Corporate Governance — Indian Perspective

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***Abstract*—Corporate Governance is the set of policies that are created for deciding a company's performance and direction. It is an overview of rules and regulations for the people in-charge of an incorporated firm. They are the ones who agree to take responsibility towards the shareholders. Corporate governance is a broad term is today's business environment. The legal outfits of corporate governance can be customized to fit the meticulous choice of each wearer.**

The paper will discuss corporate governance from India's point of view. It will analyze the barriers that an emerging economy like India has to face. In addition, it will explain why it is important for any country to follow good corporate governance practices. In the next section, it will look at how corporate governance became an inseparable part of Indian economy. Next, it discusses involvement of ethics, internal governance, and choice of auditor and audit committee for India. In the conclusion, the paper gives a summary of how corporate governance is influencing the present economic condition of India.

***Index Terms*—Indian corporate governance, internal governance, audit committee, ethics.**

I. Introduction

Corporate governance is a multidisciplinary field of study it covers a wide range of disciplines – accounting, consulting, economics, ethics, finance, law, and management [1]. The main function of corporate governance is to make agreements that describe the privileges and tasks of shareholders and the organization. In case of disagreements because of conflict of interest, it is the responsibility of corporate governance to bring everyone together. It also has the function of setting standards against which corporations work can be managed and administered [2].

One of the question that come to mind while thinking about corporate governance is - why do different countries follow or do not follow same corporate governance practices [3]?

The answer lies in the history of corporate governance, earlier the corporate governance theory was divided in two ways Anglo-American and Continental European. Anglo-American was characterized as short-term equity finance, dispersed ownership, strong shareholder rights, active markets for capital control, and flexible labor markets, where as Continental European was characterized as long-term debt financing, concentrated blockholder ownership, weak shareholder rights, inactive markets for capital control and rigid labor markets. None of the countries around the world can follow either pure Anglo-American policies or pure Continental European system. It depends on various factors like globalization, world presence, competition, deregulation etc. that decide to what degree any country will follow any of the above mentioned two systems [3].

The objective of this paper is to explain corporate governance from the point of view of India. Being an emerging economy, it has its own sets of challenges and weaknesses. The paper will look at how following good corporate governance practices is not only necessary for any firm but is essential for the benefit of the countries' economy too. For the scope of this paper we are going to discuss four of the influencing factors of corporate governance practices namely ethics, internal governance, and selection of auditors and audit committee. In conclusion, it will discuss the present unique economic situation India.

II. Literature Review

Good corporate governance practices help corporations and its stakeholders; to do so various audit committee mechanisms are required [4]. Research on corporate governance with respect to the emerging market in much needed. Various benefits of following better corporate governance practices are noticed [5]. A corporate governance framework needs to be developed by providing a broad overview of recent corporate governance research. All aspects of corporate governance are important from board structure to ownership structure [6]. In about 26 developing and developed countries major corporate governance reforms took place. These reforms affected investor protection as well as impacted corporate investments [7]. The role of audit committee and its main function is to protect the auditor from dismissal in case of unfavorable report. Independent audit committee members experience a significant increase in turnover rate after auditor dismissals [8].

Corporate governance has become an important issue for China and India as they regularly interact with investors from developed countries [1]. Various aspects of business ethics and its relation to corporate governance can be discussed in detail by understanding various issues related to corporate board of directors and the basis on which they should be analyzed [2]. Ethics in corporate governance also plays an important role; operational dynamics of corporate governance are a necessary part of modern industrialization. An outline for matching the rules and practices of US corporate governance to different cultural methods should be provided [9].

III. India and Corporate Governance

Corporate governance has played a very important role in the present economic condition of India. India successfully started its move towards open and welcoming economy in 1991. From then onwards it has seen an amazing upward

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trend in the size of its stock market, that is, number of listed firms was increasing proportionately [10]. If India wants to attract more countries for foreign direct investments, Indian companies have to be more focused on transparency and 'Shareholders value maximization' [11].

