

A Review Of Evolution And Challenges In Corporate Governance

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INTRODUCTION

The subject of corporate governance has come to the limelight after the collapses of the high profile companies. Enron, the Texas based energy giant and Worldcom, the telephone giant, shocked the business world for their unethical and illegal operations. Large and trusted companies from Parmalat in Italy and the multinational newspaper group Hollinger revealed significant and deep rooted problems in their corporate governance. Even the director of New York stock exchange, Dick Grasso has been removed from his prestigious post for the non-compliance of the corporate governance practices judiciously before the public. Corporate governance has, of course, been an important field of query within the finance discipline for decades. Researchers in finance have actively investigated the topic for at least a quarter century.

The whole corporate governance issue came again in India after the pandemonium over the sordid Satyam business scandal. The initial public outburst was caused by news that listed company Satyam computer services was using its free cash which belongs to all its shareholders- to buy out two unlisted infrastructure and property development companies, both owned by the managing shareholders of Satyam. It was a fiction created through some incredibly creative accounting. Revenues, profits, reserves, cash were all cooked up over the years leading to an inflation of the balance sheet by around Rs. 7000 core. Many questions peep into the minds of the various stakeholders of the corporate world- How did the auditors not know about such a big sign of wrong doing? How did all of it escape the audit committee? When a cash balance of such a big amount (Rs. 7000 crore) was not there, how was it reflected by a bank statement? In the post reform era, the Satyam scandal is no doubt a severe blow for which one has to rethink again that something was left untouched in the area of corporate governance all over the world.

WHY CORPORATE GOVERNANCE?

In real life, managers wield an enormous amount of power in Joint stock companies and the common shareholder has very little say in the way his or her money is being used in the company. In companies with highly dispersed ownership, the manager functions with negligible accountability. Most shareholders do not care to attend the General meetings to elect or change the board of directors and often grant their “proxies” to the management. Even those that attend the meeting find it difficult to have a say in the selection of directors as only the management gets to propose a slate of directors for voting. On his part, the CEO frequently packs the board with his friends and relatives who rarely differ with him. Often, the CEO himself is the chairman of the board of directors and ultimately the supervisory role of the board is often severely compromised and the management, who really has the keys to the business, can potentially use corporate resources for their own self- interests rather than the interests of the shareholders. Essentially, corporate governance deals with effective safeguarding of the investors' and creditors' rights and these rights can be threatened in several other ways. For instance, family businesses and corporate groups are common in many countries including India. Several family business groups in India like Birlas and Ambanies are dominating their business in India. Interlocking and pyramiding of corporate control within these groups makes it difficult for outsiders to track the business realities of individual companies in these companies. In addition, managerial control of these businesses are often in the hands of a small group of people, commonly a family, who either own the majority stake, or maintain control through the aid of other block holders like financial institutions. Their own interests, even when they are the majority shareholders, need not coincide with those of the other- minority- shareholders. Such violations of minority shareholders' rights also comprise an important issue for corporate governance.

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ALTERNATIVE CORPORATE GOVERNANCE MECHANISM

While corporate governance mechanisms differ from country to country, there are two broad categories of financial systems which differ in their very basic structure. These are the market based systems adopted by the British and American systems and other is the Bank based system followed by Japan and Germany. The market based system or the Anglo-Saxon system marked with distancing of ownership and control, trusts financial markets with the ultimate role of corporate governance. It is characterized by effective an all powerful CEO, frequently also the chairman of the board of directors, who are barely accountable to a highly dispersed group of shareholders who generally find selling shares an easier way to express their dissatisfaction with inefficient management than creating a stir against it. Good performance and high share price are essential to keep future cost of equity capital low. The market for management control and the concomitant takeover threat then works to make sure that the management does not lower shareholder interests. Block shareholders have relatively less power through financial institutions like pension funds do hold big chunks of stocks. Banks have practically no control over the management.

