CORPORATE GOVERNANCE : A NEW BUSINESS PARADIGM

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The corporate sector in India has been suddenly exposed to the new concept of corporate governance. This paper explains the concept and discusses the conditions of its successful achievement in the present Indian context.

With the globalisation of the Indian economy, many new concepts like Total Quality Manangement (TQM), Business Process Reengineering (BPR) and Corporate Governance have become the new management and corporate buzzwords. Of late, corporate governance has assumed major significance what with billions of foreign exchange pouring into the coffers either through fully owned subsidiaries or joint ventures. Corporate governance has gained tremendous importance in the recent past especially after the second half of 1996 due to two main reasons : (1) economic liberalization and deregulation of industry and business and (2) demand for new corporate ethos and stricter compliance with the law of the land. One more factor that has been responsible for the sudden exposure of the corporate sector to the new paradigm of corporate governance that is in tune with the changing times is the demand for greater accountibility of companies to their shareholders and customers.

At the last Euro Money Conference in Delhi, Rosie Catherwood, Director of Dewe Rogerson, opined that while the Indian corporate managers were rated highly on ability, they continued to suffer from low credibility amongst shareholders. He further mentioned that "only multinationals and public sector units operating in India have been rated highly on management credibility. While MNC's score for the quality for management that they offer, PSU's are rated highly for transparency of management" (see Shah, 1997).

It is becoming increasingly important that companies should be more accountable to shareholders, and follow certain ground rules especially after moving from"permit raj" to "open economy". In the late 1980s the economy began to overheat and at the end of 1980s there was a major recession and a number of significant company failures (MacDonald,1997). These concerns fell, broadly, into two categories. The first was the concern that even big companies were so vulnerable to a change in economic circumstances.It was seen that too often the company had really been led by only one dominant individual, who of course backed its own judgement. When things were good, they were good indeed — often a risk was taken which had paid off handsomely. But when the circumstances changed the business was seen to be based more on a set of strategic gambles than on a well considered and somehwat flexible plan which would remain robust even in times of adversity. There had obviously been insufficent challenge within

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the Board when its stratrgy and plans were put together and approved.

The second main concern was about the adequacy of the controls that operated within companies. Too often it seemed that within an apparently strong company there were completely unexpected weaknesses which made the company vulnerable to error or fraud. As a result of these two main concerns, the issue became a live question. It was the general issue, however, of a seach for a better way of doing things that people became concerned about rather than a search for specific procedures. This was because thinking people realised that specific procedures would never be applicable in every circumstance. The question became "what process should we seek to create which will continue to encourage companies to grow, yet address directly the risks implicit in carrying on that business!" There is a need to re-look into the role of directors so that professionalism and ethical standards of the working of the Board of Directors is made more accountable, transparent, honest and less vulnerable to manipulation to avoid repetition of corporate scams witnessed by innocent shareholders in the recent years.

This article critically examines and analyses the evolution of this new corporate paradigm — corporate governance — and how major institutions, government bodies and corporate houses are defining this "new way of doing business".

WHAT IS CORPORATE GOVERNANCE?

Corporate governance describes rules, practices and procedures by which companies interact with stake holders, namely employees, customers, suppliers, shareholders and society in general. In other words, it refers to accountability between the managers (Board of Directors) of a company and its stake holders. Usually, interests of stakeholders clash and managers try to strike a balance between them and therefore, the proposition of making managers accountable to all stakeholders dilutes the accountability to such an extent that managers become accountable to none.

The Cadbury Committee was set up by the London Stock Exchange, the financial reporting council and the accountancy profession (Cadbury,1997). The Committee published its report and Code of Best Practice in December 1992. From July 1993 all companies in the UK and listed on the London Stock Exchange have been obliged to state in their *Annual Reports* how far they comply with the Code and to give reasons for areas of non-compliance. It is important to emphasize that copanies do not have to comply with the Code but to make only a compliance statement. Compliance itself is a matter between the Boards and their shareholders. It is investors who have to be satisfied with the actions taken by the companies in response to the Code and not the Committee.

CODE OF BEST PRACTICE

The Code of Best Practice is divided into four sections. The first concerns the role of the Board of Directors and covers such matters as the duties and composition of Board of Directos. The second section deals with the role of the outside non-executive directors. The third section deals with the remuneration of the Executive Directors. The final section deals with the financial reporting and contorls. The code is not prescriptive. it does not say that there is only one way to govern a company. It recognises that every company, every board, and every chairman is different. It sets out the principles or guidelines which

the Committee believes Boards should follow in directing and controlling their companies. It is up to each individual Board to implement these principles in ways which best meet their particular circumstances and which carry the approval of their shareholders.