Even though corporate governance practices can be backdated to as early as 1961 around the world, India was lagging behind. It was not until 1991 when liberalization took place and corporate governance established an international context. The most important initiative of 1992 was the reform of Securities and Exchange Board of India (SEBI). The main objective of SEBI was to supervise and standardize stock trading, but it gradually formed many corporate governance rules and regulations. The next major change was formation of Confederation of Indian Industry (CII) in 1996, which developed the set of laws for Indian companies as to initiate the act towards corporate governance. Then two committees Kumar Mangalam Birla and Narayan Murthy under Securities and Exchange Board of India started laying the groundwork for formalizing the best practices on corporate governance. Based on suggestions from these committees, Clause 49 was introduced as part of the listing contract for the companies listed on the Indian stock exchange. However, due to scandals like Enron, Satyam, WorldCom etc. forced the clause 49 to be reformed to incorporate and overcome the problems that caused these companies to collapse and shatter the economies of the respective countries [12].

Clause 49 of the listing agreement of Indian stock exchange took effect from 2000 to 2003. It contained all the regulations and requirement of minimum number of independent directors, board members, different necessary committees, code of conduct, audit committee rules and limits, etc. Firms that were not following these principles were removed from the listing and were given financial penalties [7].

We can compare the Sarbanes-Oxley Act of 2002 and Clause 49. Clause 49 was based on the principles of Sarbanes-Oxley Act of 2002. It was developed for the companies listed on the US stock exchanges. As far as the responsibilities of management and number of directors were concerned, they are both the same. They also have same rules regarding insider trading, refusal of loans to directors and so on. The important difference between the two is under Sarbanes-Oxley legislation if fraud or annihilation of reports takes place up to 20 years of imprisonment can be charged, but in case of Clause 49, there is no such condition. Being the controller of the market SEBI can commence a criminal proceeding. If in case SEBI decides to give a severe punishment then it can commence a criminal proceeding or raise the fine for not agreeing with Clause 49, which automatically delists the company [12].

Corporate governance affects corporations as well as countries in different ways such as firm's access to outside financing increases, which leads to more investment, better growth opportunities and that causes the job market to flourish. Capital cost is decreased and so the firms are valued at higher cost. Firms can be attracted by this, which directs it to growth and again to reduced unemployment. Wealth is generated by better distribution of resources and good management practices, which is because of better operational performance. Better corporate governance can be associated to reduce financial crises. As these crises, have devastating effects of any countries economy. If corporate governance practices are followed properly this creates better rapport with the stakeholders [5]. We can further see what significant role does corporate governance plays in the investment process. As corporate governance provides property protection and safe modes of ownership registration, it automatically affects the firm's capital mobilization. For any firm to receive funds from the market effectively it has to be consistent and transparent in disclosing its details. Finally, to effectively handle the capital received, any company should have proper resource allocation, authority distribution, and well-planned incentive schemes as some of the necessary steps [10].

Fraudulent behavior of companies has caused countries to go through financial crisis. Corporate governance hence became a critical issue for all the countries around the world. From Satyam Computer Limited of India to Enron of the U.S., pattern is more or less same. Failure of companies of these massive sizes created havoc in the industry and had caused the economic meltdown. The immediate action that the Indian authority took in response to the scandals reveal how government in emerging economies also feel the need to promote good corporate governance practices. Furthermore, understanding corporate governance standards and issues is also important to executives of foreign multinationals planning to do business with India [6].

In this section, the study showed how in India corporate governance has become an inseparable entity; next, we will discuss some specific issues regarding corporate governance: ethics, internal governance, and selection of auditors and audit committee.

IV. Ethics

Business ethics is based on the vast topics of reliability and justice. Business ethics means applying the general ethical principles to business problems and finding the solution that will be "right" in all aspects [11]. Business problems arise when the decision made by the board is going to affect either profitability or its shareholders in the end.

Fig. 1 gives us a brief overview of elements of corporate governance relating to ethical behavior are defining the role of board of directors and finalizing the executive compensation [2].