Corporations in the bank based systems in Germany and Japan function quite differently. In Germany, for instance, share ownership is less diffuse and banks play an important role as providers of finance and monitor day- to-day activity. The board structure is substantially different with corporations being run by giant sized supervisory boards. The company can rarely take a major step without the consent of the bank. The power as well as salaries of the top management is far less than that in the Anglo-American model.

The Indian situation may be thought of a combination of these two conflicting models. Though the basic corporate legal structure is Anglo-Saxon, share ownership is far less dispersed and financial institutions play a much bigger role in financing corporate activity. Share ownership and Board representation of financial institutions gives these bodies the abilities to serve as important monitors of management activities though the relationship. The powers, however, are considerably limited as compared to those in typical bank based system and universal banking is not widespread. Nevertheless, financial institutions, have in general, failed to fulfil even their limited role in corporate governance.

HISTORY OF CORPORATE GOVERNANCE

The seeds of modern corporate governance were probably sown by the Watergate scandal in the USA. As a result of the subsequent investigations, US regulatory and legislative bodies were able to highlight the control failures that had allowed major corporations to make illegal political contributions and to bribe government officials. This led to the development of the Foreign and Corrupt Practices Act of 1977 in USA that contained specific provisions regarding the establishment, maintenance and review of systems of internal control. This was followed in 1979 by the Securities and Exchange Commission of USA's proposals for mandatory reporting on internal financial controls in 1985, following a series of high profile business failures in the USA. The most notable one of which being the savings and loan collapse. The Treadway Commission was formed. Its primary role was to identify the main causes of misrepresentation in financial reports and to recommend ways of reducing incidence thereof. The Treadway report published in 1987 highlighted the need for a proper control environment, independent audit committees and an objective audit function. It called for the published reports on the effectiveness of internal control. It also requested the sponsoring organizations to develop an integrated set of internal control; criteria to enable companies to improve their controls. Accordingly, COSO, (Committee on Sponsoring Organisations) was born. The report produced by it in 1992 stipulated a control framework which has been endorsed and refined in four subsequent UK reports; Cadbury, Rutterman, Hampel and Turnbull. While development in US stimulated a debate in UK, a spate of scandals and collapses in that country in the late 1980s and early 1990s led the shareholders and banks to worry about their investments. These also led the government of UK to recognize that the then existing legislations and self regulations were not working.

The issue of corporate governance became particularly significant in the context of globalization because one special feature of the late 20th century , 21st century globalization is that in addition to the traditional three elements of the economy, namely, physical capital in terms of plant and machinery, technology and labour, the volatile element of finances invested in the emerging markets and in the third world countries is an important element of modern globalization and has become particularly powerful. Thanks to the ubiquitous application of information technology, at the touch of a computer mouse, it is possible now to transfer billions of dollars across boarder. The significance and the impact of the volatility of the financial capital was realized when in June, 1997 the currency of the South east Asian

countries started melting down in countries like Thailand, Indonesia, South Korea and Malaysia. It was realised by the world bank and all investors that it is not enough to have good corporate management but one should have also good corporate governance because the investors want to be sure that the decisions taken are ultimately in the interest of all stakeholders. 'Honesty is the best policy' is a fact that is now being rediscovered.

DEVELOPMENT OF CORPORATE GOVERNANCE IN INDIA

On account of the interest generated by Cadbury Committee report and also in the wake of government initiatives to respond, various corporate developments have taken place-

(1) The Confederation of Indian Industries (CII), the Associated Chamber of Commerce and Industry and the SEBI constituted committees recommended initiatives in corporate governance. The CII, in 1996, took a special initiative on corporate governance. It was the first institutional initiative in Indian Industry. The objective being to develop a code for corporate governance to be adopted by the Indian companies(private sector, the public sector, banks and financial institutions which are corporate entities), a code by CII carrying the title "Desirable Corporate Governance" was released.

