A STUDY OF CORPORATE GOVERNANCE PRACTICES IN INDIA

Thesis Submitted to

THE MAHARAJA SAYAJIRAO UNIVERSITY OF BARODA

For the Degree of

DOCTOR OF PHILOSOPHY IN MANAGEMENT STUDIES

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DECLARATION

It is hereby stated that this research has been carried out under the guidance of **Dr. Surendra Sundararajan**. The analyses, discussions and conclusions have been drawn on the basis of the data collected. This dissertation has not been submitted to any other university.

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June 2012 **Sharma Ramroop Krishnapal**

ABBREVIATIONS

BSE	-	Bombay Stock Exchange
CalPERS	-	California Public Employees Retirement System
CAS	-	Class Action Suits
CCI	-	Controller of Capital Issues
CEO	-	Chief Executive Officer
CFO	-	Chief Financial Officer
CG	-	Corporate Governance
CGD	-	Corporate Governance Disclosure
CII	-	Confederation of Indian Industries
CLB	-	Company Law Board
COSO	-	Committee of Sponsoring Organizations
CPI	-	Corruption Perceptions Index
CSR	-	Corporate Social Responsibility
DCA	-	Department of Company Affairs
DEIC	-	Dutch East India Company
DFI	-	Development Financial Institution
EIC	-	East India Company
EPS	-	Earnings Per Share
ESO	-	Employee Stock Option
EU	-	European Union
FMCG	-	Fast Moving Consumer Goods
GDP	-	Gross Domestic Product
GNP	-	Gross National Product

GOI	-	Government of India
ICAI	-	The Institute of Chartered Accountants of India
IMF	-	International Monetary Fund
IPO	-	Initial Public Offer
LIC	-	Life Insurance Corporation of India
MCA	-	Ministry of Corporate Affairs
MD&A	-	Management Discussion and Analysis
MOF	-	Ministry of Finance
NFCG	-	National Foundation for Corporate Governance
NSE	-	National Stock Exchanges
NYSE	-	New York Stock Exchange
OECD	-	Organizations for Economic Co-operation and Development
OFCD	-	Optionally Fully Convertible Debentures
ONGC	-	Oil and Natural Gas Corporation
PFI	-	Public Financial Institutions
PSCF	-	Parliamentary Standing Committee on Finance
PSU	-	Public Sector Unit
RBI	-	Reserve Bank of India
ROA	-	Return on Assets
ROI	-	Return on Investments
SBI	-	State Bank of India
SEBI	-	Securities and Exchange Board of India
SEC	-	Securities and Exchange Commission
SFIO	-	Serious Fraud Investigation Office
SOE	-	State Owned Enterprises

SOX	-	Sarbanes Oxley
S&P	-	Standards and Poor’s
TSR	-	Total Shareholders Returns
UK	-	United Kingdom
US	-	United States
WB	-	World Bank
WS	-	Wall Street

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A STUDY OF CORPORATE GOVERNANCE PRACTICES IN INDIA

SUMMARY

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JUNE 2012

A Study of Corporate Governance Practices in India

Introduction

Corporate governance (CG) has emerged as a very important ideal. The reason is, today companies are substantially contributing to the overall growth and development, particularly in emerging economies such as India and a healthy investment environment is vital. The corporate form of business has succeeded gradually and expanded worldwide. However, not all companies are managed successfully. There has been a spree of corporate frauds worldwide, e.g., Enron in the United States and Satyam Computers in India. The latter had accounting and auditing flaws apart from lack of accountability and oversight by Independent Directors at Board meetings. There was no whistle-blowing in case of Satyam Computers unlike Enron. The Satyam Computers revelation was an outcome of a takeover attempt. It eroded the wealth of shareholders. From this fraud it is evident that we need to review the enforcement of CG practices. The role of the Ministry of Corporate Affairs as one of the stakeholders in case of Satyam Computers has been commendable especially in appointing reputed members on the Board immediately after the fraud, in order to restore confidence among investors, customers, employees and to revive the company. This initiative by the government also encouraged the stock markets to some extent.

CG aims at protecting the interest of stakeholders, mainly equity shareholders, who provide capital to companies without any assurance of returns. The corporate form of business has entailed huge amounts of capital, which are mobilized by firms in the financial markets. So a robust regulatory framework and its enforcement is the foundation for ensuring good CG. For this, CG codes and regulations have been developed in different countries and issued by stock exchanges, corporations, institutional investors, associations/institutes of directors, various committees and also by regulatory and international organizations. The Securities and Exchange Board of India regulations relating to CG viz., Clause 49 of the Listing Agreement is applicable to listed companies. Clause 49 contains mandatory and non-mandatory CG norms.

Objectives

Good CG requires that a company incorporate elements of Clause 49. Judicious enforcement helps to maintain the overall credibility of a regulatory system. While most listed Indian companies have not reaped the benefits of good CG, several high-performance organizations have implemented initiatives that are noteworthy. So it was decided to carry out a study of CG practices in India. Listed companies having a paid up share capital of Rs. 3 Crore and above or a net worth of Rs. 25 Crore or more at any time in the history of the entity were considered. Such listed companies include public sector units and body corporates i.e., private and public sector banks, financial institutions, and insurance companies. The aforesaid companies are to adhere to mandatory CG norms while adherence to non-mandatory CG norms is voluntary. A total of fifty companies, featuring in the Standard and Poor's (S&P) CNX NIFTY Index, or more popularly, the Nifty, were chosen for the study. These companies are subject to compliance with CG norms and their credibility among investors is pertinent and vital. Another reason for choosing the sample companies is that they are comparatively medium to large in size. An in-depth study of such companies can bring out model practices in CG for other companies to emulate.

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Scope

The scope of the study covered three financial years viz., 2005-06, 2006-07, and 2007-08. The financial year-end i.e. 31.03.2006 is also considered as reporting on CG practices has been made mandatory since then. Fifty companies comprising the S&P CNX NIFTY in each of the years feature in the study, considering the criteria and schedule of implementation of CG requirements. The results of the study should be viewed in the background of limitations such as sample size, sampling technique, prevalent laws and the duration of the study. Publicly disclosed information e.g., in the annual reports is considered as correct, regardless of whether the company followed it or not in actual practice.

Methodology

It was decided to use secondary data of companies that featured in the S&P CNX NIFTY Index at the end of the years 2005-06, 2006-07 and 2007-08. The companies represented diverse industries and sectors. However, while most of the companies selected for the study are from the manufacturing sector, some of them are from service and allied sectors. The Nifty Index comprises equity shares of fifty companies. Twelve companies presently featuring, were not listed at the National Stock Exchange in all the three years as mentioned above. Further, for certain reasons, four companies were excluded from the sample in order to provide a comparable basis for the study and also to discern trends in CG. Eventually, the sample for the study comprised thirty-four companies.

Seeing the nature of the data collected from sample companies, it was decided to adopt Single-Sample Tests involving proportions. For suitability of statistical tests and applications, data were classified into two categories. The first set included those that demonstrated full compliance while the other comprised those whose compliance was either partial or nil. As a part of computation of the Test Statistic, Z score was used.

Findings

A majority of the companies has adhered to most of mandatory provisions of CG as per requirements of Clause 49. However, though a majority of companies complied with the mandatory requirement of certification of financial statements by Chief Executive Officer/Chief Financial Officer, the level of compliance is comparatively lower vis-à-vis other mandatory requirements. Encouragingly, since the year 2005-06, compliance with the certification requirement shows an improving trend. The results further suggest that a majority of the companies has not adhered to all non-mandatory provisions of CG prescribed by the aforesaid clause. A majority of companies has adhered to the non-mandatory provisions of CG with respect to the remuneration committee in all the years studied. However, in case of the whistle-blower policy, the results do not uphold compliance in the year 2006-07 though there is adherence to this requirement in the years 2005-06 and 2007-08. Further, companies follow exemplary CG practices but they do not constitute a majority. However, adherence to such exemplary CG practices over the three years shows an increasing trend, which is heartening.

Conclusion

The picture that emerges is a mixed one as results strongly support a view that there exists compliance with mandatory CG provisions but not so with all non-mandatory provisions and exemplary CG practices.

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Implications

A fallout of the findings is that regulatory attention and if need be, action, are warranted to ensure full compliance with mandatory provisions of Clause 49. Further, regulatory persuasion and self-regulatory impetus are desirable with regard to adherence to non-mandatory provisions of CG, in the larger public interest.

Apart from lack of compliance with non-mandatory provisions of CG, inappropriate size of the Board, lack of formal training to directors in CG matters, lack of evaluation for Non-Executive Directors, a failure to articulate priorities about the protection of interests of shareholders vis-à-vis other stakeholders and the lack of representation of Independent Directors especially on the Board of Government companies may work as barriers to CG reforms.

Sharma Ramroop Krishnapal	Dr. Surendra Sundararajan
(Student)	(Guiding Professor)

CHAPTER 1

INTRODUCTION

Corporate governance (CG) has emerged as a very important ideal. The reason is, today companies are substantially contributing to the overall growth and development, particularly in emerging economies such as India and a healthy investment environment is vital. To overcome the limitations of the partnership form of business, mainly on account of the limited availability of capital, the corporate form of business has gained widespread acceptability, succeeded gradually and expanded worldwide. However, not all companies are managed successfully. There has been a spree of corporate frauds worldwide, e.g., Enron in the United States (US) and more recently in India, Satyam Computers. The latter had accounting and auditing flaws apart from lack of accountability and oversight by Independent Directors at Board meetings. There was no whistle-blowing in case of Satyam Computers unlike Enron. The Satyam Computers revelation was an outcome of a takeover attempt. It eroded the wealth of shareholders. From this fraud it is evident that we need to review the enforcement of CG practices. The role of the Ministry of Corporate Affairs (MCA) as one of the stakeholders in case of Satyam Computers has been commendable especially in appointing reputed members on the Board immediately after the fraud, in order to restore confidence among investors, customers, employees and to revive the company. This initiative by the government also encouraged the stock markets to some extent.

1.1 CG-A Historical Background

The East India Company (EIC) was chartered by Queen Elizabeth-I in 1600.[1] It was one of the earliest manifestations of the modern form of the corporation.[2] When the British government granted the company special privileges to engage in trade with American colonies, small traders in Boston, alarmed at the imminent threat to their livelihood, rebelled and dumped the company's tea into the Boston harbour. The incident provoked a much larger American uprising against bad governance, that threw the British right out of their colonies. Similarly, the Dutch East India Company (DEIC) was granted a royal charter in 1602.[3] The history of EIC and the DEIC exposed the trade and accounting malpractices, resulting in widespread public protests and a subsequent clamour for CG reforms.[4] On account of a failure by the EIC to protect public interest, the East India House in London was attacked and ransacked in 1699.[5] The incorporated form of business was soon followed in Europe.[6] For instance, the Bank of Amsterdam was founded in 1609 to finance corporate trade with the East Indies. These corporations had monopoly provisions. In 1694 the monopoly provisions were also included in a charter granted to the founders of the Bank of England, which was quickly capitalized by public subscription of shares. In the 17th century the emergence of the markets of the West Indies and the East Indies led to the establishment of joint stock companies in Holland and the United Kingdom (UK).[7] In 1711, the South Sea Trading Company was founded to exploit business opportunities in South America.[8] It had an overwhelming response from investors. This company sold an illusion and soon it collapsed in 1720. There were many other such failures and the corporation - as a legal form of business, did not gain much prominence in England at least for the next few decades. Consequently, in 1720, the British Parliament enacted the Bubbles Act, which proscribed unchartered companies from issuing stock.[9] Corporate charters were given by special legislations. For this a corporate applicant had to negotiate with the legislators regarding specific provisions in the charter as for instance, objectives and location of business, and the amount of capital to be raised by the issue of stock. Legislators had to ensure that there prevailed ethical and fair practices by the newly established corporate bodies. In 1773, three years before declaration of independence in America, the EIC influenced the King and Parliament for tax reduction and tax rebates.[10] Similarly in 1773, it obtained a right in England, under the Tea Act that allowed it to trade in US at predatory prices that threatened the existence of several local companies.

Adam Smith was critical about the EIC and other incorporated monopolies.[11] He then believed that the corporation as a creature of privilege was able to disregard laws of market economics and to depend on taxpayer bailouts when it faced financial distress. One of his concerns about the future of the corporations included divergence of interest between managers and investors.[12] In this context he stated, "The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own…Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company".[13] He advocated that joint stock companies would be expedited for 'turnkey operations' i.e., for banks, canal operators and water suppliers, as these operations do not require managerial genius but administrative abilities to which pre-established and well-understood rules would suffice.[14] He believed in the power of self-interest, yet, was pessimistic about the survival of joint stock companies. Smith further stated that “Without a monopoly…a joint stock company, it would appear from experience, cannot long carry on any branch of foreign trade. To buy in one market, in order to sell, with profit, in another, when there are many competitors in both; to watch over, not only the occasional variations in the demand, but the much greater and more frequent variations in the competition…is a species of warfare…which can scarce ever be conducted successfully, without such an unremitting exertion of vigilance and attention, as cannot long be expected from the directors of a joint stock company”.[15] Shareholders quite often demonstrate limited knowledge and understanding of the business of the company.[16] In the context of emerging global markets, it is not possible for owners to oversee the business all the time. So the feasibility of monitoring the affairs of the company becomes an uphill task for the investors. If the investors do not care about their investment and do not monitor the company they have invested in, it is unlikely that professional managers will be able to protect their investments with due care at all times. As has been emphasized, the CG system will not function properly until shareholders step up to their responsibilities as owners and actively engage with the Boards.[17] In this regard, Smith asserted “Frequently a man of great, sometimes even a man of small fortune, is willing to purchase a thousand pounds share in India stock, merely for the influence which he expects to acquire by a vote in the court of proprietors. It gives him a share, though not in the plunder, yet in the appointment of the plunderers of India…. Provided he can enjoy this influence for a few years, and thereby provide for a certain number of his friends, he frequently cares little about the dividend; or even about the value of the stock upon which his vote is founded".[18] The first statute providing for incorporation through registration under a general Act was the Joint Stock Companies Act, 1844 in England.[19] The three main features of this Act were (i) incorporation by registration (ii) compulsory registration and (iii) publicity of affairs of the company. The main drawback of this Act was that it did not provide for 'limited liability' of the members. Until mid 1850s, the entrepreneurial owners of failed companies were mainly responsible for the debts of companies they had set up.[20] The expansion of the British Empire accompanied with expansion of trading entities gave rise to pressures for limiting owners' personal liability. This led to refinement of the UK's Companies Acts of 1855 and 1862 with limited liability. Between 1855 and 1900, fewer than 1,00,000 limited liability companies in UK were formed. However creditors described this limited liability as a protection to the directors and shareholders of companies. They described it as 'rogues charter' and a means of encouragement for speculation, overtrading and swindling. Objections from creditors led to passing of the Insolvency Act 1986. According to this Act, the directors are held responsible if any liability of the company is not paid on the due date, provided the directors know about such an outstanding liability. During the 20th Century, particularly post 1985, the number of limited liability companies multiplied and there were over 20,00,000 registered companies at the Companies House in Cardiff. The UK legal blueprint has been adopted by many countries across the world. Meanwhile, in the US, the merchants founded the New York Stock Exchange (NYSE) in 1792 to trade corporate securities in US.[21] By 1800, there were about 300 companies chartered by states in America. In 1811, the state of New York passed legislation in order to curb bribery.[22] The other states were also required to follow these legislations. In the

