CHAPTER - FOUR

VARIOUS ISSUES OF CORPORATE GOVERNANCE.

PROLOGUE

The fourth chapter of the study covers various aspects of corporate governance. All these aspects have been covered under the reports of various committees and commissions at global level and Indian level. The reports deal with pursuing excellent corporate practices and also guidelines and directions. Despite, many Indian companies have failed in their attempts to realized the significance of best corporate governance practices. Lack of sustained commitment by senior management and in adequate strategic planning have often contributed to a shortfall in the good corporate governance practices. Other causes of failures include the manipulative business practices, failure to identify the interest of various stakeholders and profit maximisation objectives and lack of visionary and dynamic leadership.

In the changing industrial and economic scenario in India, there is immediate needs for managers and executives to
understand the significance of corporate governance, business ethics and social responsibility. They should find out better ways to implement good corporate practices. Customer and employee satisfaction, committed leadership, quality policy, optimal use of resources, high belief in quality and unleashing energy for continuous improvement are some of the well accepted essential features of corporate governance and TQM adoption.

4.1 THE CADBURY CODE OF BEST PRACTICES.

The Cadbury Committee was set up in May 1991 in the United Kingdom. The stated objective of the committee was “to help raise the standards of corporate governance and the level of confidence in financial reporting and auditing by setting out clearly what it sees as the respective responsibilities of those involved and what it believes is expected of them.

Nations world over are recognising the need and importance of ‘Corporate Governance’ OECD (Council of Organsation for Economic Cooperation and Development) has drafted a set of principles of Corporate Governance. These will provide a base of each nation to develop their own set of laws/rules and guidelines to implement corporate governance, according to their social, financial and organizational needs.
Any corporate governance framework designed on the basis of above principles should ensure that timely and accurate disclosures are made on all material matters regarding the corporation, including the financial situation, performance, ownership and governance of the company.

Cadbury Committee also recommended its Code of Best Practices on the principles of openness, integrity and accountability. An open approach to the disclosure of information contributes to the efficient working of the market economy, prompts boards to take effective actions and allow shareholders and others to scrutinize companies more thoroughly. The cardinal principle of financial reporting is that the view presented should be true and fair. Boards should aim to maintain the highest level of disclosure consonant with presenting reports which are understandable and with avoiding damage to their competitive position. They should also aim to ensure the integrity and consistency of their reports; and they should meet the spirit as well as the letter of reporting standards. On the other hand the demand for an ever increasing amount of details in reports and accounts has to be weighed against the need for them to be understandable by the reasonably informed shareholder.
Hampel Committee also acknowledged that the importance of corporate governance lies in its contribution both to business prosperity and to accountability. Business prosperity cannot be commanded. It is dangerous to encourage the belief that rules and regulations about structure will deliver success. Accountability by contrast does require appropriate rules and regulations, in which disclosure is the most important element.

Issue of corporate governance has assumed lot of importance in India. It is looked upon as a distinctive brand and benchmark in the profile of corporate excellence. Three distinctive developments were witnessed in this regard recently. The Companies Act, 1956 has been amended extensively through the Companies Amendment Act, 2000. The Accounting Standards Board of the Institute of Chartered Accountants of India has issued several accounting standards which are almost mandatory in nature. Based on the report of Kumar Mangalam Birla Report, SEBI has directed all stock exchanges to amend listing agreements between them and entities whose securities are listed, or who have applied for listing with them, so as to implement the prescribed code of corporate governance.
Broadly, the Companies Act, 1956 contained the following provisions relating to disclosure and transparency in the working of companies:

- Section – 210 – Laying before the company annual account and balance sheet.
- Sector – 211 – read with Schedule VI to the Act – Forms and contents of balance sheet and profit and loss account.
- Section – 212 – Balance sheet of holding company to include certain particulars of its subsidiaries.
- Section – 216 – Profit and loss account to be annexed and auditors’ report to be attached to balance sheet.
- Section – 217 – Board’s Report to be attached to every balance sheet laid before a company in its general meeting and its content such as, information on key personnel, conservation of energy, technology absorption, etc.
- Section – 219 – Right of member to copies of balance sheet and auditors’ report.
- Section – 224 to 229 – Provisions relating to appointment, removal, qualification of auditors, their duties and contents of their report, audit of branches, etc.
- Section – 233A – Power of the Central Government to direct special audit in certain cases.
- Section – 233B – Audit of cost records in certain cases.
Chapter Four: Various Issues of Corporate Governance

Thoroughly the Companies (Amendment) Act, 2000, the following sections have been amended with respect to disclosure and transparency aspects of corporate governance.