(2) The SEBI appointed Committee known as the Kumar Mangalam Birla Committee's recommendation, which led to the addition of Clause 49 was largely made mandatory by listed companies. The committee recommended that there should be a separate section on corporate governance in the Annual Report of companies. This section was required to detail the steps taken to comply with the recommendations of the committee and thus inform the shareholders of the specific initiatives taken to ensure corporate governance. The committee accorded recognition to the three vital aspects of corporate governance, namely, accountability, transparency and equality of treatment for all stakeholders.

(3) The Development of Company Affairs (DCA) appointed a study group on 15.05.2000 under the chairmanship of the then secretary DCA to suggest ways and means of achieving corporate governance. The study group appointed a task force. The study group recommended the setting up of an independent autonomous centre for corporate excellence with a view to accord accreditation and promote policy research and studies, training and education and awards etc. in the field of corporate excellence through improved corporate governance. It favoured greater shareholders' participation, formal recognition of CSR, non- executive directors being charged with strategic and oversight responsibility, minimisation of interest conflict potential, and also suggested application of corporate governance principles to the public sector.

(4) The Department of Company Affairs also contributed on August 21, 2002 a high level committee, popularly known as Naresh Chandra Committee to examine various corporate governance issues and to recommend changes in the diverse areas such as the statutory auditor company relationship, rotation of statutory auditors, procedure for appointment and determination of audit fees, restrictions if necessary on non audit fees, inter dependence of auditing functions, ensuring presentation of " True and Fair" statement of the financial affairs of companies, certification of financial statements and accounts, regulation of oversight functionaries, setting up an independent regulator and the role of independent directors. The committee has made very significant recommendations for changes in the companies Act.

(5) Yet another major development includes the contribution of a committee by SEBI under the chairmanship of N.R. Narayan Murthy for reviewing the implementation of corporate governance code by listed companies.

(6) The Department of Company Affairs has also set up a proactive standing company law Advisory Committee to advise on issues like inspection of corporates for wrong doings, role of independent directors and auditors and their liability, suggesting steps to enhance imposition of penalties. A high powered Central Coordination and Monitoring committee (CCMC) co-chaired by secretary DCA and chairman was setup. SEBI was also set up to monitor action against vanishing companies and unscrupulous promoters, who misused funds raised from public.

(7) SEBI has also undertaken a project on development of a comprehensive instrument by a reputed rating agency for rating the good corporate governance practices of listed companies.

DEFINITIONS

According to ICSI, "Corporate governance is a blend of rules, regulations, laws and voluntary practices that enables

companies to attract financial and human capital to perform efficiently and thereby maximise long term value for the shareholders besides respecting the aspirations of multiple stakeholders including that of the society.”

According to proceedings of Silver Jubilee National Convention of ICSI, October, 1997, “Corporate governance is not just corporate management, it is something much broader to include a fair, efficient and transparent administration to meet certain well defined objectives. It is a system of structuring, operating and controlling a company with a view to achieve long term strategic goals to satisfy shareholders, creditors, employees, customers and suppliers and complying with the legal and regulatory requirements, apart from meeting environmental and local community needs. When it is practiced under a well laid out system, it leads to the building of a legal, commercial and institutional framework and demarcates the boundaries within which these functions are performed.”

OBJECTIVES OF CORPORATE GOVERNANCE

Corporate Governance Seeks To Achieve The Following Objectives:

1. That a properly structured board capable of taking independent and objective decisions is in place at the helm of affairs.
2. That the board is balanced with regards to the representation of adequate number of non-executive and independent directors who will take care of the interests and well being of all the stakeholders.
3. That the board adopts transparent procedures and practices and arrives at decisions on the strength of adequate information.
4. That the board has effective machinery to sub-serve the concerns of the stakeholders.
5. That the board keeps the shareholders informed of relevant developments impacting the company.
6. That the board effectively and regularly monitors the functioning of the management.
7. That the board remains in effective control of the affairs of the company at all times.