US, the Boston Manufacturing Company was the first public company established in 1813 in Waltham, Massachusetts.[23] Evidently, the corporate form of business gained momentum even to the extent that private owners shifted to public shareholding. Consequently, two-thirds of the industrial wealth was accounted for by the public shareholding pattern. Small and medium companies preferred the public company status. Moreover, equity-based compensation attracted executives to work for public companies. After the Civil War, American industries strived to become national by combining businesses.[24] The state corporate law at that time did not allow it. So acquisition of shares was difficult. In 1882 John D. Rockefeller formed the Standard Oil Trust to resolve this issue. The trust was an interstate alternative to the federally chartered corporation and issued trust certificates to acquire oil companies. This move was followed in other several industries and by 1889, the total number of trusts stood at 350. Trust certificates soon became actively traded securities on the NYSE. So in this way, trusts enjoyed sufficient liquidity and appealed to shareholders of companies sought to be acquired as a part of the trusts' expansion strategies. In 1889 the state of New Jersey passed a new flexible corporate law permitting interstate holding companies. Around that time, public opinion swung sharply against trusts. Trusts were not unfair with the public but allegedly not so with business. Consequently, the Congress for the first time intervened directly by passing the Sherman Anti-Trust Act in 1890. In order to avoid the Sherman Anti-Trust Act, most of the trusts transformed into New Jersey based corporations by exchanging trust certificates with shares. Due to this, in American economic history, New Jersey corporations are also often referred to as 'trusts'. The importance of public companies arose. The apparent reason was hindrances in funds mobilization.[25] Availability of adequate capital to finance innovative business ventures was difficult. The reason being, that banks were conservative and had shown reluctance to provide funds to newly established corporate firms. In 1910, Woodrow Wilson, as governor of New Jersey started a series of legal reforms.[26] Consequently, many companies moved and reincorporated across the river, in Delaware, where the original New Jersey holding company law had been implemented. Ever since, Delaware has remained the preferred state for incorporation of large businesses. The Initial Public Offer (IPO) by Ford Motor Company in the US was historical in the context of public ownership (after World War I).[27] About 10 million shares were sold through 722 underwriters. Along with the Ford family, 3,00,000 investors joined as fresh co-owners of the Ford Company. The public offer signalled a shift in American capitalism. Influence of Wall Street (WS) grew rapidly in companies like Ford Motor. WS became a partner with the business families which had to adhere to certain norms. Initially WS did not make high demands as a partner. Later on since the stock market was in a state of flux, WS placed high demands on the families, as it was facilitating the sale of their companies' stock. This market momentum gave a boost to capitalism for the American companies. So the post-war era witnessed a new world order thrust by WS in which average American citizens had turned into stockowners. Since WS was open to all, newer companies like Polaroid and Xerox surged ahead of classical companies like Ford and US Steel. At this point of time a new understanding between promoters and investors began to emerge.

1.2 Emergence of CG

A spate of corporate frauds in Australia, US, and UK in the period from 1960s to 1990s shocked the business world.[28] In the 1960s corporate collapses in Australia led to the formation of committees for strengthening regulatory mechanisms. For instance, the Chambers Committee in 1978 was set up to review the prevailing regulatory mechanisms. The failure of Reid Murray, Mineral Securities of Australia Ltd., Cambridge Credit Corporation Ltd., Associated Securities Ltd., Ariadne Australia Ltd., Westmex Ltd., Bond Corporation Holdings Ltd., Ansett, Pasminco, Harris Scarfe Centuar revealed that the main reasons for corporate collapse have been accounting and auditing manipulations, raising of excessive debt, unnecessary expansion and diversification, inadequate disclosures and inflated profits. The Adelaide Steamship Company Limited, one of the oldest Australian companies, was also exposed as its financial statements did not represent the company's true and fair financial condition. Health International Holidays Insurance Ltd., being the second largest insurance company in Australia with significant importance at national and international level, was also rocked amidst the spree of corporate scandals on account of inappropriate policies and window-dressing and secret reserves. Even the favourable conditions of 1980s could not help Australian companies to come out of these scandals. Similar were the cases with reputed American companies such as WorldCom, Dynegy and K-Mart. The directors of the above bankrupt companies were questioned for their inappropriate decisions.[29] Consequently facing intense pressure, the directors asked the management to inflate earnings within given constraints. In August 1940, one of the sub committees of the NYSE had recommended selection of an independent auditor by the committee composed of directors who were not officers of the company.[30] In 1960s, despite the recovery in the securities markets, there was no major change in the regulations related to CG.[31] The Securities and Exchange Commission (SEC) was the first regulator to recognize that companies not only have to submit financial statements but managers too need to report on forward-looking prospects of the company.[32] Consequently in 1968, the SEC included a report on Management's Discussion and Analysis in the 'Guides for Preparation and Filing of Registration Statements'. In 1970s, there were numerous corporate scandals and the SEC had to investigate such misconduct.[33] The NYSE also supported the idea of audit committees.[34] In the US, instances came to light of companies making illegal political contributions and having bribed government officials. Later on, the Foreign and Corrupt Practices Act was legislated in the US in 1977 and the Act had provisions for the establishment, maintenance and review of internal control.[35] The NYSE formally adopted an 'Audit Committee Policy Statement' in January 1977, requiring its listed companies to establish audit committees.[36] In 1979, the SEC proposed mandatory reporting on internal controls.[37] Before 1980s, the focus of managers was on growth and stability of organizations. Moreover hostile takeovers were rare and so was the case of management ownership of stock options.[38] In 1980, the SEC effected a change in the focus from operating results to financial position by stipulating the requirement of the Management's Discussion and Analysis report.[39] In 1980s, following prolonged neglect of shareholders' interests, a spate of takeovers and restructuring of businesses took place and about 50 per cent of the total companies were the target of takeovers.[40] From 1984 to 1990, firms repurchased their own shares or borrowed funds to finance takeovers. The debt of these companies rose to over 80 per cent of total capital. In 1985, on account of corporate failures in the US, particularly the Savings and Loans Collapse, the Treadway Commission was established.[41] The objective of Treadway Commission was to identify the reasons for misrepresentations in financial statements and to make requisite recommendations. Hence the Treadway Commission recommended adequate controls, independent Audit Committees and objective internal audit. Accordingly, the Committee of Sponsoring Organizations (COSO) was born. The report on control given by COSO in 1992 was refined and endorsed in four subsequent UK reports i.e., Cadbury, Rutteman, Hampel and Turnbull. The performance of US companies in terms of CG was considerably inferior compared to German and Japanese firms.[42] By the end of 1990s companies such as International Business Machines, General Motors and Sears incurred huge losses. Investment decisions in low-return projects and diversifications led to lower earnings. This caused agony among stakeholders. Also massive investment in internet and telecommunications had led to rapid expansion in the economy. However, by 2000, the share prices bubble had burst and the economy had a setback.[43] In July 2002, the Sarbanes-Oxley (SOX) Act brought about significant changes in CG in publically traded companies.[44] The NYSE and the National Association of Security Dealers Automated Quotation System also changed listing requirements. The impact of SOX Act is on three areas, viz., executive compensation, shareholder monitoring and board monitoring.

In UK also, on account of financial collapses in the late 1980s and early 1990s, the London Stock Exchange set up the Cadbury Committee in 1991, for strengthening the role of self-regulation, to avert such debacles.[45] The impact of the Cadbury Committee report on the financial aspects of CG has been dramatic.[46] The crux of the Cadbury

Committee report is that the commitment and capability of Non-Executive Directors is critical for the effective functioning of the Board, in order to attain the highest standards of CG. It led to the establishment of various committees on CG world-wide.[47] The CG committees' recommendations are based on the environment and historical background pertaining to businesses, prevalent in the respective countries. These concepts related to particular business environment in a country can be, collectively and formally called "Corporate Governance Theories" (Exhibit 1.1). The major committees on CG were the King Committee (South Africa, 1994), and those of The Toronto Stock Exchange (Canada, 1994), Australian Association of Investment Mangers (Australia, 1995), International CG Network (1995); Centre for European Policy Studies (Brussels, 1995); The Vienot Committee (1995); Greenbury Committee (UK, 1995), Davis Global Advisors Inc. (1996) and The Hampel Committee (UK, 1997).

EXHIBIT 1.1
FOCUS AND THEORETICAL UNDERPINNINGS OF UK CORPORATE GOVERNANCE REPORTS AND CODES

Committee	**Year**	**Focus**	**Theoretical Underpinning**
Cadbury	1992	Financial aspects of corporate reporting	Agency Theory
Greenbury	1995	Directors' remuneration and disclosures	Agency Theory
Hampel	1998	Implementation of Cadbury and Greenbury	Agency, Stakeholder Theory
Combined Code	1998	Incorporating various elements of prior codes	Agency, Stewardship
Turnbull	1999	Internal control requirements	Agency, Transaction Cost Economics
Myners	2001	Institutional investors	Agency Theory
Higgs	2003	Non-Executive Directors	Agency Theory
Smith	2003	Audit Committees	Agency Theory
Combined Code	2003	Revision including recent codes	Agency, Stakeholder Theories

Source: Adapted from Mallin, C., *Corporate Governance*, Oxford University Press, 2004 cited by Rolph, N. S. Balgobin, "Global Governance Practice: The Impact of Measures Taken to Restore Trust in Corporate Governance Practice Internationally," *The Icfai Journal of Corporate Governance*, Vol. VII, No. 1, January 2008, p. 9.

In June 1997, as the currencies of Thailand, Indonesia, Malaysia and South Korea started plummeting, the investors and the World Bank (WB) realized that apart from corporate management, good CG was equally essential.[48] The importance of CG was further emphasized on account of the collapse of Xerox (Exhibit 1.2), Tyco and many other leading companies.[49]

EXHIBIT 1.2

SELECTED CASES OF CORPORATE FRAUD

Company	**Year**	**Audit Firm**	**Country**	**Notes**
Nugan Hand Bank	1980	PW	Australia	Money laundering; organized crime
Robert Maxwell	1991	Coopers & Lybrand	UK	Falsifying receivables' numbers to inflate sales, beat the market
BCCI	1991	PW; E &Y	UK	Fraud and corruption; underworld links
Barings Bank	1995	Deloitte & Touche and Coopers & Lybrand	UK	Fraud
Xerox	2000	KPMG	USA	Falsifying financial results
Enron	2001	Arthur Andersen	USA	Falsifying financial results
Dynegy	2002	Arthur Andersen	USA	Round trip trades
Kmart	2002	PW	USA	Misleading accounting practices
Qwest Communications	2002	Arthur Anderson	USA	Inflated revenues
WorldCom	2002	Arthur Andersen	USA	Overstated cash flows
Parmalat	2003	G & T	Italy	Falsified accounting papers
Satyam Computer Services	2009	PW	India	Falsified accounts

Source: Kar, Pratip, "Capital Concerns - Patterns in Governance Failures," Issues and Insights, *Business Standard*, Ahmedabad, 13th April 2009, p. 12.

The Higgs report on Non-Executive Directors and the Smith report on Audit Committees published in January 2003, constituted a part of CG reforms in UK and Europe.[50] Further, in April 2004, the government of thirty Organization for Economic Co-operation and Development (OECD) countries approved a revised set of its principles of CG. The principles focused on awareness among institutional investors and enhanced role of shareholders in executive compensation, thereby ensuring public trust, transparency and disclosures. So CG emerged mainly on account of a failure by companies across the world, particularly in UK and US, to protect the interests of their shareholders.

1.3 CG

According to Webster's Dictionary the term 'Corporate' means a body having the nature of, or acting by means of a corporation.[51] The term 'Governance' is derived from the word Gubernate, means to rule or steer. Even though the term governance is from political science, these days it is also debated under public administration. In common parlance, CG means protecting interests of shareholders but not at the cost of other stakeholders. However, there are varied opinions about the terms 'Management', 'Governance' and 'Administration'. The term 'Management' in the context of CG means "executing strategic as well as all other decisions taken by the Board'. The Chief Executive Officer (CEO) is entrusted with the responsibility of managing the day-to-day affairs of business in consonance with the decisions of the Board. Moreover, in management, there is a hierarchy, where the CEO (being senior executive with managerial roles and responsibilities, is also a part of the Board) is on the top of the managerial pyramid, delegating authority and responsibility for management functions downwards while demanding accountability upwards (Figure 1.1). The term 'Management' is mostly referred for businesses with the profit motive. As explained by Carver, Governance is a subcategory of ownership, not a branch of management; the Board is owner-representative.[52] The authority of ownership can be passed into the organization via the Board. The Board cannot have a boss for regular guidance, the way managers have.

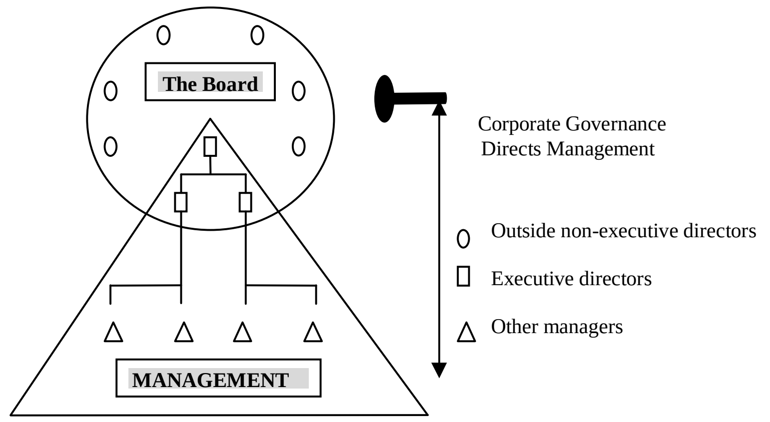

FIGURE 1.1
Governance and Management Distinguished

Source: Tricker, Bob, *Essential Director (The Economist)*, Replika Press Pvt. Ltd., Kundli, 2004, p. 3.

The term 'Governance' denotes a controlling or ruling function, which is the sole responsibility of the Board of Directors. The accountability of 'Governance Function' is higher than the accountability of 'Management Function'. The reason is, management is accountable to the Board while the Board is accountable to the management for taking timely decisions as these decisions are to be executed by the management. Simultaneously, the Board is also responsible to equity shareholders for implications of the decisions so made. The term 'Administration' means compliance with specific rules and procedures. The term 'Administration' is also used in the context of non-profit businesses.

In general CG reforms have significantly focused on the relationship between the management and the Board particularly on separating these two functions for effective management and hence may lead to greater transparency.[53] The Board members usually may not get enough time and the management has to manage the day-to-day affairs. So the role of CG becomes more pertinent. Further, the reforms cover the implications of risk-return relationship between management and shareholders to some extent. However, limited focus has been given to the implications of risk-return relationship between the Board and shareholders. Lack of accountability of the Board of Directors and inadequate information to the shareholders (Figure 1.2), results in weak controls.