Section 217 has been amended to provide that the Board's report to the shareholders will also include a directors' responsibility statement indicating that in preparation of annual accounts, the applicable accounting standards had been followed, annual accounts had been prepared on a going concern basis, they had selected such accounting policies and applied them consistency so as to give a true and fair view of the state of affairs of the company at the year end and of the profit or loss of the company for that period. It will also indicate that directors had taken proper care for the maintenance of adequate accounting records for safeguarding the assets of the company; and for preventing and detecting fraud and other irregularities.

Section 226 has been amended to provide that security holders of a company will not be eligible for appointment as auditors of the company.

Section 227 has been amended to require auditors of a company to state in thick type or in italics the observations or
comments of the auditors which have an adverse effect on functioning of the company.

Section 383 A has been amended to provide for secretarial compliance certificate from a secretary in whole time practice and to attach the same with Director’s report to the shareholders.¹

4.2 GREENBURY CODE OF BEST PRACTICES.

The greenbury commission has also given code of best practices. In the preamble of the commission’s report states that the purpose of accompanying code is to set out best practice in determining and accounting form for directors remuneration, recommendations for London Stock Exchange and disclosure, remuneration policy and service contracts and compensation.

It was suggested by the greenbury committee that to avoid potential conflicts of interest, board of directors should setup remuneration committees of non-executive directors to determine on their behalf of shareholders within agreed terms of reference. The company’s policy on executive remuneration and other packages. The remuneration committee should make a report each year to a shareholder on behalf of the board about all types of

¹ Kumar, Surender: Corporate Governance - A Question of Ethics, Galgotia Publishers, New Delhi, 2005.
of compensations to the directors and their other packages and benefits.

The remuneration committee must provide the packages needs to attract, retain to motivate directors of the quality required but should avoid paying more than is necessary for the purpose. The remuneration committee should be considered points about service contracts of directors. There is a strong case for setting notice for the contract period or reducing to a one year or less. Within the legal constraints, remuneration committee should tailor approach in individual early termination cases to the wide variety of circumstances.

Remuneration committee should take a robust time on payment of compensation where performance has been unsatisfactory and on reducing compensation to reflect departing Directors' obligations to mitigate damages by earning money elsewhere. Where appropriate and in particular where notice or contract periods exceed one year, companies should consider paying all or part of compensation in installments rather than one lump-sum and reducing or stopping payment when the former director take on new employment.
The greenbury recommendations mainly pertain to the code of best practices for the directors. As such, they are not very comprehensive to cover various other aspects of corporate governance practices.²

4.3 DESIRABLE CORPORATE GOVERNANCE – A CODE.

Although “Corporate Governance” still remains an ambiguous and misunderstood phrase, three aspects are becoming evident.

First, there is no unique structure of “Corporate Governance” in the developed world, nor is one particular type unambiguously better than others. Thus, one can not design a code of corporate governance for Indian Companies by mechanically importing one from or another.

Second, Indian companies, banks and financial institutions (FIs) can no longer afford to ignore better corporate practices. As India gets integrated in the world market, Indian as well as international investors will demand greater disclosure, more

² Kumar, Surender: Corporate Governance – A Question of Ethics, Galgotia Publishers, New Delhi, 2005.
transparent explanation for major decisions and better corporate value.

Third, corporate governance goes far beyond the company law. The quantity, quality and frequency of financial and managerial disclosure, the extent to which the board of directors exercise their fiduciary responsibilities towards shareholders, the quality of information that the management share with their boards and the commitment to run transparent companies that maximize long-term shareholder value can not be legislated at any level of detail. Instead, these evolve due to catalytic role played by the more progressive elements within the corporate sector and enhance corporate law.

