to the changing scenario. Sensing the importance of the corporate governance, the Government of India instituted a National Award for Excellence in Corporate Governance during the year 1999. The National Award for Excellence in Corporate Governance Award was bagged by Infosys Technologies Limited during the year 2000 and during the year 2001 TISCO had been selected for the same.

Therefore, the corporate sector needs to be studied which will help the public and in particular the individual investors to understand how best their companies are being managed vis-à-vis corporate governance. The study will be an eye opener for the promoters if they are lagging behind the expected standard. The results of the study will also assists the policy makers at the Government level, to frame new rules and regulations, so that the mechanism of corporate governance can be tuned.

1.14 SCOPE OF THE STUDY

The scope of the present study is narrated below.

1.14.1 Reference Period

The study proposes to cover a period of five years from 1993 to 1997.

1.14.2 Geographical Area

The study attempts to cover the State of Tamil Nadu in India.
1.14.3 **Scope of the Study**

A number of models of corporate governance are in practice. On the one hand, there is the Shareholders Model, known as Anglo-American Model, which is in vogue in U.K. and other parts of the world previously ruled by the British Empire as well as in the U.S.A. The company form of organisation for such countries is a legacy of British rule. Hence, many such countries like South Africa and India are following the Anglo American Model. On the other hand, the Continental European Countries like Germany and France and other countries like Japan are following yet another model known as Stakeholder Approach. Since in India, the system followed is stockholder approach, the study is attempted only from that angle.

1.15 **OPERATIONAL DEFINITIONS**

1.15.1 **Executive Director**

The directors who are also employees of the company have been treated as executive directors.

1.15.2 **Non-Executive Director**

The directors of the company who are not on the pay-roll of the company is treated as non-executive directors.

1.15.3 **Attitude of Secretaries**

Attitude of secretaries means settled position of the minds of the secretaries with reference to the functioning of the board, shareholders and auditors. In simple, it is the opinion of the secretaries.
1.16 REVIEW OF RELATED LITERATURE

Though the studies conducted in this area are negligible in India especially in the State of Tamil Nadu, researchers from other parts of the World have made rich contribution in this area in developed countries like the U.S.A., the U.K., and the Germany besides the international bodies like World Bank, OECD and the like. Hence there is a good amount of literature in the developed countries. The researcher in the following paragraphs outlines the contribution of some researchers from other parts of the World that are directly or indirectly related to the study:

In 1997, Brockmann in his study “The relationship between corporate governance patterns and the potential for surviving a bankruptcy episode” examined the impact of corporate governance mechanisms during the reorganisation and recovery times after filing for bankruptcy. He concluded that reorganisation time could be reduced with a powerful CEO.

LI Joanne Wai Mei in his study (1997) “Board of directors in the context of corporate governance” concludes that the monitoring by Board of Directors acts as a mechanism to resolve the agency problem between top management and shareholders.

Purbach and Michal Joseph in their dissertation entitled “The changing face of Corporate Ownership - Do institutional owners affect firm performance?”, examined the inter relationships among the major participants in corporate governance - owners, boards of directors and top management teams. The dissertation also examines as to how these inter relationships may affect corporate decision making and ultimately firm performance.

Karish, Gail Amn in his dissertation (in 1997) entitled, “Toward a national model for corporate governance ”, made an attempt to know as to whether there is a link between privatisation and corporate governance, with
reference to private sector in Latin America. Latin America was chosen for the study because considerable privatisation activity has taken place there. The analysis revealed that private sector corporate governance has several weaknesses leading to economic inefficiencies.

In 1996, Ellingson made a study on “Board composition and the use of Accounting measures: The effect on the relation between CEO compensation and Firm performance”. The result of the study revealed that outside directors act in the interests of shareholder by linking compensation to stock return. Thus, the outside directors play an important role in the corporate governance process.

In 1996, Darazsdi, James Joseph conducted a study on “The identification of characteristics associated with corporate boards and their members which demonstrate a significant statistical relationship to above average financial performance over time “Food processing industry”. This study identified those variables which were viewed by experts in the field of corporate governance as influential in the determination of financial performance.