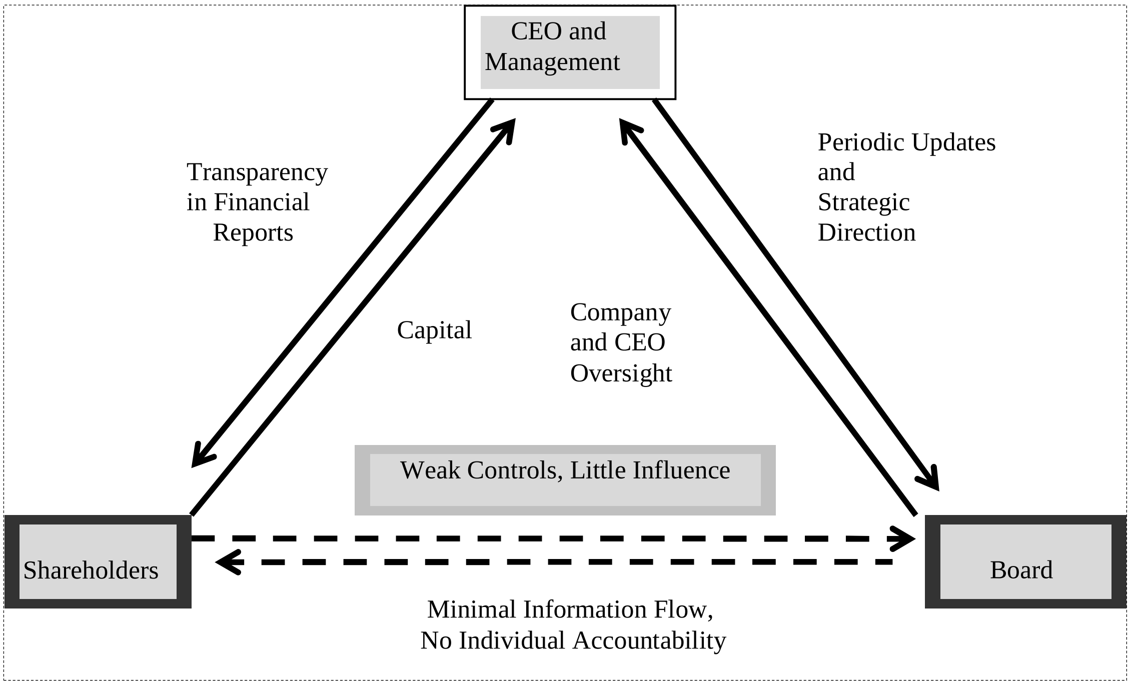

FIGURE 1.2
The CG System

Source: Cynthia, A. Montgomery and Rhonda Kaufman, "The Board's Missing Link," *Harvard Business Review*, March, 2003, p. 89.

A broader view of CG can be grasped from some of the following definitions:

According to Milton Friedman, "Corporate Governance is to conduct the business in accordance with owner or shareholders' desires, which generally will be to make as much money as possible, while conforming to the basic rules of the society embodied in law and local customs".[54] This definition clearly emphasizes the focus on the interests of shareholders without jeopardizing the interests of stakeholders (law and local customs). Support for the view can be found in the following statement of Adam Smith: "By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good".[55]

The Cadbury Committee's definition is: "Corporate Governance is a system by which companies are directed and controlled".[56]

Shleifer and Vishny define it as "The ways in which suppliers of finance to corporations ensure themselves of getting a return on their investment".[57]

In his preface to the World Bank publication, *Corporate Governance: A Framework for Implementation*, Sir Adrian Cadbury states the following: "Corporate Governance is… holding the balance between economic and social goals and between individual and community goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of these resources. The aim is to align as nearly as possible the interest of individuals, corporations and society. The incentive to corporations is to achieve their corporate aims and to attract investment. The incentive for states is to strengthen their economies and discourage fraud and mismanagement".[58]

Maw *et al.,* sum up the evolution of CG as "Some commentators take too narrow a view, and say it is (Corporate Governance) the fancy term for the way in which directors and auditors handle their responsibilities towards shareholders. Others use the expression as if it were synonymous with shareholder democracy. Corporate Governance is a topic recently conceived yet ill-defined and consequently blurred at the edges…Corporate Governance is a subject, as an objective, or as a regime to be followed for the good of shareholders, employees, customers, bankers and indeed for the reputation and standing of our nation and its economy".[59]

James Wolfensohn, the former president of the WB said "Corporate Governance is about corporate fairness, transparency and accountability".[60]

OECD defines thus "Procedures and processes according to which an organisation is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organisation - such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision-making".[61]

According to Tricker, "Broadly, Corporate Governance is about the way power is exercised over corporate entities".[62]

Apart from the CEO, the role of Independent Directors and auditors is crucial. Though societal (stakeholders) interests cannot be ignored, economic considerations and shareholders' interests are the priorities as a business enterprise is created by the profit motive. To what extent societal interests are to be considered, depends on the discretion of the company, including its financial position. Hence, the scope of CG is wide and encompasses not only the interests of shareholders but also the interests of other stakeholders as presented in Figure 1.3.

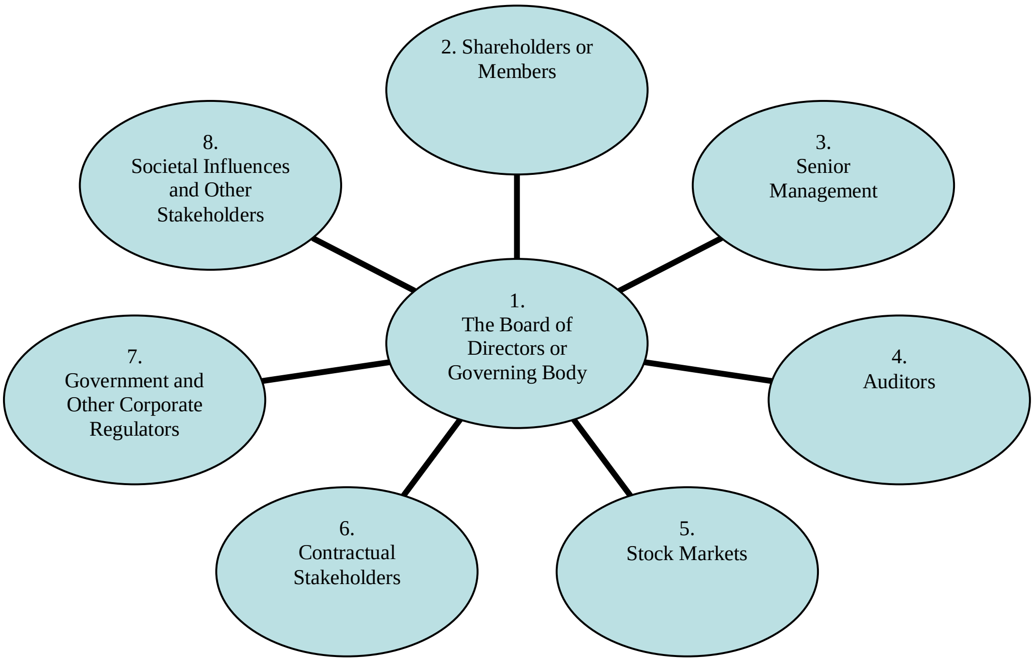

FIGURE 1.3
Scope of CG

Source: Tricker, Bob, *Essential Director (The Economist)*, Replika Press Pvt. Ltd., Kundli, 2004, p. 5.

Ethics plays a crucial role in CG. Lack of ethics in CG gives ample scope for companies to mislead stakeholders and simultaneously raise doubts about the efficacy of the system of CG. However an emphasis on ethics does not mean a compromise on profits. Bruce Weinstein says "Being ethical ultimately means taking the interest of others as seriously as your own and considering consequences of your words and actions".[63] In this regard, Peter Drucker said, "there is neither a separate ethics of business, nor is one needed; for men and women do not acquire exemptions from ordinary rules of personal behaviour at their work or job. Nor do they cease to be human beings when appointed vice-president, city manager or college dean. And there have been a number of people who cheat, steal, lie, bribe or take bribes. The problem is one of moral values and moral education of the individual, of the family, of the school".[64]

1.4 CG Models

The historical records relating to securities market in India, though deficient, indicate that loan securities of the East India Company were traded towards end of the 18th century.[65] By 1830s, trading in shares of banks commenced. In 1850, the Companies Act introducing limited liability was enacted, announcing the era of joint stock company which boosted trading volumes.

1.4.1 MANAGING AGENCY SYSTEM

In India, corporations emerged from the managing agency system.[66] In this system the terms, 'Managing Agent' and 'Managing Agency' were used for individuals and business firms that entered into a legal contract with joint stock companies to manage the affairs of the latter. The managing agencies were established by the business families. These business families took to the managing agency system for two reasons: (i) managing agency system provided a quick turnover on capital and (ii) a small sum of capital to be spread over a large number of ventures. Overall, the managing agencies facilitated actions such as establishment and management of companies, and executing finance functions, when the capital markets and credit system were underdeveloped.

Since most managing agencies were established as partnerships involving members of a single family, this relationship between the agency and the business family established the foundation for the family-controlled conglomerates that have dominated the Indian economy since independence. In this model corporate control led from the individual to the joint stock company and a parent or apex company. Profits were generated not due to productivity or innovations but on account of market imperfections, price fluctuations, wars, famines and artificial scarcities. Profit-making in this fashion highlighted the ad hoc-nature of business. The laissez-faire capitalism, which facilitated industrial development to some extent in the western countries, did not work out in India's colonial context. Moreover, managing agents deprived shareholders of their basic rights and ignored their voice in managing affairs of the firms. So, the process of industrialization failed to generate wealth either in the form of wages or dividends, for the concerned stakeholders.

1.4.2 BUSINESS HOUSE MODEL

According to the Business House Model, after independence the Indian government adopted an interventionist approach to development, with the intent to accelerate industrialization and growth.[67] The managing agents capitalized on new business opportunities by promoting new business ventures. The promoters of such ventures became the key players in India's post-colonial business sector providing the basis for the emergence of conglomerates.

1.4.2.1 A Shift from the Business House Model to the Anglo-Saxon Model. Many large corporations thrived under the Business House Model.[68] Examples are the Birla and Tata groups. They managed to grow and enter new areas of business. But, a change was triggered in the 1980s, when the Indian economy was hit by a crisis. Some reasons for such crisis include low foreign exchange reserves, high fiscal deficits, huge losses suffered by Public Sector Enterprises and inflating subsidies. Low foreign exchange reserves and huge deficits forced the Indian government to approach the International Monetary Fund (IMF) and the WB. The WB's assistance arrived first, viz., US $500 Million in the form of a structural adjustment loan, that warranted a comprehensive reform programme. The IMF loan, of US $1.78 Billion, put an end to the interventionist period and brought in the era of neo-liberal economic reforms in India. These reforms include changes in company law, financial and banking sectors, foreign investment and the industrial policy. This led to a shift from the Business House Model to the Anglo-Saxon Model[*] of CG (Exhibit 1.3). As Louis Lavelle stated in the context of changes in the US, and which had relevance to developments in India: "Almost overnight, Boards that were at the CEO's beck and call became more independent, skeptical and determined than ever to hold top executives accountable. As revolutions go, not a bad start".[69] The salient features of this model are dispersed ownership, professional managers, separation of ownership and management, passive institutional investors with short-term orientation to hold equity stock, comprehensive disclosures and an active market for corporate control.

There were significant hostile takeover activities in the US and the UK also during the period 1976-1990. As Jensen pointed out, the mergers and acquisitions activity enriched selling-firm shareholders by more than $700 Billion (at 1992 prices), and precipitated the political and legal reaction against takeovers.[70] The Anglo-Saxon Model

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[*] Anglo-Saxon Model is also referred as the Anglo-American Model.

has been described as a "High-Tension Model" because of the important role of the CEO, active capital markets, short-termism, and credible takeover threats.[71] The Anglo-Saxon Model can be found in the former British colonies.[72] There are subtle differences in CG in US and UK: the UK is a proponent of self-regulation in CG, unlike the US.

EXHIBIT 1.3
CG IN INDEPENDENT INDIA

Feature	The Business House Model	The Anglo-American Model
Formal structure of governance	Single-tiered Board of Directors	Single-tiered Board of Directors
	Role for Nominee Directors	Reduced role for Nominee Directors with a move toward abolishing Nominee Directors altogether
Macro-economic milieu	Direct government intervention in capital markets through pricing of corporate securities	Anglo-Americanization of capital markets with deregulated pricing of corporate securities
	Development banking - heavy use of financing from public financial institutions (PFI)	A more 'marketised' model of development banking; banking system continued toward profit generation - but for finance it depended on PFIs
	Protected, non-competitive product markets	Limited reduction in protection
	Stringent controls on foreign ownership as well as portfolio investment	Relaxed controls on foreign ownership as well as portfolio investment
	Regulation of foreign exchange expenditure by firms	Reduced regulation of foreign exchange expenditure by firms
	License-permit-quota regime	Abolition of license-permit-quota regime
	No buybacks of its own shares by a firm	Firms allowed to buyback their own shares through open-market operations; formulation of the Takeover Code and the CG codes
Control Proximate	Minority ownership (of group companies by the apex company)	Minority ownership (of group companies by the apex company)
Ultimate	Majority ownership (of apex company by controlling family)	Majority ownership (of apex company by controlling family)
Other mechanisms of control	Interlocking Boards Inter corporate investments Debt financing through PFI Discouraging shareholder participation Control of share offerings	Interlocking Boards Inter corporate investments Private (or regulated) placement of stocks Mergers (of group firms) Encouraging shareholder participation

Source: Adapted from Reed, D., "*The Three Historical Models of Corporate Governance: An Evaluation of Corporate Economic Responsibility in India,"* (IIM Calcutta), 1998, cited by Mukherjee, Ananya Reed, "Corporate Governance Reforms in India," *Journal of Business Ethics*, May 2002, Vol. 37, No. 3, p. 259.

In UK, a company has to either comply with or explain CG, while in US it is binding for companies to comply with the SOX Act, 2002. As control and ownership are distinct, the ownership is widely dispersed among the shareholders, so this model is also called the Outsider Model. It is called the Principal-Agent Model because the shareholders (principal) entrust management of the firm to the managers (agents). This model is characterized by an effective and powerful CEO, but, existence of the agency issues and absence of bank control over management. The said salient features of the model determine the CG structure in the Anglo-Saxon countries (Figure 1.4). In this model, it is apparent that the general committee of the stockholders is the highest body in the structure, authorized for appointment and dismissal of the Board of Directors.

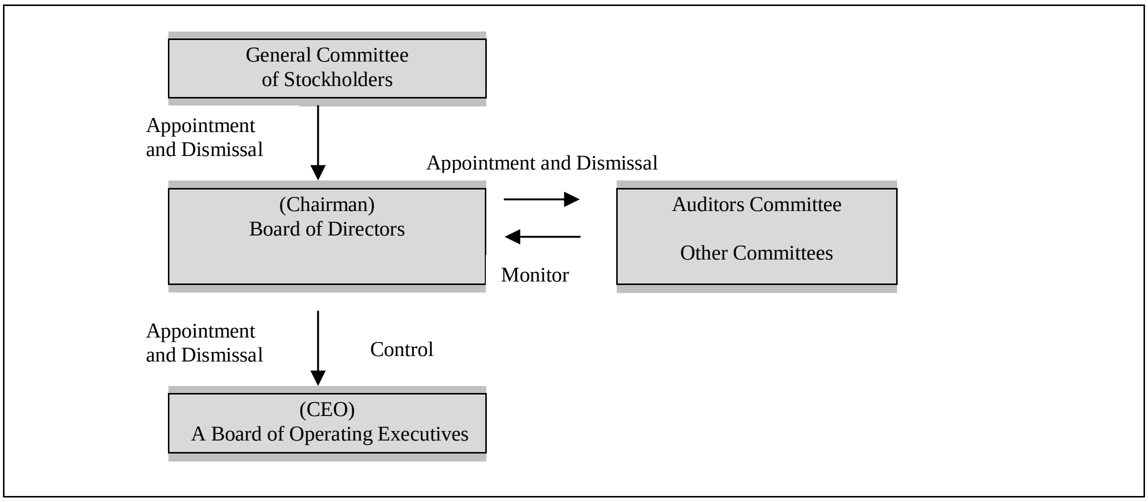

FIGURE 1.4
Typical American Governance Structure

Source: Masami, Atarashi, "Corporate Governance-A Japanese Perspective," Focus, *Productivity*, Vol. 40, No. 4, January- March 2000, p. 513.