**A MINIMAL DEFINITION**

Corporate governance deals with laws, procedures, practices and implicit rules that determine a company's ability to take managerial decisions vis-à-vis its claimants – in particular, its shareholders, creditors, the state and employees. There is a global consensus about the objective of 'good' corporate governance: maximizing long-term shareholder value. Since shareholders are residua claimants, this objective follows from a premise that, in well performing capital and financial markets whatever
maximizes shareholder value must necessarily maximize corporate value and best satisfy the claims of creditors, employees and the state.

For a corporate governance code to have real meaning, it must first focus on listed companies. These are financed largely by public money (be it equity or debt) and, hence, need to follow codes that make them more accountable and value-oriented to their investing public. There is a diversity of opinion regarding beneficiaries of corporate governance. The Anglo-American system tends to focus on shareholders and various classes of creditors. Continental Europe, Japan and South Korea believe that companies should also discharge their obligations towards employees, local communities, suppliers, ancillary units, and so on. In the first instance, it is useful to limit the claimants to shareholders and various types of creditors.

There are two reasons for this preference:

- The corpus of Indian labour laws is strong enough to protect the interest of workers in the organized sector and employees as well as trade unions are well aware of their legal rights. In contrast, there is very little in terms of the
implementation of law and of corporate practices that protects the rights of creditors and shareholders.

There is much to recommend in law, procedures and practices to make companies more attuned to the needs of properly servicing debt and equity. If most companies in India appreciate the important of creditors and shareholders, then we will have come a long way. Irrespective of differences between various forms of corporate governance, all recognize that good practices must at the very least satisfy two sets of claimants: creditors and shareholders.

In the developed world, company managers must perform to satisfy creditors' dues because of the disciplining device of debt, which carries with it the credible threat of management change via bankruptcy. Analogously, managers have to look after the right of shareholders to dividends and capital gains because if they do not so over time, they face the real risk of takeover. An economic and legal environment that puts is a brake on the threat of bankruptcy and prevents takeovers is a recipe for systematic corporate mis-governance.

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4.4 TOOLS FOR IMPROVED CORPORATE GOVERNANCE.

From time to time SEBI has issued directives to be complied by the companies in different directions. The companies have to attach various schedules and information as appendices. Their forms and formats and enclosures to be enclosed are also given. They are also mandatory in nature. Some of the points of regulations are being given by the researcher as hints in the following statements:

- SEBI GUIDELINES ON DISCLOSURE AND INVESTOR PROTECTION.
- GUIDELINES FOR PREFERENTIAL ALLOTMENTS OF SHARES, ETC.
- GUIDELINES FOR RAISING FOREIGN EQUITY IN EXISTING COMPANIES AND DETERMINING ISSUES PRICE OF PREFERENTIAL SHARES.
- GUIDELINES FOR DETERMINING ISSUE PRICE FOR RAISING FOREIGN EQUITY IN EXISTING COMPANIES THROUGH PREFERENTIAL ALLOTMENT OF SHARES TO NON-RESIDENTS.
- COMPOSIUM OF CIRCULARS TO MERCHANT BANKERS.
GUIDELINES ON ISSUE OF SECURITIES BY DEVELOPMENT FINANCIAL INSTITUTIONS.

ISSUE OF NOC BY SEBI WITH RESPECT TO THE RELEASE OF 1% DEPOSIT PLACED BY THE ISSUER COMPANIES WITH THE REGIONAL STOCK EXCHANGES.

ISSUE OF FOREIGN CURRENCY CONVERTIBLE BONDS AND ORDINARY SHARES (THROUGH DEPOSITORY RECEIPT MECHANISM) SCHEME, 1993.

GUIDELINES ON POLICIES AND PROCEDURES FOR EXTERNAL COMMERCIAL BORROWINGS FOR 1997-98.

GUIDELINES FOR EURO-ISSUES.

SECURITIES LENDING SCHEME.

SEBI GUIDELINES FOR GOOD/BAD DELIVERIES.