Hence, the underlyinbg principles of an ideal corporate governance system are : (1) It should be effective in protecting the shareholders' interest while making the managers free to run and develop business and to take risk and to show entrepreneurship; (2) It should provide transparency in terms of disclosure of information to enable shareholders to evaluate the performance of managers; (3) It should provide accounting integrity; (4) It should offer a proper composition of Board of Directors; and (5) It should not encourage insider trading.

Thus, the basic governance issues relate to the effectiveness and accountability of the Board of Directors. Effectiveness is a measure of quality of leadership which the Boards are giving to their companies and test of effectiveness is the result which those comapnies achieve. Accountability is largely a matter of disclosure, and transparency of the company's activities is to those to whom the company has responsibility.

CORPORATE GOVERNANCE IN INDIA

The standard of corporate governance has been poor in India because of various reasons (see the debate between Goswami, Vaghul and Banker, 1996; Kasbekar, 1997). First, there are historical reasons. The world over,corporate governance has grown from family managed companies to professionally managed. But in India, it is still in the stage of family managed companies. Family members take most of the important investment and operational decisions without bothering much about their impact on the balance sheet and, in the process, ignore the interests of shareholders. Only now, with the broadbasing of shareholders and with the increasing assertion by shareholders of their rights; the issue of corporate governance has come to the fore.

Secondly, there is the laxity of secured creditors. In the past, neither the banks nor financial Institutions (FIs) were concerned about the health of their debtors or whether debts were repaid in time. Nor did they have legal remedies to enforce their securities.

Thirdly, there is the laxity of shareholders. There used to be two main groups of shareholders — the development banks and the public sector financial institutions — which accounted for atleast a third of the shares and a large mass of small investors. The former were inefficient monitors who supported existing managements irrespective of performance. The latter were far too small and spread out to combine into an effective counterforce.

These trends are changing. Suddenly the debate on corporate governance has hotted up. The reasons for this transformation might be attributed to the following reasons. First, there is the assertion of rights by a new breed of shareholders who are more discerning. Second, now banks and financial institutions have to account for their non-performing assets in a non-discretionary manner. So, thay are getting more focussed on their debtors. Moreover, the FIs have decided to play an active role in the board room and expect international standards in corporate governance. Thirdly, there is the rise of the foreign institutional investors who are demanding greater professionalism in the management of Indian corporates. Lastly, the Euro issues, namely Global Depository Receipts (GDRs) and

American Depository Receipts (ADRs) have forced the companies to be much more rigorous in disclosure and accounting and have demanded information and performance like never before. The disclosure requirements of ADRs, are even tougher than those for GDRs. Initially, Indian companies kept away from the US market because of greater disclosure and compliance norms. But when companies such as those getting into infrastructure areas like telecom need to raise large sums of money abroad, they will have to go to the US and will have to disclose more. A similar step has been taken up by the Confederation of Indian Industry (CII) and the Indian government to provide the same kind of information which investors in Europe and America are accustomed to.

Whatever might be the reasons, with liberalization, presssure on managers to impove the quality of corporate governance is mounting. We have witnessed a sea change in the economic environment during the last five years. A good number of shackles have been removed and considerable operational freedom is available to the management. As a result, the overall corporate scene has become quite dynamic and lively.

There is virtual scramble amongst the corporates to increase turnover, improve profitability and boost the earning per share. This is good for the investors. Obviously, to attain these objectives, a good number of restructuring and re-engineering exercises are taking place.

ROLE OF THE GOVERNMENT

The government's role in ensuring better corporate governance is limited to bringing about legislative changes wherever necessary for implementing the new concept of corporate governnance. The legal and procedural aspects impinging on the quality of corporate governance are set by the statute enacted by the Parliament (Bhattacharya, 1996). These take in their sweep the Companies Act, Monopolies Restrictive Trade Practices (MRTP), Foreign Exchange Regulation Act (FERA), Consumer Protection laws, capital market regulations, etc. For example, the Companies Act 1956 provides the formal structure of corporate governance. It assures accountability to shareholders by providing exclusive rights to the general body of shareholders to constitute the Board of Directors. Further, under the Company Law, it is mandatory for the Board of Directors to periodically report on their stewardship to shareholders. These legislations set the minimum level of governance by the corporates and there is no limit on the maximum level of governance which some of the corporates would like to achieve. Those who have achieved minimum level of governance are better poised to achieve better governance and the ultimate goal should be to achieve better than the best and a cut above the rest.