It has a unitary (single-tier) Board structure (Figure 1.5). The Board of Directors appoint different Board committees including Audit Committee, by delegating authority and responsibility to such committees for smooth functioning of the company. According to this model, there is ample scope to dismiss the CEO, if his performance is poor. This model provides the highest level of transparency compared to other major models (German and Japanese). In this case, directors can directly intervene and in fact they are entrusted with the control function of executive management. However, this model's focus is on the interest of shareholders.

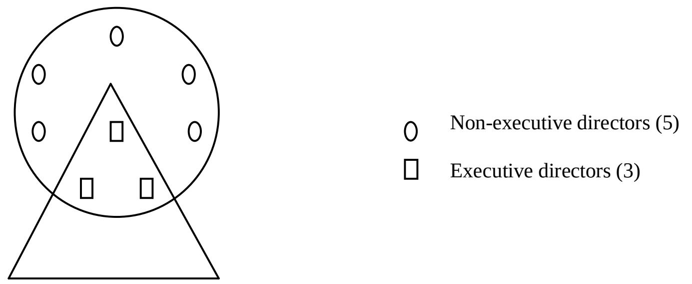

FIGURE 1.5

Unitary (single-tier)/The Majority Non-Executive Board Structure

Source: Tricker, Bob, *Essential Director (The Economist)*, Replika Press Pvt. Ltd., Kundli, 2004, p. 41.

1.4.3 INDIAN AND SOUTH ASIAN MODEL

A study of a small sample of Indian companies brought out the following:[73]

The features of the Indian (South Asian) Model of CG are: dominant promoter-shareholders, promoter-CEO, diluted principal-agent relationship and the need for additional protective measures by the market regulator i.e., by the Securities and Exchange Board of India (SEBI) in India. The features of this model indicate a remote possibility, if at all, of a conflict between: (a) promoter-shareholder and agent (managers) and (b) promoter-shareholders (for e.g., promoter-directors) and retail shareholders.

1.4.4 THE CORPORATION AS A 'CONTRACT' MODEL

Hart observes that every business organization, including the corporation "represents nothing more than a particular 'standard form' contract".[74] Theoretically, the problems of CG arise from the existence of incomplete contracts. Contracts spell out each participant's rights, duties, benefits and obligations. There is no presumption of a superior claim for one class of claimants over another. The claimants must get benefits according to their bargains and contracts with the firm, no more and no less. The bargains by the claimants differ between firms and depend on situations. Therefore the rules of CG are aimed at filling in the gaps left in these contracts, in congruence with the corporate goal. While doing so, the directors owe corporate fiduciary duties to the corporation and its shareholders.[*]

1.4.5 THE GERMAN MODEL

The notable feature of this model is that the banks in Germany have major influence on CG as they provide finance to the German companies.[75] Due to this, it is also referred to as a Bank-Oriented System of governance. It is more of an institution-oriented structure. The system of CG based on Germanic civil law is called Insider

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[*]The corporate fiduciary duty is a principle that fills gaps in the corporate contract. (As defined by Easterbrook and Fischel cited by Smith, Thomas A., "The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty," *Michigan Law Review*, Vol. 98:214, p. 216 available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=195588&http://www.ask.com/web?q=Maccy%2C+Jonathan+R.+fiduciary+duties%2C+%E2%80%A6.available+at+www.&search=&qsrc=0&o=10148&l=dis&tpr=1, website accessed on 04.5.2012, 9.05 a.m.

Model.[76] There is concentrated ownership which perhaps explains Germany's less developed stock market. In this model, the agency problem does not arise as firms are only coordination devices, aligning self-interest with that of the stakeholders. There is a Dual Board (Figure 1.6), the Supervisory Board (i.e., Supervisory Directors) and the Management Board[*] (i.e., Executive Board Members).

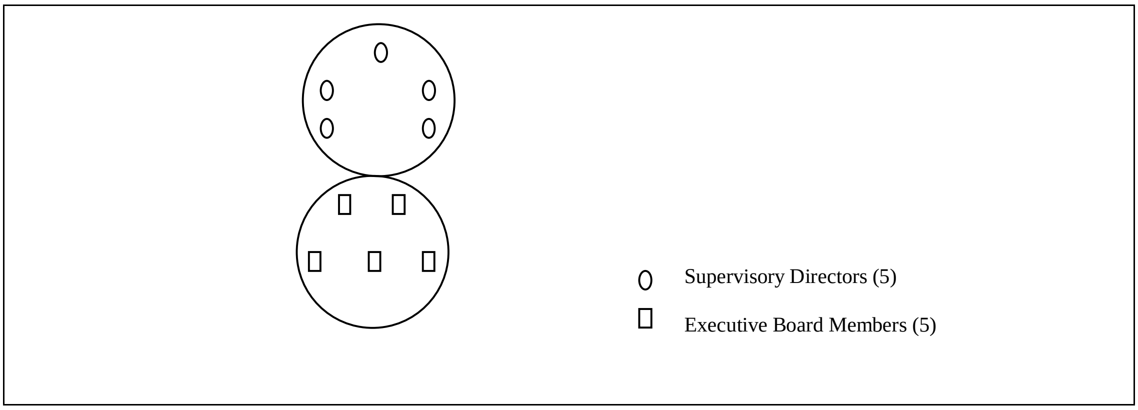

FIGURE 1.6

The Dual (Two-Tier) Board Structure

Source: Tricker, Bob, *Essential Director (The Economist),* Replika Press Pvt. Ltd., Kundli, 2004, p. 42.

The Supervisory Board is responsible for accounting aspects, strategic acquisitions and closures, dividends and appointment to the Management Board. The Management Board is responsible for running the company. The companies are closely associated with a Universal Bank that owns shares and the bank has Board representation. For most of the decisions, the consent of the Universal Bank is required. The power of the top management in this model is less than that in the Anglo-Saxon Model. In the European Model, there is a relatively compact group of shareholders having control over the corporation unlike the East Asian Model in which the founding families hold the

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[*] Known as *Aufsichstrat'* and '*Vorstrand'* in German Model.
Source: Vishwanath, S. R., "Corporate Governance," in Chandrasekhar, Krishnamurti and S. R. Vishwanath (Eds.), *Advanced Corporate Finance*, PHI Learning Pvt. Ltd., New Delhi, 2009, p. 360.

controlling shares directly or indirectly through pyramids or cross holdings. The above mentioned features support the dual-structure of German CG (Figure 1.7), based on joint decisions.[77] The hierarchy includes general committee of stockholders, Audit Committee (referred to as, Auditors Committee) and a Board of Directors. An Auditors Committee performs a checking function, while the Board of Directors performs operational function. The highest legal position is designated to the Auditors Committee, based on mutual decision and participation of labour is mandated. The Auditors Committee comprises representatives of stockholders elected by the general committee of stockholders and representatives of labour elected by the employees. The Board of Directors is appointed by the Auditors Committee and the Board carries out the operating function under the supervision of the Auditors Committee. So the Auditors Committee and the Board of Directors are separate and one member cannot have dual positions simultaneously.

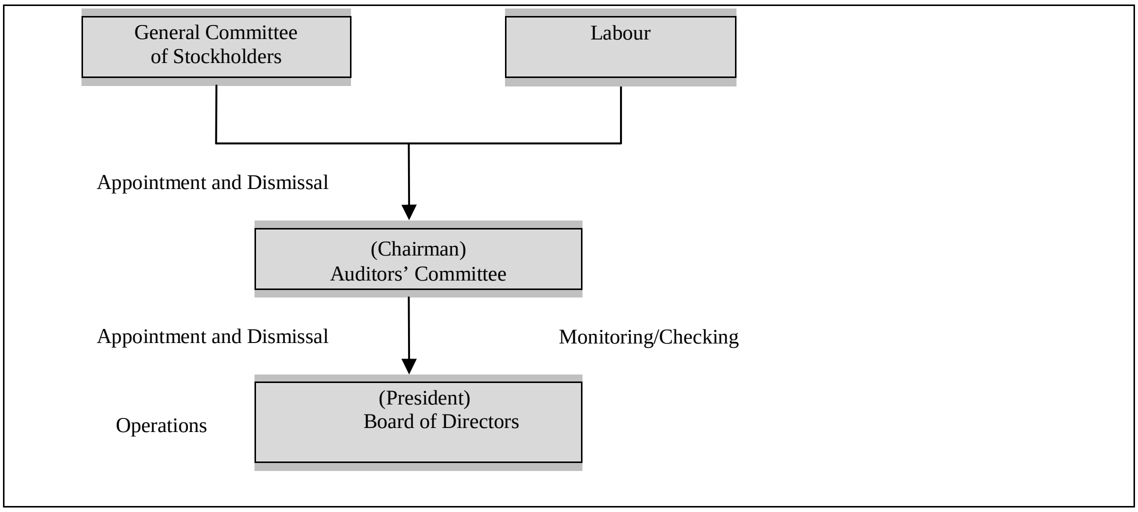

FIGURE 1.7

Typical German Governance Structure

Source: Masami, Atarashi, "Corporate Governance-A Japanese Perspective," Focus, *Productivity*, Vol. 40, No. 4, January- March 2000, p. 514.

1.4.6 THE JAPANESE MODEL

The Japanese CG is also characterized by the dual structure i.e., the Board of Directors and the Representative Directors. The Representative Directors carry out operational functions. The auditors and the Board of Directors, who check Representative Directors, perform the checking function (Figure 1.8). In this model, stockholders are positioned at the top as they have the highest power to elect the Board of Directors. The Board of Directors in turn elects Representative Directors, checks their operations and performance and entrusts them responsibility to manage the company. The general committee of stockholders reserves the right of removal of directors and makes the auditors responsible for scrutinizing the operations overseen by directors.

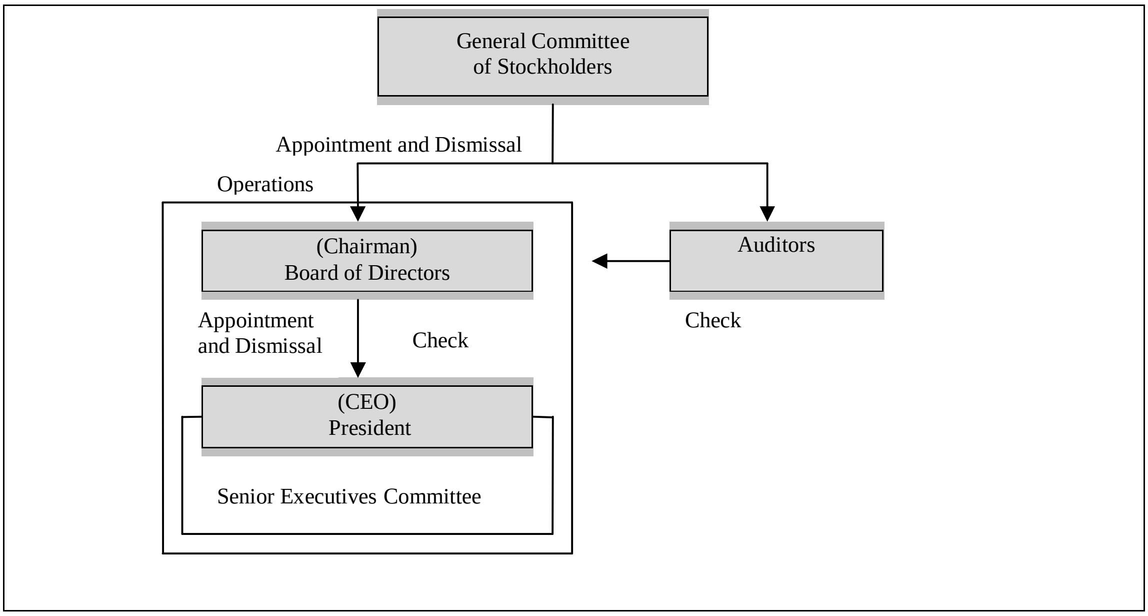

FIGURE 1.8

A Typical Japanese Governance Structure

Source: Masami, Atarashi, "Corporate Governance-A Japanese Perspective," Focus, *Productivity*, Vol. 40, No. 4, January-March 2000, p. 515.

In addition to this, large companies also set up their own operational bodies known as 'Jyomukai', i.e., the Management Committee (Senior Executives Committee). The CG structure in this model is characterized by a high presence of corporate or institutional stakeholders, decreased role of main banks and labour unions.

1.4.7 THE OPEN ENTERPRISE MODEL

In this model, firms are expected to be actively transparent but where they manage their critical competitive information and security.[78] Creating value for all stakeholders is the goal of these enterprises. These firms demonstrate high standards of integrity, and infuse trust, global stability and social justice. This model contains four steps which run in a sequence. The first step pertains to honesty, accountability and transparency. These factors help the firm to build a foundation of trust, which is the second step. In today's environment, the firm can build trust by correctness of conduct, which in turn kindles reciprocal obligations and inspires good values and proper behavior, so essential for the various classes of stakeholders. The third step is building healthy relationships. Individuals today have greater access to information, about the organization and this engenders a new kind of relationship among them. Stronger relationships help the firm to fortify values and thus succeed in the long run. The final step in the model relates to values and integrity. Integrity is based on honesty, accountability and transparency. Integrity is at the core of value creation, through the firm's superior competitive strategy and competitive advantage.

1.4.8 THE FOUR P_S MODEL

This model recognizes four vital aspects of CG i.e., four Ps viz., People, Principles, Process and Practice. According to this model (Figure 1.9), if all 4 Ps are satisfactorily met, preferably in sequence, the result will be good CG. The first P, i.e. “People” is the most important aspect in the CG process. “People” here mean CEO, Chief Financial Officer (CFO), Directors, Auditors, and Shareholders or any combination of these, who are the important actors in CG. For instance, inadequacy of the first P, will have adverse consequences on the fourth P, hence effectiveness of the second and third Ps will be blunted. It is the first P, i.e., People, who make principles, set up the requisite processes and practice principles. So there is an urgent need to recognize the importance of human values, whether in the Board meetings, or dealing with the external auditor or providing protection to the shareholders interests.