TRADING MECHANISM AND BUSINESS RULES OF OTCEI.


♦ SEcurities AnD ExCHANGE BaORD OF INdia (MERCHANT BaNKERS) RULES, 1992.
♦ SEcurities AnD ExCHANGE BaORD OF INdia (MERCHANT BaNKERS) REGULATIONs, 1992.
♦ SEcurities AnD ExCHANGE BaORD OF INdia (PORTFOLIO MANAGERS) RULES, 1993.
♦ SEcurities AnD ExCHANGE BaORD OF INdia (PORTFOLIO MANAGERS) REGULATIONs, 1993.
♦ SEcurities AnD ExCHANGE BaORD OF INdia (APPEAL TO CENTRAL GOVERNMENT) RULES, 1993.
♦ SEcurities AnD ExCHANGE BaORD OF INdia (REGISTRARS TO AN ISSUE AND SHARE TRANSFER AGENTS) RULES, 1993.
♦ SEcurities AnD ExCHANGE BaORD OF INdia (REGISTRARS TO AN ISSUE AND SHARE TRANSFER AGENTS) REGULATIONs, 1993.
♦ SEcurities AnD ExCHANGE BaORD OF INdia (UNDERWRITERS) RULES, 1993.
♦ SEcurities AnD ExCHANGE BaORD OF INdia (UNDERWRITERS) REGULATIONs, 1993.
♦ SEcurities AnD ExCHANGE BaORD OF INdia (DEBENTURE TRUSTEES) RULES, 1993.
♦ SEcurities AnD ExCHANGE BaORD OF INdia (DEBENTURE TRUSTEES) REGULATION, 1993.
♦ Securities and exchange board of india (form of annual statement of accounts and records) rules, 1994.
♦ Securities and exchange board of india (bankers to an issue) regulations, 1994.
♦ Securities and exchange board of india (prohibition of fraudulent and unfair trade practices relating to securities market) regulations, 1995.
♦ Regulations and guidelines for foreign institutional investors.
♦ Securities and exchange board of india (custodian of securities) regulations, 1996.
♦ Securities and exchange board of india (depositories and participants) regulations, 1996.
♦ Securities and exchange board of india (venture capital funds) regulations, 1996.
• SECURITIES AND EXCHANGE BOARD OF INDIA (MUTUAL FUNDS) REGULATION(S), 1996.
• SEBI (SUBSTANTIAL ACQUISITION OF SHARES AND TAKEOVERS) REGULATIONS, 1997.
• SEBI (EMPLOYEE STOCK OPTION SCHEME AND EMPLOYEE STOCK PURCHASE SCHEME) GUIDELINES, 1999.
• SEBI (CREDIT RATING AGENCIES) REGULATIONS, 1999.
• PRIVATE LIMITED COMPANY AND UNLISTED PUBLIC LIMITED COMPANY (BUY – BACK OF SECURITIES) RULES, 1999.
• SEBI (COLLECTIVE INVESTMENT SCHEMES) REGULATIONS, 1999.
• SECURITIES APPELLATE TRIBUNAL (PROCEDURE) RULES, 2000.
THE DEPOSITORIES (APPEAL TO SECURITIES APPELLATE TRIBUNAL) RULES, 2000.

SEBI (FOREIGN VENTURE CAPITAL INVESTORS) REGULATIONS, 2000.

REQUIREMENTS FOR BROKERS OFFERING SECURITIES THROUGH WAP.

There are many non-mandatory recommendations of the SEBI on corporate governance. These are the general guidelines, recommendations and directives for the compliance of companies in various fields like – accounting professionals, company secretaries, employees and other managerial personnel. Some of the general guidelines relate to fulfillment of social obligations, ethical issues, environmental issues, protection of the ecology and maintenance of social and human values. Some of the guideline pertains to the protection human rights, moral values, intellectual property and IT related guidelines.