Minimum level of governance is not a static concept, but keeps changing in tune iwth the changing econimic environment and social ethos. The New Economic Policy of 1991 and the subsequent trade related reforms have ushered in unprecedented liberalized business and legal environment. There is an increasing emphasis on self-regulation on the part of corporates and the state intervention has been reduced to the barest minimum. This is reflection of the confidence which the state has reposed in the corporates in their ability to manage their affairs in the larger interests of our economy and of those who are concerned with corporate governance.. This casts a larger responsibility on the corporates and this has to be reflected in better corporate governance.

ROLE OF CII

The task force of CII comprising eminent industrialists like Rahul Bajaj, Subodh Bharghava, C.K. Birla, and Rajeev Kaul has prepared a report titled "Desirable Corporate Governance in India- A Code" which is the first Indian paper of its kind on the subject (*The Economic Times*, 1996). The draft report has been commissioned in order to study the existing corporate governance and thereby to make some recommendations to make the code more effective.

Some of the major recommendations of the Code are : (1) Exit of FIs from manangement of companies where their shareholding is less than 10 per cent; (2) Withdrawal of FI nominees from the boards of companies which are not defaulting on loan repayment; (3) Transparency in credit rating of financial instruments; (4) Removal of restrictions on takeover of companies; (5) Debarring defaulting companies for accepting further deposits (government has already modified depost rules to this effect from March, 1997); (6) The task force has also dealt with the role of directors, both executive and non-executive, and the reduction in the number of directorships one can hold; and (7) The other suggestions are that the corporate board should be restructured and also its relationship with the owners, since there has a been a perceptible change in corporate ownership on account of various factors like preferential allotment of shares, etc., and the entry of Foreign Institutional Investors (FIIs), Non-Resident Indians (NRIs) and mutual funds.

The role of the Chairman has to be defined. He has to create strategic vision of the business, set standards of performance in terms of parameters such as product quality, market share, etc. The key function of Board of Directors should include election and appointment of the Chief Executive Officer and the delegation of powers to him, establishment of the long term corporate objectives and allocation of productive resources in accordance with the firm's priorities and the annual appraisal of CEO's performance. Every company should have an audit committee to review significant transactions outside the normal business, effectiveness of financial control and compliance with statutory and stock exchange requirements for financial reporting.

ROLE OF FINANCIAL INSTITUTIONS

Individual shareholders demand comprehensive financial reporting and look to the auditors and the regulatory authority, Department of Company Affairs and Stock Exchange Board of India (SEBI) in our country, for protection of interest. They cannot provide any worthwhile support to corporate governance. Financial Institutions (FIs) and institutional investors hold blocks of shares in companies and therefore are in a much better position to strengthen the accountability relationship.

Over a period time, FIs have made an entry into the corporate boards through financial participation and assistance (Bhattacharya, 1996). They have also brought about some measure of discipline and objectivity in the decision making prcess by the corporates. Rightly, FIs have supported existing management as loans are sanctioned on the track record of promoters running the business and the repayment of loans depended on the ability of promoters to run the business successfully. This would also ensure a fair return on their investments in the capital of the company. While this is in the self-interest of FIs the larger interest of the corporation seems to have taken a back seat. Till recently the role of FIs has come in for severe criticism because of the passive role they have played so far. They followed hands-off approach and in most of

the cases played the supportive role to management irrespective of their performances in spite of having significant investments in companies in the form of debt and equity. The nominee directors were passive watchers and rarely intervened except in crisis situations.

The Cadbury Committee has suggested the following role for the institutional investors in corporate governance : (1) They should encourage regular, systematic contact at senior executive level to exchange views and information on strategy, performance, board membership and quality of management; (2) They should make positive use of their voting rights,unless they have good reasons for doing otherwise; and (3) They should take a positive interest in the composition of boards, with particular reference to concentration of decision making power not formally constrained by appropriate checks and balances and to the appointment of a core of non-executive directors of the necessary calibre, experience and independence.