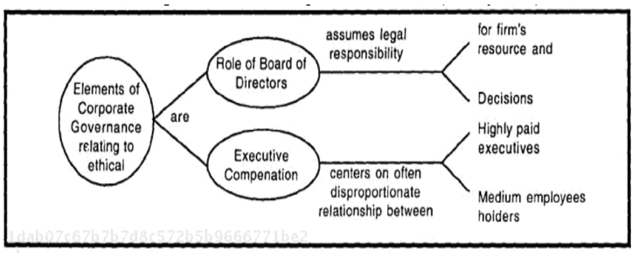

Fig. 1. Elements of corporate governance (Murthy, 2009).

Some basic functions that come under business ethics umbrella are outlining proper behavior, set up firms values, defining responsibilities, present leadership and guidance, relate conclusions to stakeholders as well as shareholders, increasing liability, always keeping in mind the consequences, continues inspections and options for improvement etc. [2].

Corporate governance acts as a bridge between shareholders, stakeholders, and board of directors. It should be able to restore the trust and confidence of management and the company to the shareholders in the company [13].

As the paper discussed how important it is for a company to follow good corporate governance practices which are ultimately ethical too. Companies need to do much more than just attaining the good corporate governance practices; it should constantly strive for fulfilling the best interest of all its members. It focuses on deciding the management structure in any organization such as board of directors, audit committee, shareholders committee, selection of independent auditors etc. The basic issue with governance is that there is no objective measure against which it can be said if it is good or bad. Here the companies' ethics come into play [11].

Corporate Governance practices should be planned in such a way that it will encourage a suitable atmosphere for corporate social responsibility, reliability, and ethics. It is one of the ten core principles of corporate board of directors that was authored by the National Association of Corporate Directors, 2008. Business ethics mostly has to deal with choice of conflict of interest and value. Corporate directors have fiduciary duty towards the stockholders. Board members are the eyes and ears for the shareholders [9].

To understand the role of board of directors and executive compensation we need to understand what internal governance is. It is discussed in detail in the next section.

V. Internal Governance

Debt holders, shareholders, board of directors, all together contribute to decide internal governance for any organization. To understand external governance we need to understand how organizations adopt the governance code, the competition that company needs to face, and the regulatory environment. As per the scope of this paper, it looks at the internal governance only. Being the decision makers of the company the board of directors are the most crucial and inseparable part for any company.

Board of Director – The proprietor and shareholders are associated to each other through board of directors. They are the link between managers sitting in the corporate office and the huge group of controllers of a corporation that are all over the world. They have fiduciary duty towards its shareholders, as shareholders are the ones who have elected them as board of director. The board is made up of internal and external directors. The internal directors sometimes called as executive directors are usually senior position holder people from the firm; they usually know intimate details about the company and its performance. Whereas the external directors' also known as non-executive directors are not the employees of the company, they are experts in their subject that is important as per the company [14].

Duty of care and duty of loyalty are the most important roles of any director. The American Law Institute lists one of the tasks as choosing, estimating, and fixing the benefits of the senior executives, another task is to look at the business and its future responsibilities towards the society, they also approve corporate plans for the future and the financial objective that the corporation has to achieve, finally they also look at if the corporation is making the required changes as per the need of the society [4].

The board of directors are also responsible for looking at the validity of the financial statements that are been audited. However, it is very questionable about how much authentic these reports are and in what depth the board analyzes them. Arthur Levitt, the former US SEC chairperson, suggests that US recommends 40 hour of service in a week is must to do a satisfactory job where as in real the board does only 22. The main reason for the board members in not devoting sufficient time are that they have full time jobs of their own as well as they are board members of various company boards. All this restricts them from managing their time to audit the financial statements of any company in-depth [14].

Executive compensation is one of the ways in which the board members can be compensated for the extra time and effort they have to put in this work but recent scandals have given a negative spin on this topic. In developed countries like USA executive compensation is not decided by shareholders but the board and the compensation committee has full right to decide on this issue. However in developing countries like India, as insiders start abusing these kinds of policies rather than having agency problems through managerial compensation, other principal agency problem stem up [13].