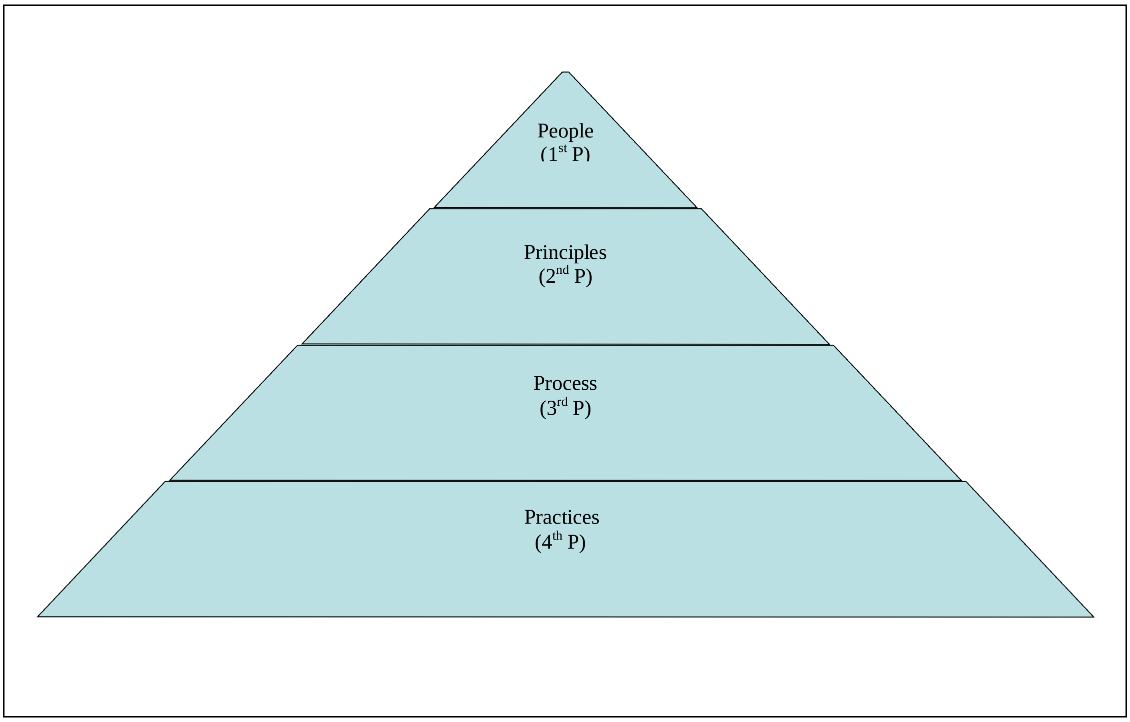

FIGURE 1. 9

The Four Ps Model

Further, corporate leaders nurture their most valuable asset, the human resources.[79] If people have ethical values, probability of frauds reduces.

1.4.9 THE PRIVATE-EQUITY MODEL

The governance structure at top private equity firms has been widely studied by finance academicians. The typical Board of a private-equity controlled company has a few (say five to eight) members, a Non-Executive Chairperson, and only one Executive Director.[80] The Non-Executive Directors include financiers and individuals with strong management and industry experience. The Board of Directors has significant equity-based incentives, either through direct share ownership or an incentive structure in the form of appreciation in share value (Figure 1.10). The approach of private equity to reorganization is useful with a corporate coordination and control framework to address the dual problem of managing information and incentives in large organizations.[81]

The framework identifies three elements of organizational structure: (1) the allocation of decision rights i.e., who is going to make what decisions? (2) internal performance measurement i.e., how is success specified for the company, business units, and for individuals, and (3) incentives and disincentives, including promotion and compensation systems.

According to this model, the four principles for foundation of the reorganizing approach taken by the best private-equity firms are as follows.[82] (i) Governance by a small Board of Directors with significant equity ownership; (ii) decentralizing decision-making; (iii) adoption of new performance measures that stress cash flow and long-run value; and (iv) adoption of a new management compensation system that includes:-

a) higher levels of remuneration, with more pay at risk,

b) bonuses based on cash flow and or value addition, and

c) significant percentage of management-equity ownership.

Weak Corporate Governance

Focus on size and growth rather than value, weak internal capital markets

↓

Underperformance

↓

Pressure from the Market for Corporate Control

Hostile Takeover Offer, Leveraged Buy-Out as an Alternative

↓

Asset Sales, if necessary, Private Equity-Style Governance: High leverage facilitates concentrated equity ownership

Changes in Organizational “Rules of the Game”

1) Decision Rights Decentralized

2) New Performance Measures focus on cash-flow rather than EPS and on firm value rather than size or growth

3) Rewards that align Incentives with bonuses based on new performance measures and management-equity ownership

↓

Improved Strategy and Decision-Making

Utilizing valuable specific knowledge through effective decentralization allocating capital more efficiently

↓

Improved Performance and Value Creation

FIGURE 1.10

Reorganizing the Firm for Value

Source: Wruck, Karen H., “Private Equity, Corporate Governance and the Reinvention of the Market for Corporate Control,” *Journal of Applied Corporate Finance*, Vol. 20, No. 3, Summer 2008, p. 15.

1.4.10 THE HYBRID MODEL

This model recognizes the possibility of application of principles and practices of CG based on any combination of the models referred to previously. The likelihood of this model will be in a situation, where no one particular model is suitable or the patterns and nuances of business conduct are too diverse and go beyond the scope of any other existing model. A group of scholars believe that there is some convergence of CG towards a Hybrid Model, based on blending and adoption of best practices among countries.[83]

1.4.11 CONVERGENCE MODEL

Economic efficiency, due to globalization will ultimately cause varying CG structures around the world to converge in terms of the rules and forms, or in terms of the functions.[84]

1.4.12 PATH-DEPENDENCE MODEL

According to this model, the evolution of CG system is path-dependent i.e., convergence of CG is barred by the national history trajectories and political considerations.[85]

The German Model (Insider System) of CG is appropriate in a situation where commitment between stakeholders is vital.[*86] The Anglo-Saxon Model (Outsider System) of CG is more appropriate where technological progress is fast.[**] In the last decade, India has been moving towards adoption of the Anglo-Saxon Model of CG.[87] The reasons

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* The German Model is also referred as Bank Based System of CG.

** Anglo-Saxon Model is also referred to as Market Oriented Model of CG because of dispersed equity ownership.

include global political-economy pressures and problems emanating from the previous model, viz., the Business House Model of CG.[88] Further, it gives importance to shareholders' interest and promotes product-market competition. The move to the Anglo-Saxon Model can help conglomerates to maintain control of their business provided their business still remains competitive. Most features of the Anglo-Saxon Model exist in the Indian corporate scenario barring a few, such as the dispersed equity ownership. In the Anglo-Saxon Model agency issues exist between managers and shareholders. In the Indian context, agency issues are less between managers and shareholders, and more between dominant shareholders (promoters) and minority shareholders. These features of CG in India are expected to exist, at least in the foreseeable future. However in India, the regulatory mechanisms and market for corporate control[*] seem similar as in the US and UK. Also, the Indian Companies Act, 1956 is largely based on the provisions of English company law. Therefore, Indian CG system significantly follows the pattern of the Anglo-Saxon Model.[89] The 1990s economic reform policies are closely related to the Anglo-Saxon Model, characterized by a single-tier Board structure, where directors are representatives elected by shareholders and a strong dependence on capital markets that works as a disciplinary tool.[90] The Anglo-Saxon Model is based primarily on the Agency Theory, with a unitary-Board and it seeks to focus on the interests of shareholders.[91]

Implementing policy measures with a view to improving CG is significantly more difficult than just devising them.[92] Various policy proposals have been advocated in the past but never effectively enforced. It is widely believed that business families in India use various devices to influence public policy so as to continue to maintain control of

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[*]Existence of a market for corporate control means a business environment in which acquisitions and mergers can freely take place.

their empires. Thus, if governance reforms occur on a larger scale encompassing political and legal reforms, then society would be in a position to exercise effective control over corporations.

1.5 CG Theories

The CG theories are as follows:

1.5.1 AGENCY THEORY

Traditionally, economists assumed that managers, shareholders, bondholders, and other stakeholders in a company strived to promote the common good.[93] In recent decades, financial economists have studied in depth, the likely conflicts of interest among various stakeholders and the ways to resolve such conflicts. Collectively, these ideas are termed Agency Theory.[*] The theory is essentially concerned about developing the optimal contractual relationship and to harmonize the disparate expectations in order to maximize the effectiveness of all interest groups.[94]

According to Jensen and Meckling "Agency theory involves a contract under which one or more persons (the shareholders) engage another person (the directors) to perform some service on their behalf which includes delegating some decision-making authority to the agent. If both parties to the relationship maximize utility, then there is good reason to believe that agent will not always act in the best interests of the principal".[95] According to Rappaport, the proposition that the business strategies should be assessed in terms of the economic value they yield to shareholders is well accepted in

[*] Agency Theory is also known as 'The Shareholder Value Perspective'.

the business community. In other words, to suggest that companies be managed in the best interests of their owners is hardly disputable.[96] However, managers may not act in ways that maximize the wealth of shareholders.[97] If managers and directors do not act to maximize firm value, then they are likely to face threats of takeover.[98] These assumptions are predicated on the operation of an efficient, competitive environment, in which information asymmetries are minimal.

1.5.2 STAKEHOLDER THEORY

According to Freeman and Reed the word 'stakeholder', was coined in an internal memorandum at the Stanford Research Institute in 1963. It refers to those groups without whose support the organization would perish.[99] Most advocates of the Stakeholder Theory* assert that pursuing interests of all stakeholders is not only just but also more effective for organizations.[100] A study commissioned by British accounting bodies in 1975 suggested that corporations were bound to be accountable to all those who might bear the consequences of their actions, that is all stakeholders.[101] However, as Drucker pointed out, the stakeholder concept did not last mainly because of hostile takeovers in 1970s.[102] Further, the idea vanished in the free market growth ethos of 1980s but subsequently re-surfaced.[103]

Returns to stakeholders are influenced by the levels of protection that are extended to them in a particular country.[104] For instance, firms operating in countries with better protection of minority shareholders pay higher dividends.[105] Moreover, high-growth firms retain more and pay lower dividends than slow-growth firms, in line with

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* Stakeholder Theory is also known as 'The Stakeholder Value Perspective'.

the idea that legally protected shareholders are willing to sacrifice near-term dividends when investment opportunities are attractive while shareholders with deficient protection seem to accept whatever dividends a company gives irrespective of investment opportunities. Such distortions in investment are presumably due to the agency costs of poor legal protection. The operation of an effective system of stakeholder management by firms, therefore, assumes that such stakeholders are identified and recognized through legislations.

1.5.3 STEWARDSHIP THEORY

This theory recognizes that directors can be entrusted with a fiduciary duty towards the company to act as stewards of shareholders interests, which they elevate over their personal interest.[106] The term 'fiduciary' comes from two Latin words i.e., *fide* means faith and *fiducia* means trust.[107] It refers to one who is invested with trust, and spells out a sacred legal and ethical relationship between the fiduciary and the beneficiary. A director is a fiduciary of a public limited company.

1.5.4 RESOURCE DEPENDENCE THEORY

A view that has been expressed is that Boards of Directors can be a key source of various resources.[108] This theory is strongly contingent on the presence of a competitive environment by assuming the availability of efficient, competent and skilled directors.

1.5.5 INSTITUTIONAL THEORY

The theory considers organizations to be not just entities that churn out goods or services, but as "social and cultural systems".[109] Therefore, the theory holds that organizations and their actors also seek legitimacy, beyond just engaging in a scramble for resources. In view of the broader role the theory envisages for companies, it effectively empowers people in organizations to address the expectations of external and internal groups, beyond the narrow set figuring in the Agency Theory.[110]

1.5.6 SIGNALLING THEORY

It is in the interest of the firm if a manager makes voluntary disclosure of privileged information that may have a positive effect on share prices.[111] The information disclosure is at the discretion of the manager. Moreover the content, manner of presentation and moment of publication of such information is determined by the manager. Of this, the choice of timing of publication is critically important in signalling. In Morris' view, the combination of Agency and Signalling Theories provided an appreciable theoretical foundation for the studies that are related to accounting, especially for voluntary disclosures.[112]

1.5.7 BUSINESS ENVIRONMENT AND CG THEORIES

CG developments in various countries are inspired by their corporate histories. That is why the recommendations of various committees are contextual to the respective countries. The CG models are complemented by the relevant CG theories. The CG theories in turn are based on certain pre-suppositions or contingencies pertaining to the business.

The Anglo-Saxon Model presupposes the presence of active forces of competitive advantage, outlined in Michael Porter's Five-Forces Model (Figure 1.11).

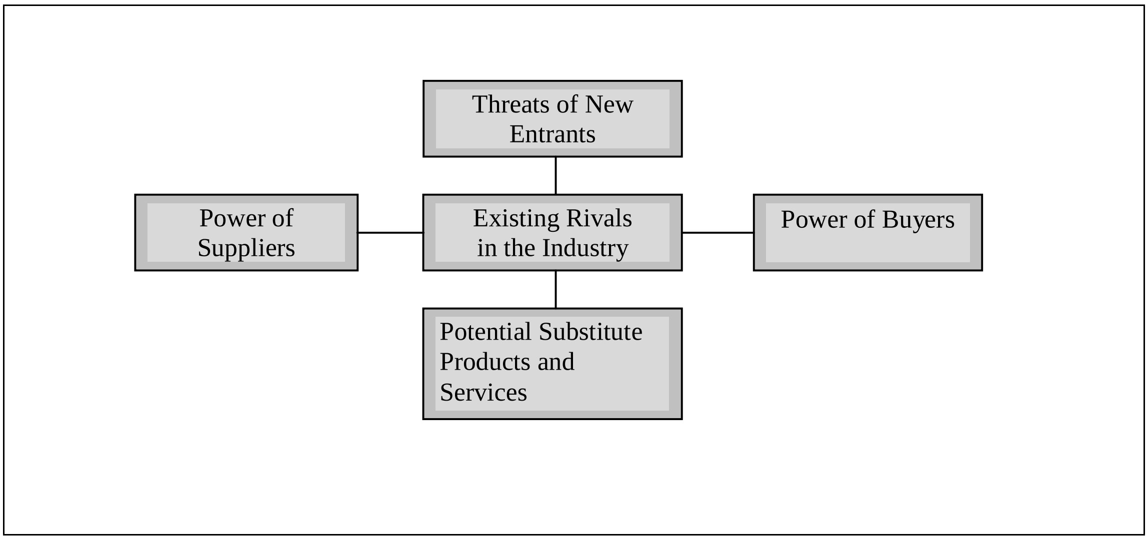

FIGURE 1.11

The Driving Forces of Competitive Advantage

Source: Tricker, Bob, *Essential Director (The Economist),* Replika Press Pvt. Ltd., Kundli, 2004, p. 117.

It is evident that Agency Theory is relevant to countries like UK and US. Competition and an urge to expand ensures an active market for corporate control and also provides a competitive advantage for outperforming corporations. However, the existence of agency problems and conflict of interest between owners and managers is the fundamental assumption of the Agency Theory. Agency problems also arise between creditors and shareholders' having divergent interests, thus causing each party to want to monitor the other.[113] The directors are presumably expected to fulfill their fiduciary duties in order to protect the interest of shareholders. The Agency Theory provides academic and intellectual basis for policy reforms including requiring companies to have more Independent Directors to keep a check on managers.[114] According to this theory, the protection of shareholders' interest is the crux of CG. The reason is, except shareholders, other stakeholders have legal rights to assert their claims. Therefore the Agency and

Resource Dependence Theories are more suitable in competitive environments. Stewardship Theory does not consider debt and capital structures as motivators of managers.[115] It derives inspiration from a tradition of psychological theorizing and research that views the job that the manager performs as being the most powerful determinant of his or her work behaviour.[116] It is the triggering of this intrinsic motivation and the needs of achievement, responsibility and others that are the main well-springs of managerial effort and performance.[117]

Moreover, belief in the organization and its mission, fidelity, respect for authority and social esteem together influence managerial work behaviour.[118] These factors are the key motivators under Stewardship Theory rather than the narrow pursuit of self-interest that Agency Theory emphasizes. The Stewardship Theory warrants that managers must recognize their responsibility towards all constituents.[119] Maximizing shareholders value, at the cost of stakeholders would be unfair. There seems no congruence between Shareholder Value Perspective and Stakeholder Values Perspective (Exhibit 1.4). In UK and US, Shareholders' Value Perspective *(Monistic)* prevails, while in Japan it is Stakeholder Values Perspective *(Pluralistic)*.[120] Germany and France consider the interests of both, shareholders and employees *(Dualistic)*. In all these countries, varying CG structures exist and there is a possibility of convergence of CG, though partial. It is improbable that one governance system will drive out another, at least in the foreseeable future. Moreover, the Stakeholder Theory and Institutional Theories expect regulatory efficiency. So in the environment of inadequate enforcement of investor protection regulations, application of these theories may not be appropriate.