Kang, David Lee, 1996, made a study on “The impact of ownership type on organisational performance”. This dissertation concluded that the separation of ownership and control found in U.S. public corporations has resulted in decreased firm performance, as dispersed shareholders have failed to encourage managers to make strategic decisions that enhance firm performance.

David, Parthiban in 1996, conducted a study on ‘Corporate Governance, Strategy and Performance. Antecedents and consequences of Activism by institutional Investors”. The study concluded that the diffusion in ownership accompanying the increase in size of public corporations decreased the power of its owners and provided managers significant discretion over corporate policies. According to this dissertation, institutional investors have appeared to be active monitors. Institutional investors have been found to leverage the power gained from their ownership stake by adopting an activist stance.
Anderson, Ronald C, in his dissertation entitled “Intervention on interference. An examination of the new rules governing managerial compensation”. Concluded that the compensation committees have played an important role in corporate governance.

Luchansky, William Josheph, in his dissertation entitled. ‘The overthrow of the managerial revolution? An examination of managerial, agency theory, and institutional approaches (corporate control) made an attempt to find out the impact of ownership patterns on corporate governance. The study concluded that large institutional owners, such as pension or mutual funds have been able to exert much influence over managers who hitherto controlled the corporation. Thus these large institutional owners have been in a better position than the small shareholders.

O’Neal, Donald E in his dissertation entitled “Director Network And Directors selection keys to the strategic role of the Board of Directors”, explains the need for “strategic role of the Board of Directors. The primary role of Board of Directors includes continued, advice / counsel and strategy. This study focuses on the implications of the strategic role of directors, and how it may be significantly influenced by the process of selecting directors and by multiple board memberships, commonly referred to as interlocks.

Gillan, Stnart Leigh in his dissertation entitled “shareholder activism through the proxy mechanism. An Empirical investigation (Pension Funds)” made an attempt to investigate the effects of shareholder activism by both institutional and non–institutional investors over the 1987 – 1991 time period. The purpose of this study is to find out as to whether this activism was effective, during the said period, in achieving the primary goal of pressuring under performing management to enhance corporate value.
Hanson, Danny Carrol in his dissertation entitled “The legal responsibilities and implications of Non-profit corporate governance paid his attention to governance of non-profit organisations.

Jolls, Christure in his dissertation entitled “The growth of performance based managerial pay – Implications for corporate governance” made an attempt to examine the implications of the principal – agent, paradigm of shareholder – manager relations, for a set of policy issues in corporate finance.

Wahal Suml in his dissertation entitled “Institutional investors and firm performance” (shareholder activism) made an attempt to provide evidence on the efficacy of shareholder activism.

1.17 METHODOLOGY AND TOOLS

The study attempts to sketch the present state of corporate governance in Tamil Nadu by conducting a survey among the secretaries of the companies to collect the data about the Board of Directors, the meeting of Board of Directors, the meeting of shareholders and other information required for the study. As the secretary has all the information, the researcher has decided to collect the information from him. The researcher has specifically constructed a questionnaire to collect the data from the secretaries. To assess the level of corporate governance, the researcher plans to measure the board room practices for which the present researcher has also constructed a Model.

The present study is an empirical research based on both primary and secondary data. The researcher collected the names of companies for the study from the Madras Stock Exchange Year Book.

1.18 CONSTRUCTION OF THE QUESTIONNAIRE

The present study has been undertaken by constructing a questionnaire to solicit information from the secretaries of the companies. The questionnaire was
constructed by preparing 100 items. The items were then submitted to a panel of
judges, comprising five academicians from commerce and management area,
five secretaries of listed companies and five auditors of the companies,
requesting them to scrutinise the items for clarity and appropriateness to realise
the objectives of the study and validity in terms of the subject matter of the
study. The remarks offered by the judges were considered and finally 78 items
were given in the questionnaire with minor modifications. The questionnaire
thus prepared was subject to pilot study. Hence the questionnaire was again
given to five professors, five secretaries. Responses of the respondents were
analysed and lexicon items of the questionnaire item were modified. Finally the
items were given for field-testing.

1.19 COLLECTION OF ITEMS

As an initial step in the construction of the questionnaire, the present
researcher studied the literature, concerned with corporate governance and the
related information and prepared necessary items to the study.

1.19.1 Validity of the tool

The tool has been tested for the content validity and construct validity.

