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ORGANIZATION AND EFFECTIVENESS OF CORPORATE GOVERNANCE IN FOREIGN COUNTRIES

Ушбу илмий мақолада хорижий мамлакатларда корпоратив бошқарувни ташкил этиш ва самарадорлиги масалалари Ҳиндистон давлати тажрибалари асосида баён этилган. Мақолада Ҳиндистонда корпоратив бошқарувни вужудга келиши ва бугунги кундаги ҳолати ҳамда истиқболда амалга оширилиши кўзда тутилаётган масалалар ёритилган.

This article studied the foreign experience of the organization and the effectiveness of corporate governance based on the experience of India. Also, the article studied the appearance and developmental condition today and the tasks to be implemented in the future.

Key words: *Corporate governance, Board of Directors, Institute of Company Secretaries of India (ICSI), Chief Executive Officers (CEO), Confederation of Indian Industries (CII), Comptroller and Auditor General (CAG).*

Corporate Governance in India –A historical background

The historical development of Indian corporate laws has been marked by many interesting contrasts. At independence, India inherited one of the world's poorest economies but one which had a factory sector accounting for a tenth of the national product. The country also inherited four functioning stock markets (predating the Tokyo Stock Exchange) with clearly defined rules governing listing, trading and settlements, a well-developed equity culture (if only among the urban rich), and a banking system replete with well-developed lending norms and recovery procedures. [1] In terms of corporate laws and financial system, therefore, India emerged far better endowed than most other colonies. The 1956 Companies Act built on this foundation, as did other laws governing the functioning of joint-stock companies and protecting the investors' rights.

Early corporate developments in India were marked by the managing agency system. This contributed to the birth of dispersed equity ownership but also gave rise to the practice of management enjoying control rights disproportionately greater than their stock ownership. The turn towards socialism in the decades after independence, marked by the 1951 Industries (Development and Regulation) Act and the 1956 Industrial Policy Resolution, put in place a regime and culture of licensing, protection, and widespread red-tape that bred corruption and stilted the growth of the corporate sector. The situation worsened in subsequent decades and corruption, nepotism, and inefficiency became the hallmarks of the Indian corporate sector. Exorbitant tax rates encouraged creative accounting practices and gave firms incentives to develop complicated emolument structures.

In the absence of a stock market capable of raising equity capital efficiently, the three all-India development finance institutions (the Industrial Finance Corporation of

India, the Industrial Development Bank of India and the Industrial Credit and Investment Corporation of India), became the main providers of long-term credit to companies together with the state financial corporations. Along with the government-owned mutual fund, the Unit Trust of India, these institutions also held (and still hold) large blocks of shares in the companies to which they lend and invariably have representations on their boards--though they traditionally play very passive roles in the boardroom.

The corporate bankruptcy and reorganization system has also faced serious problems. India’s system is driven by the 1985 Sick Industrial Companies Act (SICA), which considers a company “sick” only after its entire net worth has been eroded and it has been referred to the Board for Industrial and Financial Reconstruction (BIFR). As soon as a company is registered with the BIFR, it wins immediate protection from the creditors’ claims for at least four years. Between 1987 and 1992, the BIFR took well over two years on average to reach a decision, after which the delay to resolution roughly doubled. Very few companies emerge successfully from the BIFR and even for those that need to be liquidated the legal process takes over 10 years on average, by which time the assets of the company are usually almost worthless. Protection of creditors’ rights has therefore existed only on paper in India, and its bankruptcy process has featured among the worst in World Bank surveys on business climate. This may well explain why Indian banks under-lend and invest primarily in government securities.

Though financial disclosure norms in India have traditionally been superior to most Asian countries, noncompliance with disclosure norms is rampant and even the failure of auditors’ reports to conform to the law attracts nominal fines and little punitive action. The Institute of Chartered Accountants in India almost never takes action against erring auditors.

While the Companies Act provides clear instructions for maintaining and updating share registers, in reality minority shareholders have often suffered from irregularities in share transfers and registrations. Sometimes non-voting preferential shares have been used by promoters to channel funds and expropriate minority shareholders. The rights of minority shareholders have also been compromised by management’s private deals in the relatively infrequent event of corporate takeovers. Boards of directors have been largely ineffective in India in their monitoring role, and their independence is more often than not highly questionable.