To find the solution for this kind of problem in India, Kumar Mangalam Birla Committee (2000) was appointed by the capital market regulator Securities and Exchange Board of India (SEBI) which noted that "the board of a company provides leadership and strategic guidance, objective judgment independent of management to the company and exercises control over the company, while remaining at all times accountable to the shareholders." To match with the international standards SEBI code was changed many times to adopt and adapt the best practices around the world [15]

The board of directors has very high overall burdensome responsibilities and those responsibilities are dependent on the relevant information, which is provided by the management of the company, considering the fact that this provided information is correct. The board needs sufficient, pertinent, and high-quality data to make the best decisions for the company's shareholders and stakeholders. This is particularly important for developing countries like India as they have too much inside dominance [14]. To resolve all the issues many factors should be taken into consideration. In this paper, we will discuss board size, composition, its profile, and diversity.

Board Size and Composition – There is no universally acceptable number for the most favorable size of board of directors. Even if the company has a small or a large board, they both have there pros and cons. There is a very complicated relationship between board size, board usefulness, and business performance. According to the Corporate Library's study, the average board size is from 3 to 31 members [15]. For India, there is no mandatory number for the board of directors except the rule of minimum of two members in private limited companies and three for public limited companies.

Some advantages and disadvantages of small and big board sizes are - if the board size is small, members feel more ownership and accountability for the decisions they make. The contact between members is easier. Board members know each other individually. The drawbacks are small size limits various opportunities due to fewer expertise and viewpoint. If the board size is big, members have expertise in different areas and so the opportunities grow very high. Work is shared among groups. Fundraising events are easier. The drawbacks are big boards cannot engage all the members effectively and efficiently. Meetings are difficult to schedule etc. [16].

Some critics think that the optimum number of board members is seven. The two important committees are compensation committee and audit committee. Each committee should have minimum of three members. That makes six members so that none of the committee will have more power. The seventh member if chairperson of board. The role of the chairperson is to make sure the board is working properly and looking at if the CEO is fulfilling his/her responsibilities [17].

Board Profile and Diversity – Board profile refers to the area of expertise the board member brings to the table, whereas the board diversity refers to the socio-cultural aspect of the member. There are varieties of studies that prove the need of both versatile profile as well as diversity. The decisions made by the board affect the corporation in day-to-day business. People with same mindset tend to support each other. This can sometimes lead the company in wrong direction. For the sustainable growth of the corporation, it needs diversity in the board. For now though US lags Europe and Asian countries in case of board diversity [18].

As it is important to understand the internal governance factors, so is the process of selection of auditors and the audit committee. The paper will explain how the choice of auditor affects the issues that we have discussed until now.

VI. Election of Auditors and Audit Committee

A company can choose to have internal or external auditor. Internal auditors are usually full time company employees whereas external auditors are hired on a contractual basis they are independent of the entity they are auditing. After the collapse of Enron, Sarbanes-Oxley act of 2002 issued several new rules regarding the auditors and their committee. First, the auditor of any company will be involved only in consulting activities. Second, auditing committee is selected by independent board of directors rather than by chief financial officer. Third, public chartered accountants oversight board regulates accountants; they monitor all the accounting firms too. Fourth, lead accounting partner should be rotated every five years just to avoid any clashes between auditor and the company. Finally, to avoid any other kind of fraudulent behavior, SOX mandated all the off-balance sheet transactions to be declared in detail by the company. [19].

The Blue Ribbon Committee (BRC), which is sponsored by NYSE-NASDAQ, standardized the role of audit committee as the "ultimate authority and responsibility to select, evaluate, and where appropriate, dismiss the outside auditor." In addition to that, Securities Exchange Commission (SEC) gave out the rule 'that management cannot fire an auditor without permission from audit committee' [8].