The role of nominee directors of financial institutions (FIs) in corporate board is very important. The new economic environment has changed their role from mere spectators to key players. Since the FIs hold a major chunk of shares in companies, their role is significant in a way to strength the accountability. In pursuit of this objective, the FIs have
prescribed 19 point agenda for nominees in companies. The important points in this agenda are:

- Well defined and declared long-term dividend policies.
- Depreciation charging method should be examined.
- Investments in unlisted companies to be carefully examined.
- No resource raising in the form of equity or loans unless required for expansion and long-term working capital needs.
- Transfers of profitable divisions and hiving-off require approvals.
- The impact of merger on the equity shareholding pattern and on promoter holding to be examined.
- Loans and advances for share acquisition should be examined.  

The areas, in which they are expected to play an effective role, include crucial areas such as investments in subsidiaries and loans, awards of contracts, merger and acquisitions, expansion and diversification, dividend and accounting policies and subsidiarisation and de-subsidiarisation. The list of guidelines and the areas prescribed is not static. It will keep on changing with the need. But what is important to the nominee is to act in a cohesive manner with other directors on the board.

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As per the recommendation of the Cadbury Committee, all the listed companies in UK should establish audit committees within a specific period. Although this practice is not prevalent in India, few companies have taken initiative in this direction. Such committee is desirable due to the fact that a director individually may not be so competent to look after important financial matters. It is essentially to include non-executive directors as members of audit committees to protect the interest of investors.

The Cadbury Committee has succinctly pointed the potential of such entity in the areas of quality financial reporting, controlling of fraud, providing channel of communication with external auditor, helping the finance director, enhancing the credibility of financial statements, etc. The committee members should be competent, committed and independent. But its overall effectiveness will depend on the attitude of promoters and executives towards the good practices of corporate governance.

A good team of employees is the backbone of a company. But what is important is that there are individual ethical standards. A responsible employee should be altered enough to point out the wrong doings of his superior. When employees are shareholders of
a company, their responsibility rises further. They should have to raise issues in the appropriate form for prompt action.

On the wake of changes in domestic and international economies, the old perception of corporate world has changed drastically and expectation from every quarter has been increasing for greater transparency, accountability as well as better performance. The Board of Directors including Non-executive Director, Auditor, Company Secretaries as well as employees of a company are equally instrumental and responsible for better corporate management.

The Government and other law making agencies shall only provide the guidelines but the actual performance lies on the value and ethics of the person who practices it. It is not possible to ensure better governance by forcing corporate world through new laws and rules, rather it should come from the corporate sector itself. There should be consensus among the industrial houses and financial institutions for better governance norms. But the norms should be flexible enough to adopt new changes in the environment.\footnote{Bhattacharya, A.K.: Corporate Governance, The Chartered Accountant, 1999.}
4.5 LATEST DEVELOPMENTS IN CORPORATE GOVERNANCE.

Jawaharlal Nehru had always cherished the dream of creating a ‘Socialist Pattern of Society’. In 1947, S. Radhakrishnan had stated ‘unless we destroy corruption in high places, root out every trace of nepotism, love of power, profiteering and black marking which have spoiled the good name of the country in recent times, we will not be able to raise the standard of efficiency in administration as well as the production and distribution of goods of life.”

However, nothing of the sort happened. India had to witness a number of scandals in high places during era of the ‘Licence Raj’. Starting with Jeep scandal in 1948 and the HG Mudgal case in 1950, a series of scandals likes the Mundhra deal, the Partap Singh Kairon’s mis-adventure in 1964, imposition of Emergency in 1977, the memory raising exercise for the party during Indira Gandhi’s period, the HDW deal with Germany for submarines in 1981, the Bofors scandal of 1987, the Harsad Mehta’s scam of 1992 and finally the Jain Hawala case in 1995 were just a few glaring examples of degeneration of values and unethical practices in high places in political field.
Political corruption, no doubt has very high degree of visibility and it makes sensational news. But it is chicken feed compared to corporate corruption. As per S.S. Gill (The Pathology of Corruption), unofficial estimates by the International Monetary Fund (IMF), state that the Indians have stashed away at least hundred billion dollars in foreign banks. According to US research study, India’s capital flight to the United States during 1994 and 1995 was to the tune of four to eleven billion dollars.