For most of the post-Independence era the Indian equity markets were not liquid or sophisticated enough to exert effective control over the companies. Listing requirements of exchanges enforced some transparency, but non-compliance was neither rare nor punished. All in all, therefore, minority shareholders and creditors in India remained effectively unprotected despite the laws on the books.

Recent Developments in Corporate Governance in India

The years since liberalization began in 1991 have witnessed wide-ranging changes in both laws and regulations, driving corporate governance as well as the general consciousness about it. Perhaps the single most important development in the field of corporate governance and investor protection in India has been the

establishment of the Securities and Exchange Board of India in 1992 and its gradual empowerment since then. Established primarily to regulate and monitor stock trading, it has played a crucial role in establishing the basic minimum ground rules of corporate conduct in the country. Concerns about corporate governance in India were, however, largely triggered by a spate of crises in the early 1990’s—particularly the Harshad Mehta stock market scam of 1992--followed by incidents of companies allotting preferential shares to their promoters at deeply discounted prices, as well as those of companies simply disappearing with investors’ money[2].

These concerns about corporate governance stemming from the corporate scandals, coupled with a perceived need to opening up to the forces of competition and globalization, gave rise to several investigations into ways to fix the corporate governance situation in India. One of the first such endeavors was the Confederation of Indian Industry Code for Desirable Corporate Governance, developed by a committee chaired by Rahul Bajaj. The committee was formed in 1996 and submitted its code in April 1998. Later the SEBI constituted two committees to look into the issue of corporate governance-the first chaired by Kumar Mangalam Birla, which submitted its report in early 2000, and the second by Narayana Murthy, which submitted its report three years later. These two committees have been instrumental in bringing about far reaching changes in corporate governance in India through the formulation of Clause 49 of Listing Agreements.

Concurrent with these initiatives by the SEBI, the Department of Company Affairs, the Ministry of Finance of the Government of India also began contemplating improvements in corporate governance. These efforts include the establishment of a study group to operationalize the Birla Committee recommendations in 2000, the Naresh Chandra Committee on Corporate Audit and Governance in 2002, and the Expert Committee on Corporate Law (the J.J. Irani Committee) in late 2004. All of these efforts were aimed at reforming the existing Companies Act of 1956 that still forms the backbone of corporate law in India.

Corporate governance issues in India

Corporate governance standards and practices vary across the world. Every country develops its own code of corporate governance depending upon its socio-economic conditions and political philosophy and modifies the code from time to time based upon its own experiences.

There is inadequate research available regarding the issues of corporate governance in India. In light of the growing importance of India in the world economy as a source of intellectual capital and outsourcing possibilities, there is an urgent need to understand the governance structure in India[3]. Indian corporate governance codes based on the US and UK experiences do not resolve specific governance issues in India. “Corporate governance issues and problems in India are different from those typically encountered abroad”. Despite a long corporate history, the phrase corporate governance remained unknown until the late 1990s in India. The liberalization of the Indian economy in 1991 opened up vast potential for the Indian capital market, which saw spectacular growth in its size. However, cases of fraud malpractices and inefficiency reveal structural problems in the Indian capital market

and call for better implementation of corporate governance standards in the country[4].

According to Lalita S. Som (2006) the issues in corporate governance in the Indian context arise due to (a) “ownership structure in companies”, (b) “failure of boards”, (c) “accounting practices and transparency”. Truly independent directors are “rare” in Indian companies. Corporate governance problems also arise due to problems of (a) “surveillance and enforcement mechanisms and the court system” and (c) “lack of shareholder activism in India”[5].

According to Vittal (2001), the for corporate governance in India has been highlighted because of the scams we have been having almost as an annual feature ever since we had liberalization in 1991. We had the Harshad Mehta Scam, the Ketan Parikh Scam, the UTI Scam, the Vanishing Company Scam, and the Bhansali Scam and so on. In the Indian corporate scene, we must be able to induct global standards so that at least while the scope for scams may still exist, we can reduce the scope to the minimum[6]. Vittal further feels that the legal and administrative environment in India provides excellent scope for corrupt practices in business. The ethical temperature of any business or capital market depends on three factors. The first is the individual’s sense of values. The second is the social values accepted by the business and industry. The third and perhaps the most decisive factor is the system. It is here we face the main challenge. Our system encourages the lack of corporate governance[7].