Over the years Confederation of Indian Industries (CII), Kumar Manglam Birla Committee, new rules of the Securities and Exchange Board of (SEBI) and Company Law has helped in evolution of audit committee in India too. Now a day, audit committee is viewed as "oversight function of corporate governance, financial reporting process, internal control structure, and audit functions" [4]. Table I shown below tells us that most of the Asian countries officially started planning the corporate governance policies from the 1990's.

From a range of research done on the topic of audit committee it will be fair to conclude that an audit committee's performance is better if its members are independent, they have governance and financial expertise, and they do not have any stake in the company at all. For example having a higher level of stock ownership in the company can impair the judgment of the member [8].

TABLE I: Development of Corporate Governance Code in the Asian Countries

Country	Date of Main Code(s)	Are Independent Director's Required?	Are Audit Committees Required?
China	2002/2005	Yes	Yes
Hong Kong	1993/2004	Yes	Yes
India	1999/2005 /07	Yes	Yes
Indonesia	2001/2006	Yes	Yes
Japan	2003/2004	Optional	Optional
South Korea	1999/2003	Yes	Yes(Large Firms)
Malaysia	2001/2007	Yes	Yes
Philippines	2002	Yes	Yes
Singapore	2001/2005	Yes	Yes
Taiwan	2002	Yes(Certain Firms)	Yes(Certain Firms)
Thailand	1999/2006	Yes	Yes

Source: Jamie Allen, Asian Corporate Governance Association: Corporate Governance Seminar, Organized by Chubb Insurance and Solidarity, Bahrain, 16 April 2008, p.10.

From a range of research done on the topic of audit committee it will be fair to conclude that an audit committee's performance is better if its members are independent, they have governance and financial expertise, and they do not have any stake in the company at all. For example having a higher level of stock ownership in the company can impair the judgment of the member [8].

Either the country is developed like the U.S. or a developing country like India, it is must that they provide measures that will make auditor independence stronger and improve the influence, purpose, and independence of audit committee. If the outside shareholders perceive that, audit committee has enough independence to make the 'correct' decision; it can decrease the risk premium of raising capital and so provides another good incentive for the companies to invest time and energy on both auditor and audit committee independence [4].

One of the key roles of an audit committee is to hire and protect the autonomy of external auditor. To keep other factors from influencing an auditor's judgment, auditors independence is must. The autonomy is also important for vital information about a client as it can lure the auditor to look at the issue from the clients' point of view.

We looked at how important it is for an organization to select an auditor. We also found how vital the role of audit committee in any firm is. Let us now look at the summary of all the topics we discussed so far.

VII. Limitations and Implication for the Future

As the scope of this paper was limited to India, it discusses only the perspective of India's corporate governance. For future research, more developing and developed countries can be compared to see the affects of reforms of corporate governance practices. In addition, this paper discusses only four of the influencing factors of corporate governance that are ethics, internal governance, and selection of auditors and audit committees; other factors that influence corporate governance can be analyzed and added to this study too.

To study this topic further, in future more research can be done to see how firms from countries like India affect the corporate governance of other countries as they develop new relations abroad.

VIII. Summary and Conclusion

In this paper, we saw how important it is for a company to follow good corporate governance practices. Then we looked at the brief history of corporate governance in India and its present economic and financial situation. Then the paper started going deep into the root cause of factors that affect corporate governance such as ethics, internal governance, and choice of auditors and audit committee. India being an emerging economy needs to work more on regulating the corporate governance policies.

Indian companies still have the scope to paint a brighter future for them. They need to acknowledge and continue with the corporate governance reform, and always keep in mind that this brighter future will have its own set of challenges.

The future of corporate governance is becoming a little clear now, as in the future the investors would be promoted to behave like owners rather than just traders. Independent directors will have more defined roles and responsibilities. And the incentives said to be given out to others will be distributed to the shareholders. In long run, a market-oriented and shareholder-centered system will develop into a new emerged system as stakeholder-oriented system making finance itself accountable to the public interest.

We can very well conclude that, "As legal rules are, to a significant degree, endogenous to the political economy context of the systems in which they operate and so are the corporate governance practices" [3].

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