1.19.1.1 Content Validity

A compilation of findings was made from an extensive survey of
literature on corporate governance. Items were correlated by attempting to
translate research findings into items for the study. The questionnaires were
given to 30 respondents and the present researcher requested the secretaries to
find out whether sufficient number of concepts were included in the study. The
secretaries studied the questionnaire and suggested a few concepts that have to
be included in the questionnaire.
Initially, the researcher included the research items and related concepts on Board of Directors and shareholders. The secretaries who studied the questionnaire suggested that auditors were also an important constituent of the corporate governance mechanism. Hence the auditors are also included in the study. Thus the content validity of the study was established.

1.19.1.2 Construct validity

To establish construct validity of the study, the items were collected by reviewing the existing literature, journal and the pertinent discussion with company secretaries, auditors and shareholders. Based on the lines of the corporate hierarchy, the items were developed and existing items were modified and subjected to the constituents of the corporate governance system. Based on the structure of the constituents, the pertinent items were developed, establishing the construct validity. After two long hours of two sittings, the validity and dependability of the questionnaire was established and made fit for the study.

1.19.1.3 Reliability

The reliability of the questionnaire was established by submitting the prepared questionnaire to a panel of judges consisting of five secretaries and five professors. These panel of judges were then asked to scrutinise how far the items given in the questionnaire were relevant and inter-correlated with the objectives of the study and fathoming the results. The panel of judges in a round table discussed the items one by one and analysed how far the items are tactical to the study in eliciting the required information.

1.20 SAMPLING TECHNIQUE

The researcher intends to apply random sampling method for the selection of the companies for the study. The sample companies were selected by random sampling technique. The geographical scope of the study covers the
listed companies in Tamil Nadu. The number of listed companies in Tamil Nadu was 348 as on 31st March 1994. Out of 348 companies, 87 companies (one fourth of the population) were selected as a target population for the main study. From 348 companies, 87 secretaries were selected using Tippet's random table. Necessary items were collected by administering the prepared questionnaire.

1.21 BOARD ROOM PRACTICES MODEL

The management performance is revealed by financial data like Return On Investment (ROI), EPS and the like. However, these numbers fail to highlight the qualitative aspect of the board functioning. The above mentioned data are the cumulative effect of a number of factors like the board room practices, the performance of the management team headed by managing director and a number of other factors. However, the researcher wants to measure the functioning of the board in terms of its practices and other features. With that object, the researcher has developed a Model to measure the corporate board practices. The following factors were taken for the construction of the above mentioned Model:

(i) Proportion of executive directors to non-executive directors.
(ii) The practice of sending the agenda to the director along with the notice of the meeting.
(iii) The duration of the notice given for the meeting.
(iv) Deliberation in the board meeting.
(v) Decision making authority inside the board.
(vi) The practice of recording the dissent note.
(vii) Attendance of executive directors.
(viii) Attendance of non-executive directors.
(ix) Separation of the posts of Chairman and CEO
(x) Proportion of relative directors to total number of directors.
The following paragraphs attempt to sketch how the 'Model' has been developed and used to evaluate the practices of the board. The researcher is awarding suitable weight to the factors that are taken into account for the construction of model.

(i) Proportion of executive directors to non-executive directors

There is a universal consensus that the proportion of executive directors to non-executive directors should be reduced. More weightage should be given for the non-executive directors in the board. The issue of insider vs. outsider, though it is as old as the corporate form of business, the consensus is that the proportion of outsider should exceed the insider. Even the CII Code suggests a formula where it is recommended that 30 per cent of the board should be constituted by accommodating non-executive directors, if the chairman of the company is a non-executive director. Their recommendation is that if the chairman also occupies the position of managing director, 50 per cent of the board representation should be given to non-executive directors.