The central problem in India corporate governance is a conflict between the dominant shareholders and the monitory shareholders. The governance structures of PSUs are incompatible with the efficient and successful operation. The Board has very little say in the selection of the CEO or in the composition of the Board. As far as audit is concerned, the dominant role is that of the Comptroller and Auditor General (CAG). Many operating decisions have to be brought to the Board for decision-making, which pushes the Board into managing rather than directing[8].

Independence of non-executive directors appears to be one of the main issues of corporate governance in India. Very few such competent people are in supply. Any suitable candidate needs to have a public stature to inspire confidence in the shareholders. Ideally, they should be prominent industrialists and not friends or promoters of the manager[9].

Corporate governance structures in different countries are two broad categories namely, the market-based system as in British and American models and the bank-based system as in Japan and Germany. The Indian situation is “combination” of these two models. Although the financial institutions play a much bigger role in financing corporate activity, the “financial institutions in general have failed to fulfill their limited role in corporate governance”[10].

“In India, enforcement of corporate laws remains the soft underbelly of the legal and corporate governance system”. Boards do not monitor management effectively. There is inadequate protection for monitory shareholders and chambers of commerce themselves pushing for an improved corporate governance system, the future of corporate governance in India promises to be distinctly better than the past”[11].

Codes of Good Corporate Governance in India

The Cadbury Code of Best Practices (1992), adopted by the London Stock Exchange as the listing requirement for companies in the UK, is the first modern corporate governance code, consisting elements of good governance of business corporations. Following the example of the Cadbury Code, different countries and markets developed codes of best practices to be followed by their companies. By the end of the country, there were more than sixty CG codes were also issued aimed at uniformly raising the governance standards of firms in different countries in order to attract investors and reduce the cost of capital.

The different CG codes prescribe appropriate management and control structures of a company and the rules relating to the relations between owners, the Board of Directors and the management led by the CEO. In its broad’s sense, corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as closely as possible the interests of individuals, corporations and society[12].

Corporate Governance Initiatives in India

Corporate Governance initiatives in India began in 1998 with the desirable Code of Corporate Governance – a voluntary code published by the Confederation of Indian Industries (CII). SEBI, the regulator of companies listed in the stock exchanges, introduced the first regulatory framework for corporate governance in the listed companies in February 2000, following the recommendations of the Kumar Mangalam Birla Committee, appointed by SEBI in this regard.

The Kumar Mangalam Birla Committee stated that, “It is almost a truism that the adequacy and the quality of corporate governance shape the growth and future of any capital market and economy. Studies of firms in India and abroad have shown that markets and investors take notice of well-managed companies, respond positively to them, and reward such companies with higher valuations”.

The Narayana Murthy Committee (2003), appointed by SEBI, stated that “investment is ultimately an act of faith in the ability of a corporation’s management. When an investor invests money in a corporation, he expects the board and the management to act as trustees and ensure the safety of the capital and also earn a rate of return higher than the cost of capital. In this regard, investors expect management to act in their best interests at all times and adopt good corporate governance practices”.

Objectives of Good Corporate Governance

Good governance is integral to the very existence of a company. It inspires and strengthens the investor’s confidence by insuring the company’s commitment to higher growth and profits. Corporate Governance must be based upon the principles of transparency in board processes and independence of boards, accountability to stakeholders, fairness to all stakeholders; and social, regulatory and environmental concern. Based upon the above principles, the Institute of Company Secretaries of India recommended that the Board should be properly structured with adequate number of non-executive and Independent Directors. Board procedures and practices

should be transparent and decisions should be informed, independent and objective. The board should keep the shareholders informed of the relevant developments of the company. The board should monitor functioning of the management team and remain in effective control of the company"[13].

Elements of Good Corporate Governance

According to the Institute of Company Secretaries of India (ICSI), good corporate governance requires inter alia, identification of powers and accountability of the board, CEO and Chairman of the Board, transparent and ethical management environment, an efficient and effective board consisting of competent persons appointed following due procedure, training and continuous education of directors, appointment of sufficient number of independent directors, provision of independent legal and professional advice to directors at the company's expenses. Further, ICSI also recommended for code of conduct for all managers and its effective monitoring, long-term strategic plan for the company, corporate social responsibility, regular and accurate financial position of the company of the shareholders, evaluation by the board of its own performance, independent Audit Committee and effective risk management plans[14].

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