The overall endeavor of the board should be to take the organization forward, to maximize long- term value and shareholders' wealth.

GOOD GOVERNANCE AND VALUE ADDITION

1. Adoption of good governance practices, stability and growth to the enterprise.
2. Good governance builds confidence amongst shareholders as well as prospective stakeholders. Investors are willing to pay higher price to the corporates demonstrating strict adherence to internationally accepted norms of corporate governance.
3. Effective governance reduces perceived risks, consequently reduces the cost of capital. It also enables the board of directors to take quick and better decisions, which ultimately improves bottom line of the corporate.
4. In today's knowledge driven economy, demonstrating excellence in skills has become the ultimate tool in the hands of the board of directors to leverage competitive advantage.
5. Adoption of good corporate governance practices provides long term sustenance and strengthens stakeholder relationship.
6. A good corporate citizen becomes an I-Con and enjoys a position of respect.
7. Potential stakeholders aspire to enter into relationships with enterprises whose governance credentials are exemplary.
8. Effective corporate governance mechanisms ensure better resource allocation and management, raising the return on capital. The return on asset is (ROA) is about twice as high in the countries with the highest level of equity rights protection as in countries with the lowest protection.
9. Good corporate governance can significantly reduce the risk of nation- wide financial crises. There is a strong inverse relationship between the quality of corporate governance and currency depreciation. Indeed, poor transparency and corporate governance norms are believed to be the key reasons behind the Asian crises of 1997. Such financial crises have massive economic and social costs and can set a country several years back in its path to development.
10. Finally, good corporate governance can remove mistrust between different stakeholders, reduce legal costs and improve social and labour relationships and external economies like environmental protection.

GOVERNMENT INITIATIVE ON E-GOVERNANCE

India has the largest number of pilot projects in e-governance today. Many of the projects have their own awards like the Stockholm Challenge Awards. There is a separate e-governance section within the Department of Information Technology, Government Of India. There is a national e-governance plan (NEGP) with a Rs. 600 crore budget. The World Bank is providing \$500 million assistance to various e-governance plans in India.

Table 1 : States Involved in Various Schemes of E-Governance Projects

Name of the Project	States Involved
Bhoomi (Land record Management)	Karnataka
Akshaya (IT literacy and local entrepreneurship)	Kerala
Khajane (Treasury net work)	Karnataka
Gyandoot (ICT to boost village level entrepreneurship)	MP
e-seva (single window access to many government services)	Andhra Pradesh
SARI (sustainable access in rural India)	Tamil Nadu
Honey Bee Net work (Knowledge centres for local knowledge)	Gujarat
Source-Economic times- Dt.11th Feb, 2006	

Table 2 : Ranking of E-Governance

Sl. no	Name of the Index	Ranking Positions of Different Countries	Number of countries surveyed
1	UNE -Government Readiness Index, 2005	Top-10- US, Denmark, Sweden, UK, Korea, Australia, Singapore, Canada, Finland and Norway. 33 rd - Brazil;50 th - Russia;57 th - China; 87 th - India	179
2	UNE -Participation Index, 2005	Top-10- UK, Singapore, US, Canada, Korea, Denmark, Mexico, Australia, and Netherland. 18 th - Brazil;50 th - China;59 th - India;62 nd - Russia	191
3	Brown University, 5th Global E-Governance, September, 2005	Top-10- Taiwan, Singapore, US, Hong Kong, China, Canada, Germany, Australia, Ireland and Vatican. 5 th - China,48 th - Brazil, 103 rd - India, 109 th - Russia	191
4	Waseda University, Japan WorldE- governance Ranking	Top-10- US, Canada, Singapore, Japan, Korea, Germany, Taiwan, Australia, UK and Finland. 21 st -Brazil,28 th - China,31 st - Russia,Non ranking-India	32
5	World Economic Forum's Network Readiness Index (NRI)	39 th - India;41 th - China;46 th -Brazil;62 nd - Russia	102
6	Human Development Index - 2005	62 nd - Russia; 63 rd - Brazil; 85 th - China;127 th - India	177

Source- Economic times-Dt. 11th Feb, 2006.