Till recently, it has been the practice of most of the companies in India to fill the board with representatives of the promoters of the company, and independent directors if chosen were also handpicked thereby ceasing to be independent. The Birla Committee also recommended that the board of a company should have an optimum combination of executive and non-executive directors with not less than fifty per cent of the board comprising the non-executive directors. This is a mandatory recommendation. Hence the researcher has decided to use the following weight for the following combination.
Points For The Representation Of Executive Directors And Non-Executive Directors in the Board

<table>
<thead>
<tr>
<th>Proportion between executive directors and non-executive directors</th>
<th>Points</th>
</tr>
</thead>
<tbody>
<tr>
<td>1:1</td>
<td>3</td>
</tr>
<tr>
<td>1:2</td>
<td>6</td>
</tr>
<tr>
<td>1:3</td>
<td>10</td>
</tr>
</tbody>
</table>

(ii) The practice of sending the agenda:

As already mentioned in the earlier paragraphs, sending agenda ahead of the meeting is a must for a purposeful conduct of the meeting. Hence, the researcher has taken this factor also for measuring the board practices. The following points are assigned:

<table>
<thead>
<tr>
<th>Practice of sending the agenda</th>
<th>Points</th>
</tr>
</thead>
<tbody>
<tr>
<td>Most of the times</td>
<td>10</td>
</tr>
<tr>
<td>Less frequently</td>
<td>5</td>
</tr>
<tr>
<td>Rarely</td>
<td>0</td>
</tr>
</tbody>
</table>

(iii) Notice for the board meeting

Sufficient and advance notice is a must to the members of the board so that they can come prepared for the meeting. Though the Companies Act has indicated any time frame for intimating the board meeting, the researcher has allotted the following points on the basis of the normal logic.

<table>
<thead>
<tr>
<th>Length of the Notice</th>
<th>Points</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 10 days</td>
<td>3</td>
</tr>
<tr>
<td>11 days to 20 days</td>
<td>6</td>
</tr>
<tr>
<td>21 days and above</td>
<td>10</td>
</tr>
</tbody>
</table>
(iv) Deliberation Process In the Decision Making

There is an adage, which is the instrumental reason for constituting a committee. The adage being, two heads are better than one. The purpose of two heads is to deliberate the issue by contributing and viewing the problem from different angle. If the board assembles and decides every thing without any discussion or deliberation, the purpose of the board is defeated. Hence the researcher has included this factor also for the construction the model. The weights are assigned on the following basis:

| Table 1.4 |
| Points for Deliberation in the Board Meeting |
|----------------|------------------|
| Deliberation Process | Points |
| Deliberation in the Meeting | 10 |
| No Deliberation | 0 |

Proportional weightage would be given for a combination of deliberation and no deliberation, if it were there in the board.

(v) Decision making authority inside the board

The following points are to be awarded to various factors:

| Table 1.5 |
| Points for Decision Making Authority |
|----------------|------------------|
| Decision Making Authority | Points |
| CEO | 3 |
| CEO + Key Executives | 6 |
| Entire Board | 10 |

If the entire board takes the decision, the maximum points are awarded to board for the best practice. However, if the CEO alone takes the decision, only 3 marks are awarded to the board.
(vi) Dissent Note

If it appears that there is only one alternative available to a problem, perhaps such alternative may be wrong. Attempts must be made to search for other alternatives. In fact, the above logic is instrumental in the formation of committees so that more ideals will be generated. Unanimous decision indicates consensus. However, it is a dangerous proposition if it is the practice to arrive only at unanimous decision. Unanimous decision is a danger to the democracy. It will lead to autocracy. Similarly in the board level, if unanimous decision is the rule, it means the discussions are snubbed at the bud stage itself. If the members insist on recording the dissent note, it indicates a democratic functioning of the board. It implies an independent board. If there is no practice of recording the dissent note, then the boardroom is the place for one-man show only.

The points are awarded for this factor on the basis of the following standard:

<table>
<thead>
<tr>
<th>Points for Decision Making Authority</th>
</tr>
</thead>
<tbody>
<tr>
<td>Practice of Insisting Dissent Note</td>
</tr>
<tr>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
</tr>
</tbody>
</table>

(vii) Attendance of executive directors

The purpose of the board is served only through the process of meeting. If the directors skip the meeting, the purpose of having such directors defeats the process of the board itself. The justification for the constitution of the board becomes a debatable point. Hence the attendance of executive directors are considered for the purpose of evaluating the boards practices. The following table indicates the way in which the points are awarded to this factor.
Table 1.7
Points for Attendance of Executive Directors