Looking at the corporate ethics from another angle. According to one of our finance minister’s statement (The Pathology of corruption) “there are about four lakh registered companies in India. Forty percent of them do not file any income tax return. In the top bracket there are nearly thirteen hundred concerns which did not pay any tax till 1995-96 as they were treated as “Zero Tax” companies. Indian banks carry a burden of forty thousand crore rupees as bad and doubtful debts and practically the entire sum has been advanced as loans to corporate sector. Despite all the noise about the government pampering the public sector at the cost of private sector, till 1990, seventy four percent of the advances made by the government financial institution went to the latter and these are mostly the borrowers
who pay no tax. After liberalisation this figure must have gone up.\textsuperscript{6}

Thus, we have a situation where on the one hand the governments are incurring ever higher and increasing liabilities. On the other the corporate sector which has become the real accumulator of capital, is contributing less and less to the state exchequer.

Luckily, there is now an increasing debate and rising demand in favour of ethics in all aspects of society, politics, administration, judiciary, business, media, family and personal life. We find wide exposure of unethical practices and criticism, which is relevant to holders of high political office and also to various corporate houses. With the increasing liberalisation and globalisation of Indian Economy, the driving forces for business ethics are getting further strengthened due to need to match the best global competitive standards of ethics. Competitive position of corporate to a large extent will be determined by the effectiveness with which their boards of Directors discharge their duties and responsibilities.

\textsuperscript{6} The Institute of CS of India, New Delhi, 2005.
It is indeed a matter of shame that Transparency International had ranked India as the ninth most corrupt country in the world. It is also a matter of history that the extent of corruption that had infested British Public life about 150 years ago was much greater. Yet for nearly a hundred years now Britain was ranked as one of the cleanest countries in the world. How was this miracle achieved?

Ethics carry importance from the point of view of employees' customers, shareholders, lenders, dealers and vendors all of whom form part of the corps of business stakeholders. All need to be treated fairly and justly. Thus, "Ethics is a good business", the motto followed by the PHD Chamber of Commerce, rightly emphasising corporate ethics and good governance, becomes highly important in today's milieu.

Various dimensions which interact and lead to Corporate Governance are:

- Legislation, Laws and infrastructure, codes of conduct for the law makers themselves.
- Corporates themselves - their values and concerns. Codes of conduct particularly at Corporate level.
Society – their values morals and awakening. Their responses to corrupt practices are expressed through pressure groups and media.

The pace of good corporate governance is set at the initial stage of statement of objectives, particularly the corporate finance objective. An objective function specifies what the decision-maker is trying to accomplish and by so doing provides a framework for analysing various decision rules. In most cases the objective function is stated in terms of maximizing some function or variable (profits, size, value, social welfare) or minimizing some function or variable (risk, costs).\(^7\)

In India, the parallel economy is working in the form of black money. In the words of D.K. Rangnekar, “If the “Parallel Economy” poses a serious threat to stability and growth of the official economy, surely it stems from the fact that the magnitude of “black money” is large and rigged deals are growing in volume and complexity at an alarming rate. Apart from the wide ramifications of the “parallel economy”, one might also be alive to the fact that “black incomes” are accentuating the inequalities in income and wealth and breeding a new class of “black” rich in a society which is already harshly stratified.”

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The parallel economy is known by different names as – 'black economy', 'unaccounted economy', 'illegal economy', 'subterranean economy' or 'unsanctioned economy'. This parallel economy is posing great threat to corporate governance in the country. From time to time many committees and commissions have estimated black money in the country. There are many causes responsible for generation of black money. The prime causes are – divergence between the acceptable net rate of return and legally permissible rate of return, black money generation as a consequence of controls, licensing system, donation to political parties, ineffective enforcement of tax laws and generation of black money in the public sector.

There is immediate need to control and check the parallel economy because it is contributory to bad corporate governance practices in the country. The corruption, prevailing in the country must be eradicated. Corruption takes many forms like – bribery both at public and political levels, pilferage and seepage of public funds, personal pecuniary gains like – commissions and convenience fees and many other forms.