EXHIBIT 1.4

SHAREHOLDER VALUE VERSUS STAKEHOLDER VALUES PERSPECTIVE

Feature	**Shareholders Value Perspective**	**Stakeholder Values Perspective**
Emphasis on	Profitability over responsibility	Responsibility over profitability
Organisations seen as	Instruments	Joint ventures
Organisational purpose	To serve owner	To serve all parties involved
Measure of success	Share price and dividends (shareholder value)	Satisfaction among stakeholders
Major difficulty	Getting agent to pursue principal's interests	Balancing interests of various stakeholders
CG through	Independent outside directors with shares	Stakeholder representation
Stakeholder management	Means	End and means
Social responsibility	Individual, not organizational matter	Both individual and organisational
Society best served by	Pursuing self-interest (economic efficiency)	Pursuing joint-interests (economic symbiosis)

Source: Adapted from Wit, Bob De and Ron Meyer (Eds), "Organisational Purpose," *Strategy: Process, Content, Context – An International Perspective*, 3rd ed; Thomson Learning, London, 2004, p. 607.

US, Germany and Japan have successful CG systems which provide legal protection at least for some investors and assign importance to the role of large investors.[121] Here the argument is that legal protection of investors' rights is one essential element of CG. However, it is not evident as to which of the CG systems of the three countries is best. A sentiment that has been expressed is that it will be desirable if the transition economies can manage to approach the CG system of Germany and Japan, in particular the legal protection aspect of investors. According to Yoshimori, Japan and Germany are moving towards the Anglo-Saxon Model for increased openness and transparency, and primacy to shareholder interest and shorttermism.[122] On account of diverse business practices, each country follows not only different CG mechanisms but also different Board structures. A similarity among the Anglo-Saxon countries such as US and UK is that they follow a single-tier Board structure (Market Oriented Model) while in Germany and Japan it is a dual Board structure (Bank-based Model). Only a few countries follow more than one Board structure. For instance, only five countries viz., Belgium, Finland, France, Greece and Luxembourg, out of a total of forty-two countries practice this option (Exhibit 1.5). The selection of a particular Board structure is not mandated but it depends on the CG practices prevailing.

EXHIBIT 1.5

STRUCTURES OF THE BOARD IN THE SELECT COUNTRIES

Country	**Structure(s) of the Board**	**Country**	**Structure(s) of the Board**
Austria	Dual Board Structure	Ireland	Single Board Structure
Belgium#	Single Board Structure	United States	Single Board Structure
Denmark	Dual Board Structure	Trinidad	Single Board Structure
Finland#	Single Board Structure	Jamaica	Single Board Structure
France#	Single Board Structure	Barbados	Single Board Structure
Germany	Dual Board Structure	Brazil	Dual Board Structure
Greece#	Single Board Structure	Japan	Dual Board Structure
Italy	Triple Board Structure	Hungary	Dual Board Structure
Luxembourg#	Single Board Structure	Russia	Dual Board Structure
The Netherlands	Dual Board Structure	Poland	Dual Board Structure
Portugal	Triple Board Structure	Czech Republic	Dual Board Structure
Spain	Single Board Structure	South Africa	Single Board Structure
Sweden	Single Board Structure	India	Single Board Structure
United Kingdom	Single Board Structure	S. E. Asia	Dual Board Structure
Note: # Countries use more than one type of Board structure.			

Source: Mallin, C., *Corporate Governance*, Oxford University Press, 2004 cited by Balgobin, Rolph, N. S., "Board Characteristics that Promote Effective Governance: A Perspective on Trinidad and Tobago and Jamaica," *The Icfai Journal of Corporate Governance*, Vol. VII, No. 2, April 2008, p. 27.

1.6 CG in India

India, as a former British colony, is viewed as a common law country.[123] On the basis of the English Joint Stock Companies Act, 1844, the Indian corporate law, i.e., the Joint Stock Companies Act, 1850 was framed. The growing form of the corporate business required a pool of resources mainly in terms of capital. Later, the Bombay Stock Exchange (BSE) was established in 1875.[124] It is the oldest stock exchange in Asia. The Cohen Committee (UK) recommended drastic changes to the English Companies Act, 1929.[125] As a sequel, the Bhabha Committee was set up in India, whose recommendations provided the foundation for the Companies Act, 1956 in India. The Companies Act 1956 provided an excellent framework for disclosures and protection of minority shareholders.[126] In the 1950s, the financial scandal involving Life Insurance Corporation of India (LIC) eroded shareholders wealth.[127] Later Raj Sethia's scandal involving the Punjab National Bank (1985) and Harshad Mehta's scam further melted shareholders wealth.[128] In practice minority shareholders and creditors in India have remained unprotected probably due to lack of enforcement despite the best laws (Exhibit 1.6). CG is weak in India compared with that of US, UK, Germany and Japan. In Exhibit 1.6, among the CG variables, the efficiency of the judicial system in India is 8.0, being lowest among the given countries. Not only that but India's score for rule of law is 4.17, corruption at 4.58, risk of expropriation at 7.75 and accounting standards rating at 57, thereby giving rise to concerns.

This deficient regulatory environment changed rapidly due to economic reforms in the early 1990s. Indian industry was fully aware of these challenges. Hence the consensus was to lift to the growth rate, supported by post-1990 economic reforms. This necessitated increased resource requirements and enhanced scale of production on one hand and proper governance and performance of companies for public good on the other. Consequently, the wealth of some companies has exceeded that of some nations i.e., in terms of Gross Domestic Product (GDP).

EXHIBIT 1.6
A COMPARATIVE ASSESSMENT OF THE QUALITY OF CORPORATE GOVERNANCE INSTITUTIONS IN INDIA VIS-À-VIS MAJOR DEVELOPED COUNTRIES IN THE 1990S

Country	**Legal origin**	**Legal variables**					**Variables representing shareholder protection***							**Variables representing creditor rights ****				
		Efficiency of the judicial system (1)	Rule of law (2)	Corruption (3)	Risk of expropriation (4)	Accounting standards (Rating) (5)	One-share, one vote	Proxy by mail allowed	Shares not blocked before meeting	Cumulative voting	Oppressed minorities mechanism	Anti-director rights (6)	Mandatory dividend	Restrictions for going into reorganization	No automatic stay on secured	Secured creditors first	Management does not stay in reorganizations	Creditors rights (7)
US	English origin	10.0	10.0	8.63	9.98	71	1	1	1	1	1	5	0	0	0	1	0	1
UK	English origin	10.0	8.57	9.10	9.71	78	0	1	1	0	1	5	0	1	1	1	1	4
Germany	German origin	9.0	9.23	8.93	9.90	62	0	0	0	0	0	1	0	1	1	1	0	3
Japan	German origin	10.0	8.98	8.52	9.67	65	1	0	1	1	1	4	0	0	0	1	1	2
India	English origin	8.0	4.17	4.58	7.75	57	1	0	1	1	1	5	0	1	1	1	1	4

Notes:
(1) Scale from 0 to 10, with lower scores showing lower efficiency levels.
(2) Scale from 0 to 10, with lower scores for less tradition of law and order.
(3) Scale from 0 to 10, with lower scores for higher levels of corruption.
(4) Scale from 0 to 10, with lower scores for higher risks.
(5) The score is given on a scale ranging from 0 to 100, with higher scores showing more stringent accounting standards.
(6) The index ranges from 0 to 6, with higher values signifying stronger 'Anti-Director Rights.'
(7) The index ranges from 0 to 4, with higher values signifying stronger 'Creditor Rights.'

*Except for 'Anti-Director Rights', a value of 1shows the presence of the relevant feature (i.e., implying that investor protection is in the law).

**Except for 'Creditors Rights', a value of 1shows the presence of the relevant feature (i.e., implying that investor protection is in the law).

Source: Various studies of La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, Robert W. Vishny, cited in Reed, Darryl and Sanjoy Mukherjee (Eds.), *Corporate Governance, Economic Reforms and Development, The Indian Experience*, Oxford University Press, New Delhi, 2004, pp. 177-178.

Until 1992, the BSE was a monopoly, characterized by entry barriers, trading and settlement inefficiencies, high costs of intermediation, manipulative practices and other deficiencies.[129] The market users were at a serious disadvantage. With economic reforms the Indian government established new institutions: the SEBI, the National Stock Exchange of India (NSE), the National Securities Clearing Corporation and the National Securities Depository Limited. The single most important development in the area of CG and investor protection has been the establishment of the SEBI initially by an ordinance and later by enacting a separate SEBI Act in 1992. SEBI has introduced a rigorous regulatory regime to usher in fairness and transparency. For instance, in all transactions where the total quantity of shares is more than 0.5 per cent of the equity of the company then such transactions require a mandatory disclosure. SEBI has also played an important role in framing minimum ground rules of corporate conduct. Concerns about CG in India arose due to a spate of frauds particularly the Harshad Mehta stock market scam of 1992. Even after the 1992 securities scam, the series of frauds continued affecting the Unit Trust of India and other institutions, thus unnerving investors.[130] In 1993-1994, 3911 companies that mobilized over Rs. 25,000 Crore vanished or failed to set up their projects.[131] In 1995-96, plantation companies mopped up about Rs. 50,000 Crore from gullible investors who were lured by the prospect of high returns from plantation schemes. In the 1995-97 scam, non-banking finance companies raised about Rs. 50,000 Crore from high-return seeking investors and these companies' vanished. The Satyam fiasco was one more chapter in this sordid saga, in 2008, which one commentator termed a "year of all-pervasive poor governance".[132]

Among the main reasons for CG developments in India, was economic reforms, as India was anxious to strengthen its competitiveness in global markets; simultaneously there was a need for abating corporate and stock market related frauds. In CG developments, one of the earliest endevours was by the Confederation of Indian Industry's (CII), Code for Desirable Corporate Governance, which was developed by a committee chaired by Rahul Bajaj a leading industrialist.[133] The committee which was formed in 1996 submitted its report in April 1998.

According to the CII's report of 1998, "Corporate Governance deals with laws, procedures, practices and implicit rules that determine a company's ability to take managerial decisions vis-à-vis its claimants – in particular, its shareholders, creditors, customers, the State and employees".[134]

Yet another definition of CG, in the Indian context is as follows.

According to SEBI CG is "the way in which companies run themselves, in particular the way in which they are accountable to those who have a vested interest in their performance, especially their shareholders".[135]

The Birla Committee lauded the virtues of CG as "a system of good corporate governance promotes relationships of accountability between the actors of sound financial reporting – the board, the management and the auditor. It holds the management accountable to the board and the board accountable to the shareholders".[136]

It endorsed the fundamental objective of CG as “the enhancement of shareholder value, keeping in view the interests of other stakeholders”. To strengthen CG, the MCA and the Ministry of Finance (MOF) of the Government of India (GOI), established a study group to operationalise the recommendations of three committees during the period 2000-04: the Kumar Mangalam Birla Committee, the Naresh Chandra Committee and J. J. Irani Committee.[137] The SEBI followed up on the recommendations of the Birla Committee by enacting Clause 49 of the Listing Agreement. Initially (March 2001) Clause 49 was binding on companies in the BSE 200 and Standard and Poors’ (S&P) C&X NIFTY stock indices and on all companies listing thereafter. Further, Dr. R. H. Patil submitted a report in March 2001, which examined issues of CG in banks including public sector banks and made recommendations to lift governance standards at par with international standards.[138] The subsequent announcement in the context of CG was made by Dr. Bimal Jalan on October 21, 2001 in the Mid-Term Review of the Monetary and Credit Policy. In November 2001, a consultative group was constituted under the chairmanship of Dr. A. S. Ganguly, with a view to reinforce the internal supervisory role of the Boards. In June 2002, the Ganguly group report was distributed to all the banks and simultaneously to GOI for appropriate consideration. Unmindful of such efforts, corporate and stock market frauds continued, as for instance, those involving Bank of India and Madhavpura Mercantile Co-operative Bank.[139] In 2002-03, audited accounts of the Global Trust Bank showed a profit of Rs. 40 Crore, while a Reserve Bank of India Inspection Report showed negative net worth.[140] The bank was forced to merge with the Oriental Bank of Commerce. It was an instance of mismanagement of bank assets in the pursuit of personal gain by the top officials, fraudulent financial reporting, and laxity by the statutory auditor, involving a total amount of Rs. 13,000 Crore. This fraud apparently indicated tunnelling and lack of enforcement of corporate laws, accountability and transparency. The Narayana Murthy Committee appointed by the SEBI earlier on issues of CG, submitted its report in 2004. The Committee further refined the rules. Hence, Clause 49 was amended in 2004. The revised Clause 49 of the Listing Agreement has been made effective since 1st January, 2006. Clause 49 includes mandatory and non-mandatory requirements of CG.[141]

Listed companies in India must comply with Clause 49. It is the responsibility of the listing stock exchange, to verify adherence to the said clause. In case of non-compliance with Clause 49, the listing stock exchange is authorized to take expeditious action(s) against defaulting companies including penalties and simultaneously verifying the reasons for non-compliance. A few years ago, government has also made CG norms as mandatory requirement for Central Public Sector Enterprises.

Clause 49 has been a milestone in the evolution of CG reforms in India.[142] It compares with the SOX Act of the US. Yet, in a few areas Indian norms are loose; for instance if the chairman of the Board is non-executive, then fewer Independent Directors will be required than if the chairman of the Board is executive. In certification compliance, Indian norms are stricter. Continuing with CG reforms, GOI has also set up the National Foundation for Corporate Governance.[143] The foundation has made a plan to organize training for trainers' course.

No doubt, since economic reforms India has grown by leaps and bounds and today is one of the fastest emerging economies of the world. The growth of an economy is also related with the growth (interests) of shareholders. A cover story in BusinessWeek mentioned 100 outperforming companies that are expanding abroad.[144] While 21 and 44 of them were from India and China respectively, the rest are from Brazil, Russia and other emerging economies. Overall these companies rewarded their shareholders very well. Between January 2000 and March 2006, whereas Total Shareholder Returns (TSR) declined by 2 per cent for S&P 500 stocks, emerging markets as a whole provided a TSR of 106 per cent, within which these 100 outstanding firms gave an even higher 168 per cent. Within these 100, the TSR of 44 Chinese firms was only 13 per cent whereas the Indian firms returned as much as 201 per cent. Moreover, the success stories of Infosys, Tatas, Reliance Industries and Wipro provide inspiration to Indian enterprise.