<table>
<thead>
<tr>
<th>Attendance of Executive Directors</th>
<th>Points</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 60 per cent</td>
<td>6</td>
</tr>
<tr>
<td>Above 60 and up to 70 per cent</td>
<td>7</td>
</tr>
<tr>
<td>Above 70 and up to 80 per cent</td>
<td>8</td>
</tr>
<tr>
<td>Above 80 and up to 90 per cent</td>
<td>9</td>
</tr>
<tr>
<td>Above 90 and up to 100 per cent</td>
<td>10</td>
</tr>
</tbody>
</table>

viii. Attendance of Non-Executive Directors

Similarly, the attendance of the non-executive directors is considered for the construction of the model for measuring the board practices. In fact, compared to the executive directors, the non-executive directors devote lesser time in the company concerned. Therefore, attendance is more necessary for them to get acquainted what is going on inside the company or for review etc. Their appointment is justified only if they attend the board meeting. More number of meetings they attend, more will be the point the board will be getting for a good board. Though CEO may be the creator of the board. Still this methodology does not consider that fact. Instead, it measures the practices. If the board continues to function with the directors who are absenting themselves frequently, the rating of the board will be poor. The following table indicates the way in which the points are awarded to this factor.

Table 1.8
Points for Attendance of Non-Executive Directors

<table>
<thead>
<tr>
<th>Attendance of Non-Executive Directors</th>
<th>Points</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 60 per cent</td>
<td>6</td>
</tr>
<tr>
<td>Above 60 and up to 70 per cent</td>
<td>7</td>
</tr>
<tr>
<td>Above 70 and up to 80 per cent</td>
<td>8</td>
</tr>
<tr>
<td>Above 80 and up to 90 per cent</td>
<td>9</td>
</tr>
<tr>
<td>Above 90 and up to 100 per cent</td>
<td>10</td>
</tr>
</tbody>
</table>
(ix) Separation of the Chairmanship and the CEO Post

The Chairman of the board is responsible for the review of the management, as the head of the review organ. The CEO is responsible for constitution the second-tier management and carry on the day-to-day management. Therefore, it is the position of the chairman which reviews the performance of the team headed by the CEO. Hence it is advisable, if these positions are separated. This issue had been given prominent importance in the Committee Reports like Cadbury, CII and SEBI. Therefore, the board practices are measured with the help of this factor also. The following table indicates the method adopted in assigning score for this factor.

| Table 1.9 |
| Points for the position of Chairman and CEO |
| Chairmanship and CEO posts | Marks |
| Combined | 5 |
| Separated | 10 |

(x) Relative Directors

More the board is independent, more will the effective functioning of the board. More the directors are not either financially or physically related to the promoters, more the board will be independent. Hence, this factor is also considered for the construction of the Model for measuring the board practices. The following table illustrates how the board is rated on the basis of this factor.

| Table 1.10 |
| Points for the Relative Directors |
| Proportion of Relative Directors to the total number of Directors | Points |
| Entire Board is related to promoters | 2 |
| 1:1 | 4 |
| 1:2 | 6 |
| 1:3 | 8 |
| 1:4 and above | 10 |
There is nothing in wrong in associating the promoters’ relatives in the board. The point to be remembered is that the companies taken for the review in the study is listed companies, where the public have invested their money. Therefore, packing the entire board with their relatives only, even if they are professionally competent will dampen the factor of independence. Hence, it is better to avoid to accommodate the relatives of the promoters in the board.

1.2.1 Interpretation of the Total Scores

The board of each company will be rated on the basis of the above factors and the sum of the scores of all the factors will be taken for measuring the board room practices of the board. The maximum possible scores is 100 points. The researcher classifies the board in to three, categories depending upon the total score secured by the board.

On the basis of the total scores secured, the researcher has decided to classify the company’s board in to three categories viz., Best, Good and Poor board. This rating reflects the board practices. If the total score of a company is 75 and above, the company will be rated as the Best Board. The company which secures less than 50 points shall be rated as a Poor Board. Companies which have secured points in the range of 50 to 74 shall be rated as a Good Board. Thus the overall total score indicates the board room practices, which influences the functioning of the board and consequently the performance of the company.