Now the government has advised FIs to act in the interest of shareholders. Collectively, FIs hold significant voting rights in companies which they can use to block decisions which they consider prejudicial to the company as a whole or to oust inefficient management. It is understood that FIs are presently working on 19-point formula which sets out the areas which nominee directors should look into at the corporate meetings.

ICICI has become the first financial institution to enforce its own brand of corporate governance through its nominee directors who are on the boards of various companies (Prasad and Singhal,1996) In the words of the top level sources of ICICI,"our responsibility does not end just by ensuring that we get back our money. But as a member on the board — to see that shareholders are benefited from every move made by the company". It will also form the basis so as to judge the performance of its nominess. The present ICICI staff is being educated on the idea of what constitutes corporate governance. ICICI has asked all the directors nominated by it to file status reports on the happenings at the various board meetings. ICICI plans to adopt a self-conscious approach implying that it aims to satisfy four parties in question — shareholders of ICICI, employees of ICICI,shareholders of companies on which ICICI has a nominee on the board and the borrowers. Corporate Governance is like a litmus test whether we have fulfilled our commitments to the four parties. Also it is a signal to the corporate sector that the FIs are becoming active".

CONCLUSION AND SUGGESTIONS

Cadbury (1997) is absolutely right when he advocates a home grown system for corporate governance in India. In India, the bulk of small and medium size corporations are managed by promoters and their representations and hence most boards are extensions of promoters' interest. Therefore the record of corporate governance in our country is poor. Concepts like corporate governance and board management cut little ice in promoter run firms with diffused shareholding.

It is high time to reform the situation. Any delay would negate our efforts to globalise capital market and to attract foreign investments. As mentioned earlier, CII has commissioned a committee to draft a code and as result has made certian suggestions but the important question is as to how many of Indian firms will comply with the code. At the same time, it will be necessary to bring suitable amendments in the Company Law which aim at greater transpar-

ency, limiting the liability of non-executive directors, making full disclosure of certain key information mandatory, and making it compulsory to present consolidated accounts of holding and subsidiary companies.

A company which constantly under-performs becomes the target for a hostile take-over (Sayed, 1997). Management of those companies whose shares are traded at a low price over a long period of time are more vulnerable since it indicates low confidence level of shareholders in the company. Hence, a take-over provides enough motivation to management of companies to satisfy shareholders. Presently, it is felt that the take-over code would help in improving the state of corporate governance. Theoretically it may ensure good corporate governance but in practice it is not so because shareholders do not have access to all the financial information and, moreover, insider trading cannot be eliminated. Therefore, it is felt that the revised take-over code does not contribute significantly to good corporate governance.

Hence, the prime responsibility has to be taken by the financial institutions. In reforming corporate governance, FIs will be required to act proactivley, collectively and decisively. They should become commercial in terms of their lending and recovery norms and should concentrate on protecting shareholders' interest. They should realize that they are also like another shareholder so that it is better to protect the shareholders' interest in general which will indirectly benefit them. Therefore, the FIs should make full use of voting rights and rights to have nominee directors on the board.

The steps discussed here can help achieve corporate governance only if there is willingess to act and implement the concept of corporate governance. Acharya Vinoba Bhave used to tell that the best way of attaing discipline would be "Atmanusasan" — discipline by self. The second way to achieve discipline is "Acharya anusasan", meaning the discipline laid down by the Gurus and the wise people. The situation so far as corporate governance is concerned would fall in the same category. The best thing that could happen about corporate governance would be for the comapnies to follow a definite code of conduct. Our leading chambers of commerce like FICCI, CII, and leading professional bodies like Institute of Chartered Accountants of India, Law Society, Institute of Company Secretaries of India, etc., should come together to lay down such a code and ensure that their members implement it. The financial press in the country should take upon themselves the job of watch-dog and see that they play a constructive role.

Often, there is reference to the economic progress of Singapore and Malaysia. Company laws in these countries provide for the duties of directors in a simple sentence: "Directors should act honestly, and in the interest of the company". Let this be the starting point of corporate governance for directors in our country. The decision by and large cannot go wrong from the point of view of corporate governance if this yeardstick is remembered. There could be two different views about any decision but if it is taken bonafide and in the interest of the company as a whole we would have achieved the concept of corporate governance by and large.

Lastly, the question of drastic transformations in corporate governance is not confined just to India; corporates in Europe and Japan are re-strategizing their operations and prioritizing their objectives to give a new meaning and direction to their accountability to the shareholders.

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