The leaders (promoter-directors or CEO) who were substantially associated with these companies have won the trust of shareholders and have contributed immensely to shareholders' wealth by providing handsome returns. It is their commitment that could take their companies to greater heights.

Even after extensive CG reforms in India, corporate and stock market related frauds have occurred. In 2007, a woman photographer from Ahmedabad, opened thousands of fake dematerialization accounts for IPO subscription. This challenged the then prevailing rules and regulations of stock markets, including IPO deals. Moreover in 2008, there was an apparent case of oversight by Independent Directors in the Satyam-

Maytas deal, which was India's largest ever-related party transaction worth $1.6 Billion.[145] The Satyam Computers saga has raised many doubts about reputed companies. The reason is Satyam Computers had been an award-winning company for CG practices.

There is deficient law enforcement in India.[146] For instance, the rule of law index (Exhibit 1.7) in case of India is 4.17 out of 10, and it is also lower than the average of English common law countries i.e., 6.46. Poor law enforcement significantly affects the quality of CG in India. However, India scores well for shareholders rights index, i.e., 5 out of 6 as given in Exhibit 1.7. This score is also higher than the average score of English common law countries i.e., 4. So India does well in shareholders rights but its enforcement is inadequate. In India there is high ownership concentration i.e., 0.40, compared to 0.19 for UK, 0.20 for the US and 0.18 for Japan (Exhibit 1.8). Higher ownership concentration can lead to lower external capital in relation to Gross National Product (GNP) thereby hindering the growth of capital markets. For instance, in India, external capital in relation to GNP is 0.31 while in UK it is 1.00, US 0.58 and Japan 0.62. Like India, Germany too has higher ownership concentration i.e., 0.48 and consequently lower external capital in relation to GNP which is 0.13. The CG systems of UK and US have dispersed equity ownership.

EXHIBIT 1.7
CLASSIFICATION OF COUNTRIES BY LEGAL ORIGINS

Legal Origin	**Country**	**Shareholder Rights Index**	**Rule of Law Index**
1. English common law	Australia	4	10.00
	Canada	5	10.00
	Hong Kong	5	8.22
	India	5	4.17
	Ireland	4	7.80
	Israel	3	4.82
	Kenya	3	5.42
	Malaysia	4	6.78
	New Zealand	4	10.00
	Nigeria	3	2.73
	Pakistan	5	3.03
	Singapore	4	8.57
	South Africa	5	4.42
	Sri Lanka	3	1.90
	Thailand	2	6.25
	United Kingdom	5	8.57
	United States	5	10.00
	Zimbabwe	3	3.68
	English-origin average	**4.00**	**6.46**
2. French civil law	Argentina	4	5.35
	Belgium	0	10.00
	Brazil	3	6.32
	Chile	5	7.02
	Colombia	3	2.08
	Ecuador	2	6.67
	Egypt	2	4.17
	France	3	8.98
	Greece	2	6.18
	Indonesia	2	3.98
	Italy	1	8.33
	Jordan	1	4.35
	Mexico	1	5.35
	Netherlands	2	10.00
	Peru	3	2.50
	Philippines	3	2.73
	Portugal	3	8.68
	Spain	4	7.80
	Turkey	2	5.18
	Uruguay	2	5.00
	Venezuela	1	6.37
	French-origin average	**2.33**	**6.05**
3. German civil law	Austria	2	10.00
	Germany	1	9.23
	Japan	4	8.98
	South Korea	2	5.35
	Switzerland	2	10.00
	Taiwan	3	8.52
	German-origin average	**2.33**	**8.68**
4. Scandinavian civil law	Denmark	2	10.00
	Finland	3	10.00
	Norway	4	10.00
	Sweden	3	10.00
	Scandinavian-origin average	**3.00**	**10.00**

Note: Shareholder rights index scales from 0 (lowest) to 6 (highest). Rule of law index scales from 0 (lowest) to 10 (highest).

Source: La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, Robert W. Vishny, "Law and Finance," *Journal of Political Economy*, 106, 1998, pp. 1113-1155 cited in Eun, Cheol S. and Bruce G.Resnick, "Corporate Governance around the World," *International Financial Management*, 3rd ed; Tata McGraw-Hill Publishing Company Limited, New Delhi, 2004, p. 483.

EXHIBIT 1.8
CONSEQUENCES OF LAW: OWNERSHIP AND CAPITAL MARKETS

Legal Origin	Country	Ownership Concentration	External Cap/GNP	Domestic Firms/Population
1. English common law	Australia	0.28	0.49	63.55
	Canada	0.40	0.39	40.86
	Hong Kong	0.54	1.18	88.16
	India	0.40	0.31	07.79
	Ireland	0.39	0.27	20.00
	Israel	0.51	0.25	127.60
	Kenya	Na	Na	02.24
	Malaysia	0.54	1.48	25.15
	New Zealand	0.48	0.28	69.00
	Nigeria	0.40	0.27	01.68
	Pakistan	0.37	0.18	05.88
	Singapore	0.49	1.18	80.00
	South Africa	0.52	1.45	16.00
	Sri Lanka	0.60	0.11	11.94
	Thailand	0.47	0.56	06.70
	United Kingdom	0.19	1.00	35.68
	United States	0.20	0.58	30.11
	Zimbabwe	0.55	0.18	05.81
	English-origin average	**0.43**	**0.60**	**35.45**
2. French civil law	Argentina	0.53	0.07	04.58
	Belgium	0.54	0.17	15.50
	Brazil	0.57	0.18	03.48
	Chile	0.45	0.80	19.92
	Colombia	0.63	0.14	03.13
	Ecuador	Na	Na	13.18
	Egypt	0.62	0.08	03.48
	France	0.34	0.23	08.05
	Greece	0.67	0.07	21.60
	Indonesia	0.58	0.15	01.15
	Italy	0.58	0.08	03.91
	Jordan	Na	Na	23.75
	Mexico	0.64	0.22	02.28
	Netherlands	0.39	0.52	21.13
	Peru	0.56	0.40	09.47
	Philippines	0.57	0.10	02.90
	Portugal	0.52	0.08	19.50
	Spain	0.51	0.17	09.71
	Turkey	0.59	0.18	02.93
	Uruguay	Na	Na	07.00
	Venezuela	0.51	0.08	04.28
	French-origin average	**0.54**	**0.21**	**10.00**
3. German civil law	Austria	0.58	0.06	13.87
	Germany	0.48	0.13	05.14
	Japan	0.18	0.62	17.78
	South Korea	0.23	0.44	15.88
	Switzerland	0.41	0.62	33.85
	Taiwan	0.18	0.86	14.22
	German-origin average	**0.34**	**0.46**	**16.79**
4. Scandinavian civil law	Denmark	0.45	0.21	50.40
	Finland	0.37	0.25	13.00
	Norway	0.36	0.22	33.00
	Sweden	0.28	0.51	12.66
	Scandinavian-origin average	**0.37**	**0.30**	**27.26**

Note: Ownership concentration measures the average share ownership by three largest shareholders. External Cap/GNP is the ratio of the stock market capitalization held by minority shareholders (other than three shareholders) to the Gross National Product for 1994. Domestic Firm Population is the ratio of the number of domestic firms listed in a given country to its population (Million) in 1994.

Source: Various studies of La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, Robert W. Vishny cited in Eun, Cheol S. and Bruce G. Resnick , "Corporate Governance around the World," *International Financial Management*, 3rd ed., Tata McGraw-Hill Publishing Company Limited, New Delhi, 2004, p. 485.

Equity ownership is not widely dispersed in India because promoters are the dominant shareholders (Exhibit 1.9) and on account of this minority shareholders may suffer. For instance, promoters' ownership (holding) is 51.86 per cent in Indian Business Groups while public holding is merely 23.85 per cent. This results in conflicts of interests between dominant shareholders and minority shareholders.

EXHIBIT 1.9

SHAREHOLDING PATTERN IN INDIAN COMPANIES

Shareholders	Indian Business Groups Controlled Companies (%)	Government Controlled Companies (%)	Foreign Companies (%)
Promoters	51.86	64.71	63.01
Mutual Funds	2.40	1.95	2.37
Banks and Insurance Companies	5.18	8.24	2.92
FIIs	3.64	6.06	2.95
Public	23.85	13.18	19.68
Others	13.07	5.86	9.06
Total	100.00	100.00	100.00

Source: Brealey, Richard A., Stewart Myers C., Allen Franklin and Pitabas Mohanty, "Governance and Corporate Control around the World," *Principles of Corporate Finance,* Special Indian Edition, 8th ed; Tata McGraw-Hill Publishing Company Limited, New Delhi, 2007, p. 943.

In the Indian private and public sectors, the general responsibility of governance is that of protecting minority shareholders from the dominant shareholders.[147] So shareholders' laws, without effective monitoring and enforcements, leave ample scope for tunnelling and expropriation, which are the common issues of CG in India.[148] For effective governance, greater activism is required on part of domestic and foreign institutional investors. State-Owned Enterprises (SOEs) need a credible degree of autonomy or else they need to be privatized. Privatization of industrial firms is thus constrained to some extent by the pace of privatization of the financial sector. Moreover in India, the same courts consider both civil and criminal cases and because the criminal cases get priority over civil cases, delay results in resolving business disputes.[149] In addition to this, the number of judges per Million citizens is just 10 in India (Exhibit 1.10), which is significantly lesser than other countries; in US it is 107 and in Britain it is 50. Lack of alternative legal options and a paucity of judges' results in an increased number of legal disputes which remain pending for several years. This imposes serious challenges on the Indian judicial system.

EXHIBIT 1.10

NUMBER OF JUDGES PER MILLION OF CITIZENS IN SELECT COUNTRIES

Country	Number of Judges Per Million of Citizens
US	107
Canada	75*
Britain	50*
Australia	41*
India	10*

*Number of Judges expressed herein is approximate.

Source: Debroy, Bibek, "Some Issues in Law Reform in India," in Jean-Jacques Dethier (Ed.), *Governance, Decentralization, and Reform in China, India, and Russia*, Boston: Kluwer Academic Publishers, 1999 cited by Chakrabarti, Rajesh, William Megginson, Pardeep K. Yadav, "Corporate Governance in India," *Journal of Applied Corporate Finance*, Vol. 20, No. 1, Winter 2008, p. 69.

Moreover, corruption is higher in India. In 2008, India ranked 85th in terms of corruption (Exhibit 1.11) and its Corruption Perceptions Index (CPI) score in the same year was 3.4. Even among Brazil, Russia, India and China, India ranks 3rd just ahead of Russia. Higher corruption levels indicate lower transparency.

EXHIBIT 1.11

TRANSPARENCY INTERNATIONAL'S CORRUPTION INDEX

Country	**CPI Rank#**				**CPI Score***			
	Years				**Years**			
	2008[1]	**2007**[1]	**2006**[2]	**2005**[2]	**2008**[1]	**2007**[1]	**2006**[2]	**2005**[2]
Denmark	1	1	4	4	9.3	9.4	9.5	9.5
Singapore	4	4	5	5	9.2	9.3	9.4	9.4
Australia	9	11	9	9	8.7	8.6	8.7	8.8
Hong Kong	12	14	15	15	8.1	8.3	8.3	8.3
UK	16	12	11	11	7.7	8.4	8.6	8.6
Japan	18	17	17	21	7.3	7.5	7.6	7.3
US	18	20	20	17	7.3	7.2	7.3	7.6
France	23	19	18	18	6.9	7.3	7.4	7.5
South Korea	40	43	42	40	5.6	5.1	5.1	5.0
South Africa	54	43	51	46	4.9	5.1	4.6	4.5
Mexico	72	72	70	65	3.6	3.5	3.3	3.5
China	72	72	70	78	3.6	3.5	3.3	3.2
Brazil	80	72	70	62	3.5	3.5	3.3	3.7
India	**85**	**72**	**70**	**88**	**3.4**	**3.5**	**3.3**	**2.9**
Russia	147	143	121	126	2.1	2.3	2.5	2.4

*CPI Score relates to perceptions of the degree of corruption as seen by business people and country analysts and ranges between 10 (highly clean) and 0 (highly corrupt).

CPI Rank indicates country ranks; lower the rank, less the corruption and vice-versa (e. g., Denmark's rank in 2008 was 1, so it is least corrupt).

Sources: [1] Gajra, Rajesh, "Corruption Counter," *Business World*, December 1, 2008, p. 24.
[2] http://www.transparency.org/news_room/in_focus/2005/right_to_know_day, website accessed on 31.5.2009, 11:45 a.m.

As far as CG models are concerned, India has two distinct possibilities: First, to continue with the Anglo-Saxon Model of CG (albeit with a few distinctions). As mentioned previously, Mukherjee-Reed also observes that like many developing countries, India has been proceeding towards the adoption of the Anglo-Saxon Model of CG.[150] As the UK and US follow the Anglo-Saxon Model, there are reasons for similarities of features with respect to compliance with the Anglo-Saxon Model for CG in India. One of the reasons, for instance, is close historical business ties between the UK and India ever since establishment of the EIC and similarity of provisions of the Companies Act with that of the British Law. The EIC also had its business operations in US. The US enacted the SOX Act, 2002 in the wake of devastating corporate malfeasance and India, in turn, enacted Clause 49 of the Listing Agreement modeled on the SOX Act.[151] The second possibility is to have a Hybrid Model of CG which blends features of the Anglo-Saxon and the Stakeholder Models.

1.7 Rationale of the Study

The corporate form of business has played an underpinning role in the growth and development of economies, more so for emerging India. Companies, large and small, serve as engines of economic growth. Sometimes their capitalization exceeds the GDP of countries. To illustrate, the market capitalization of Exxon Mobil, for the year 2006 was US $469 Billion, which is greater than the GDP of 76 countries in a group that has Philippines at the top with a GDP of US $443 Billion, and Paraguay at the bottom with a GDP of US $31 Billion.[152] Companies in India, particularly business conglomerates, have played a prominent role in the nations’s development. However despite such splendid contributions, governance of such companies has emerged as a new challenge more so on account of their large size, competitive markets and cross border business. India has been proactive in enacting CG reforms, immediately after the spree of US corporate frauds. In fact, though India enacted commendable reforms, effective and efficient enforcement of the reforms is a matter of concern. Despite various CG reforms in India, there is considerable scope for improvement. If one of the top among the four information technology firms in India, i.e., Satyam which was also in the Nifty 50 Index, could deceive investors, then investors would be mistrustful of other companies. Such corporate frauds discourage equity investments at least in the short term, which India has experienced in the aftermath of the Satyam scam. Stock markets plummet, thereby causing immense loss of wealth to investors. Even though we have strict and mandatory codes[*] of CG, such frauds continue. Sometimes, the nature of frauds is also distinct in India compared to Anglo-Saxon countries. "Vanishing acts" of companies and individual stock-market related frauds are common. Frauds involving directors of companies indulging in tunnelling or misappropriations of corporate resources also occur frequently. This further necessitates specific research focusing on frauds in corporates. One of the possibilities is that CG is largely followed in letter but not in spirit. Seeing Satyam's case, the worrisome issue of CG in India seems to be sham compliance with the Clause 49 of Listing agreement. Sometimes CG is followed in letter as well as in spirit but not comprehensively, i.e., some crucial aspects of the code of conduct are avoided. Elaborating on the corporate frauds issue further, it is responsibility of the CEO/CFO to certify financial statements including CG report stating that the matters contained therein are true and fair. These financial statements are audited by the auditors culminating in the audit report. The role of auditor is also vital as he can trace the fraudulent accounting practices followed by the company. However, the preparation of financial statements is

[*] Mandatory code for CG in India is through compliance with Clause 49 of the Listing Agreement.

the sole responsibility of the management and not that of the auditors. The task of the auditor is only to audit i.e., merely express an opinion stating that the accounts so presented exhibit a true and fair view.