1.2.2 PLAN OF THE ANALYSIS

The corporate form of business organisation is a universal form, which is in existence throughout the world. The researcher is making an attempt the compare the provisions of the Companies Act, 1956 with the provisions of the Companies Act of different countries as well as the practices of different players
in the corporate sector throughout the world. A global perspective is attempted, wherever possible.

The company is a social organisation, in which the three parties, viz., shareholders, directors and auditors, are the principal players. The strength or weakness of the corporate governance mechanism in a particular situation can be traced to the part played by the different constituents. Some of the players in the game usurp the powers of another party. Similarly some players fail to act. As a result the corporate governance mechanism fails to deliver the expected results. Thus, the analysis attempts to evaluate the roles to be played and actually played by the different constituents of the corporate kingdom. Shareholders are the owners of the company. They have to elect the Board of Directors as well as auditors. The task of running the business is handed over to the board. Auditors' responsibility is to attest the accounts prepared by the board, regarding its genuineness and authenticity.

The researcher made an attempt to examine the role played by the individual players with the help of a survey for which the researcher constructed a questionnaire to solicit information from the secretaries of the companies. The prevailing situation is also portrayed with the help of the secondary literature. The snapshot of the current corporate scenario obtained, as outlined above, will reveal the state of corporate governance in the listed companies of Tamil Nadu. The result will help the researcher to expose the gap between the expectation and the reality. The researcher was able to point out the deficiencies in the role played by the different agencies as well as appreciate the role of those constituents, who are doing a good job.

The researcher was making an attempt to conduct an attitude survey among the secretaries to measure their attitude towards the independence of the board members and auditors in order to take a snapshot of the prevailing scenario. The researcher was in a position to arrive at a fair judgement regarding the attributes of the independence of directors and auditors. The sample
companies were to be rated using the model constructed specially for this purpose by the researcher.

1.23 LIMITATIONS OF THE STUDY

The coverage of the study is too broad. The main constituents of the corporate governance mechanism are shareholders, directors and auditors. There are two types of shareholders, viz., individual and institutional shareholders. Each constituent can be separately studied. As the present researcher is pursuing the course as a part-time course the time factor restricts the researcher to study the different types of shareholders in detail. The researcher contacted 87 companies. The researcher was able to collect the responses directly from 54 companies. The secretaries of the remaining companies, viz., 33 companies were personally met by the researcher. He then solicited responses. They have co-operated well and assured that they would send the responses through the post as they wanted to go through the items in the questionnaire and collect the data for the survey from the company records. However, the researcher received responses only from 24 companies. The researcher was not able to solicit information from the entire target population.

The views of the individuals who are holding the posts of executive directors and non-executive directors are more valuable in studying the issue of corporate governance. The time and resources constraint has prevented the researcher to study the problem from that angle.

1.24 SCHEME OF THE PRESENT REPORT

The present study is divided into seven chapters. The first chapter deals with the design of the study. It contains problem of the study, scope of the study, objectives of the study, hypotheses, operational definitions, methodology and tool, sampling design, period of the study, plan of analysis, review of
literature, limitations of the study, methodology for the construction of the Board Room Practices Model, and the scheme of the report.

The second chapter attempts to sketch the different models of corporate governance prevalent in today's world.

The third chapter is devoted to trace the evolution of companies in India and to present the corporate governance practices prevalent in different companies in India.

The fourth chapter is devoted to critically analyse the functioning of the board. In that process, the average strength of the board, composition of the board, conduct of board meetings, the composition of board vis-à-vis executive directors and non-executive directors are to be studied. In short, this chapter attempts to study the purpose, characteristics, structure and composition of the board of the companies taken for the study.

The fifth chapter attempts to portray the shareholders of the companies. The rights and responsibilities of shareholders are sketched in this chapter. Also an attempt on shareholders' activism in India is made. Further, the chapter attempts to sketch the role of financial institutions and shareholders vis-à-vis corporate governance. The expected role of nominee directors and role played by the institutions and the nominal directors are examined.

The sixth chapter makes an attempt to highlight the role played by the auditor in the mechanism of corporate governance in India. Attempts are made to highlight the reporting trends in India. Further, the independence of the auditor is evaluated.

The seventh chapter presents the results of the study. It incorporates suggestions to improve the corporate governance system. It is also proposed to point out the possible areas for future study.