Table 3 : Position wise Ranking of the States (Year of Ranking-2004)

Name of the Position	Name of the States
Leadership Position	Karnataka, Tamil Nadu, Andhra Pradesh, Maharashtra and Chhattisgarh
Aspiring leaders	Kerala, Gujarat, Goa, Delhi, Punjab and Haryana
Expectant Category	West Bengal, Pondicherry, and MP
Lagging Behind	All other States

Source- Economic Times -11th Feb.2006

RECOMMENDATIONS AND POLICY IMPLICATIONS

The Anglo-saxon model, which we are now imitating, is inadequate and we need to rethink a better system of corporate governance. Some of the creative ideas are mentioned below:

(1) Need For A Board Of Audit : Now, stakeholders of companies have realized that statutory auditors are not taking any responsibilities in the process of audit of accounting records of the business entities. Particularly, in private sector companies, auditors are dominating the institutional investors. In the public sector, the Comptroller and

Auditor General (CAG) provide a second layer of audit. Similarly, a second layer audit system should be made compulsory in the private sector companies. The audit board should be empowered to have a surprise visit to any of the companies in the private sector at any time to evaluate the financial statements. The audit expenses in connection of the said audit work may be realized from all the private sector (both listed and unlisted) companies.

(2) Nomination Of Directors : The Management should not be involved in the selection of all the directors of the company. Institutional investors should be given the power to appoint more than half of the total number of independent directors. It has been realized that employees' participation in the management plays a pivotal role in the growth and expansion of an enterprise for which there is an urgent need to allow the employees to elect at least one or two directors who will no doubt take special interest for the employees in the company. Better transparency in the disclosure of financial statements can be achieved when representative directors from different interested parties of a company will work together and the vested interest of a particular group of directors will not dominate the whole auditing work process.

(3) Cross Directorship : Now- a- days, it has been realized that some of the service sector companies are appointing their directors having no experience with the concerned service sector. Persons having industrial or business background are more preferred to be appointed as the directors. The real purpose for which the corporate has been established is not achieved. For example, in educational sectors, the majority of the directors have been appointed from the business sources instead of academic sources. So, the real motive of rendering of service gradually disappears and profit motive acts as the prime motive for all such concerns. So, it is necessary that at the time of selection of the board of directors, persons having adequate knowledge and proficiency in the respective field should be elected so that the real purpose of the formation of the company can be served.

(4) Review Meetings : No director should be given permission to quit a company as and when he likes. The reason for which he wants to quit must be stated by the concerned director by way of an application which is to be discussed in a general body meeting and if two third majority favours the decision, the director may be allowed to quit. Before leaving, the past activities of the concerned director should be reviewed thoroughly and if any negligence is reported, he should be penalised- both financially and physically.

(5) Politics And Corporate Governance : Very often, it has been noticed that in most of the states in the private sector enterprises, political leaders are being appointed as the Managing Directors. Such appointments will encourage nepotism and favoritism, which is dangerous for the society. We must appreciate the democratic process of selection process of the Managing Directors and try our level best to avoid politicians and keep them away from the corporate world.

(6) Abolition Of One Man Dominance : Sometimes, more than two or three top positions are being offered to a single person, and as a result, due to his dominance, the entire system of corporate governance suffers. For example, the post of a Chairman-cum-Managing Director should be separated into two posts and two separate individuals should be given appointment. If one man will remain in more than two or three important posts, then he can easily mobilize the auditor and can pressurize the auditor to present the accounts in a manner to please the different stakeholders of the company. Due to the pressure, sometimes, the auditor presents the accounts which does not reflect the true and fair view of the state of affairs of the company. So, the system of one man control should be abolished so that one man dominance can be reduced which will be beneficial for the stakeholders of the company.

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