So it is unlikely that the auditor always can find accounting frauds in all instances because the managerial personnel are creative at presenting accounts in a deceptive manner. Another possibility in this regard can be a lack of commitment on the part of auditors. So there is a need to review the role and the responsibility of auditors in order to avert negligence. Moreover, some companies are apparently disinclined to comply with Clause 49 of the Listing Agreement. So research studies can ascertain the extent of compliance with Clause 49 of the Listing Agreement and in the process find out barriers if any. Such studies will also aid the SEBI in assessing level of enforcements and in furthering reforms in CG. Companies performing well follow not only mandatory but also non-mandatory CG provisions. Whether compliance with non-mandatory CG provisions lead to increased returns to shareholders becomes a matter of investigation. Findings of such a study can benefit companies as well as shareholders interests. Another area of research relates to the background of CEO or promoter directors. The reason is, in the Indian context, due to concentrated ownership, the role of promoter-director and CEO is significant. CG is more about human conduct than about structures, strictures, rules or regulations.[153] The calibre and ethical approach of directors largely determine the effectiveness of the Board. According to studies conducted by Ethical Investment Research Services (Europe), many companies in the US, UK and Continental Europe, in particular have been imbibing good CG practices.[154] This behavior is being emulated by emerging economies as well. Therefore there is a need for research in CG and India cannot lag behind as it is one of the fastest emerging economies in the world.

1.8 Scope of the Study

The scope of this study covers three years' viz: 2005-06, 2006-07, 2007-08, including the year-end from which CG reporting has been made mandatory i.e., since 31.03.2006. Co-incidentally, most of the sample companies are manufacturing entities. 50 companies in each of the years that feature in the S&P CNX NIFTY Index are taken up for study because the criteria for CG compliance are met by such listed and larger companies. Moreover, these being generally well-regarded companies, recommendations of this study may serve as a model of good practices for others to emulate. However the results of the study should be viewed in the background of limitations such as sample size, sampling technique, veracity of available information and the duration of the study.

1.9 Statement of Research Inquiry

"A Study of Corporate Governance Practices in India."

1.10 Definitions

1.10.1 CG

CG means a set of practices that safeguards the interest of the wider set of stakeholders including employees, creditors, customers and shareholders in particular.

Since for most of the stakeholders, the company has contractual obligations, the interest of stakeholders is indirectly protected by their legal rights. Moreover creditors have superior claims on earnings and assets in the event of liquidation compared to equity shareholders. Therefore equity claimants should be provided adequate returns for bearing maximum risk after meeting the claims of creditors and preference shareholders. Yet, providing excessive returns to equity claimants at the cost of stakeholders is also not a good CG practice. There are possibilities that while upholding the interest of equity shareholders, stakeholders' interest may be jeopardized. For instance, earning good profits and distributing high dividend to equity shareholders does not guarantee ethical practices, environment protection, and timely payment of dues to other stakeholders and corporate social responsibility. So companies have to ensure that neither shareholders nor other stakeholders' interest is impaired. The Board of Directors has to ensure this by carrying out their fiduciary duty; in particular the role of CEO and Independent Directors is very significant in achieving this objective.

1.10.2 CG PRACTICES

The expression means compliance with mandatory as well as non-mandatory provisions of CG as per Clause 49 of the Listing Agreement and exemplary CG practices followed by listed companies for compliance, transparency, value creation and excellence.

1.11 Objectives of the Study

1. To ascertain the extent of compliance with mandatory provisions of Clause 49 of Listing Agreement.
2. To examine the status of non-mandatory and exemplary CG practices.
3. To ascertain barriers to CG reforms in India.

1.12 Hypotheses

In order to achieve the above objectives of the study, we propose to test relevant hypotheses, some of which are presented as follows.

H_0 : There exists no compliance with mandatory provisions of CG with respect to composition of Board of Directors in a majority of the companies.

H_0 : There exists no compliance with mandatory provisions of CG with respect to Audit Committee in a majority of the companies.

H_0 : There exists no compliance with mandatory provisions of CG with respect to CEO/CFO Certification in a majority of the companies.

H_0 : There exists no compliance with mandatory provisions of CG with respect to Compliance (as certified) in a majority of the companies.

H_0 : A majority of companies adheres to non-mandatory provisions of CG with respect to the Remuneration Committee.

H_0 : A majority of companies follows exemplary CG practices.

H_0 : In a majority of companies the size of the Board is appropriate.

H_0 : The CG approach emphasizes the primacy of equity shareholders in a majority of companies.

The preceding set of hypotheses is only illustrative and not complete, since a later chapter deals with the matter comprehensively.

1.13 Chapter Scheme

The thesis is spread over six chapters.

Chapter 1 introduced the topic and presented a historical background of CG, its emergence, CG models, CG theories and CG in India. It also furnishes the rationale and scope of the study, the statement of research inquiry, objectives of the study, hypotheses and chapter scheme.

Chapter 2 bears a review of the literature pertinent to mandatory and non-mandatory practices and other aspects related to CG.

Chapter 3 dwells on regulatory, operational and implementation aspects of CG in India.

Chapter 4 lays out the research design. It also includes details about the research methodology.

Chapter 5 presents the analysis and findings based on data used in the study and an explanation of the use of statistical tools and required tests in pursuance of the research objectives.

Chapter 6 presents the conclusions, and implications of the study and directions for future research.

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CHAPTER 2

LITERATURE REVIEW

2.1 Introduction

This chapter presents a review of the studies pertinent to mandatory, non-mandatory and other Corporate Governance (CG) practices. The area of CG became a fertile field of research after the Cadbury Committee Report in the United Kingdom (UK) in 1992.[1] In emerging markets, CG has not been studied as intensively as in developed markets.[2] Outside the United States (US), i.e., in Japan and Germany, limited research has been carried out on CG.[3] Since economic reforms, CG has gained momentum in India. Gopal has contended that establishment of various committees on CG initiated the adoption of CG practices in India.[4] Good CG addresses the need for disclosure, transparency and professionalism by managers, shareholders, foreign institutional investors and financial institutions. According to Balgobin, the number of scholarly and peer-reviewed articles on CG has gone up from 207 and 434 in 1985-1995 to 2,418 and 7,299 for the period 1996-2006.[5] Agarwal stated that companies in India have opportunities as well as threats worldwide due to entry of global companies.[6] There is a growing realization that good CG is a must not only for credibility and trust but also as a part of strategic management for the prosperity and sustainability of business. According to Stijn and Fan, enormous research work is being done on CG in Asia, excluding Japan but most of the work is based on the literature available on CG from the western countries particularly, US.[7] Khanna and Palepu analyzed the CG practices of an Indian firm i.e., Infosys Technologies and they argued that the globalization of product and talent markets have affected CG of firms.[8] Influence of such individual firms as the role model of good CG may be a positive externality on the rest of the Indian firms and may accelerate convergence of CG.[*] Kimber *et al.*, analyzed CG in four Asia Pacific countries viz., Australia, China, India and Singapore.[9] The said countries have significant diversity in terms of social, cultural, economic developments and approaches to CG. One common feature found is the high concentration of ownership by national governments and families, and such concentration had peculiar effects on the stock market and protection to minority shareholders.

2.2 The Tangible Worth of CG

According to a McKinsey survey of institutional investors around the world, investors are ready to pay a premium of up to 28 per cent for companies having good governance.[10] A joint study by *Georgia State University and Institutional Shareholder Services* found that the best-governed companies had mean returns on investment and equity which were 18.7 per cent and 23.8 per cent respectively better than poorly governed companies.[11]

2.2.1 CG, PERFORMANCE AND FIRM VALUATIONS

A three-member committee constituted by the Ministry of Finance has studied CG of 30 large Indian public companies and ascertained that profits are not related with CG.[12] But, Black found that market value of companies depends crucially on the quality of CG.[13] Using CG rankings, he predicted a seven-hundred-fold increase in firm-value

[*] Convergence means harmonization of CG regulations among various countries.

from worst to best governance. Klapper and Love studied over 400 companies in 25 emerging economies and found that CG practices are highly correlated with firm market valuations.[14] Gompers, Ishii and Metrick in US also reported similar findings.[15] According to Gompers *et al.*, portfolios of companies with stronger shareholder-rights protections outperformed portfolios of companies with weaker protections by 8.5 per cent annually. Moreover, superior CG is associated with higher operating performance and higher valuations.[16] Durnev and Kim found that good CG is positively correlated with firm value.[17]

2.3 Models of CG in India

Varma feels that the Anglo-Saxon (Anglo-American) Model of CG is not particularly suitable to the Indian context.[18] As all CG models survived and the economies prospered, the CG models of Japan and Germany are equally good.[19] Evolving arguments evidently do not settle the question as to which model of CG is more efficient. Recent research has shown that historically, political pressures are as important in the evolution of CG models, as the economic ones. Balasubramanian advocated that our own ancient texts have laid down sound principles of CG which are relevant in the present context too.[20] However, in India, policy-makers are adopting the Western models of CG, policies, and regulations without checking their feasibility in the Indian context. So, the suitability of CG norms may not be so expeditious in emerging markets. To provide adequate investor protection for enforcement of CG rules in India, key concerns are overburdened courts and significant corruption though, on paper India provides the highest levels of investor protection in the world.[21] CG in India does not compare unfavorably with, and in many respects represents a major improvement over the CG models of, the other major emerging economies notably Brazil, Russia and China.[22] No CG model is proven to be effective in all circumstances.[23] Even the Anglo-Saxon Model has its own flaws which are apparent from the corporate scandals of prominent companies viz., Enron and WorldCom. Gilson suggests the possible emergence of a globally accepted CG model, relatively uniform in functions despite persisting formal differences.[24] The Indian corporate sector offers both the best and worst kind of CG models.[25] CG in Indian Boards is apparently driven by its collective conscious and not by stakeholder' demands or market forces.

2.4 Code of Conduct

A code of conduct is one of the internal governance mechanisms used by Boards to ensure ethical behavior in corporate conduct. As per Clause 49 of the Listing Agreement, the code of conduct is a mandatory CG norm in India for listed companies since January 2006 (i.e., with effect from the quarter ended March 31, 2006).[26] Even before 2006, a good number of Indian companies had a code of conduct for their top managers. According to Laczniak and Murphy, a code of conduct should be specific (in terms of guidance), pertinent (to the industry) and enforced (contain sanctions) to be an effective, i.e., ideal one.[27] The scholars also found that the codes of a majority of Indian firms are nowhere close to *'an ideal code'* because they fall short of the conditions contained in the ideal code.

2.5 Convergence of CG Structures

According to Demb and Neubauer, the Board structures in Germany and Japan are moving towards the US structures of a single-tier Board.[28] A single-tier Board is relatively smaller and has both insiders and a significant number of Independent Directors. Yoshimori indicated that the signs of partial convergence of CG are observable among Japanese firms.[29] Kanda argued that shareholding based on 'friendly-ties' i.e., *relationships-driven,* does not work well in Japan anymore and it is now more *market-driven*.[30] Meanwhile, developing countries too are moving towards the Anglo-Saxon Model. This view is also confirmed by Mukherjee-Reed, who argued that this change is led by modifications in the legal and regulatory systems.[31] Hopt suggested that large enterprises will fall in line with CG practices adhered to by the US companies.[32] Coffee also agrees that convergence would happen.[33] Hansmann and Kraakman also believe that the global CG systems are converging towards the Anglo-Saxon Model.[34] As this model focuses on shareholders' interests, they argued that shareholder primacy will pre-dominate as legal provisions can protect the interests of the other stakeholders. Moreover, the competitive pressures of globalization may accelerate the process of convergence. Wojcik concluded that ownership concentration of German firms from the year 1997 to 2001 had fallen significantly.[35] He indicated that the German firms have started dissolving the cross-holdings and that financial sector institutions have declined in importance as block-holders. German firms are also moving towards the Anglo-Saxon Model. According to Gugler *et al.,* the Japanese financial sector was deregulated and in recent years, the members of *Keiretsus* reduced their cross-holdings.[36] Besides, a large number of Japanese firms are getting listed on either New York or London Stock

Exchanges and such listing signals a move towards convergence. However, another set of researchers argue that the CG mechanisms of countries will never converge, because of path dependence of the economies; and Bebchuk and Roe identified two sources of path dependence i.e. *structure-driven* and *rule-driven*.[37] Structure-driven path is concerned with existing basic corporate ownership structures in a country whereas rule-driven path is concerned with financial and corporate regulations which in turn are influenced by the initial corporate structure. As a consequence of path dependence, convergence of the corporate laws will not be as fast as required. According to Gilson, a third set of researchers' perspective is *functional convergence*.[38] At the outset, functional convergence occurs when institutions can respond to market participants with flexibility, without altering their own formal characteristics. For instance, according to Bris and Cabolis, the creation of new stock exchanges in Europe gives protection to investors as companies are bound to comply with norms of stock exchanges irrespective of provisions provided by other laws.[39] Second, *formal convergence* occurs when legislative action forces the adoption of best practices and thereby alters the basic structure of the existing governance institutions. Third, *contractual convergence* occurs when companies change their own CG practices by committing to adhere to a better regime as the existing provisions of CG for compliance lack flexibility to respond with a formal change. According to Khanna *et al.*, globally accepted CG norms laid down by a number of standards-setting bodies and multilateral institutions, as for instance, Organization for Economic Co-operation and Development, to foster good CG globally is a testimony to the heightened interest in the convergence issue.[40]

2.6 Ownership

2.6.1 CG, INSIDERS' OWNERSHIP AND PERFORMANCE

Gompers *et al.,* have uncovered a strong relationship between CG and firm performance.[41] Phani *at el.,* found that in the Indian context, the influence of insiders' ownership on the performance of the firm is sporadic in nature.[42] The association of insider ownership with performance could be considered as temporary aberrations and would disappear in a short time span. The study by Mujumdar and Chhiber revealed a significant negative relationship in India between the levels of debt in the capital structure of the firm and performance.[43] They argued that both short-term and long-term lending institutions are government-owned and it could be the reason behind this relationship. They advocated that CG mechanisms in the west would not work in the Indian context unless the supply of loan capital is privatized. Singh studied the ownership pattern of 14 major Indian companies and revealed that promoter-shareholders are dominant owners, owning 33 per cent to 85 per cent of the total share capital.[44] The 'Principal-agent' relationship is thus considerably diluted in this model, as the interest of promoters substantially converges with retail shareholders. Morck *et al.,* observed a positive relationship between Board ownership, ranging up to 5 per cent and firm performance but a negative relationship for the 5 per cent to 25 per cent ownership range, indicating that as ownership stakes rises, management entrenchment outweighs convergence of interest, and the positive influence of management ownership re-appears only beyond the 25 per cent ownership range.[45] According to Agrawal and Knoeber, higher insider ownership was positively related to performance.[46] Murphy (1999) and Core *et al.,* (2001) as well as Holderness found that the relationship between inside ownership and performance is mixed.[47] Khanna and Palepu have detected a positive linear relationship between insider ownership and performance of the firm in a single year, 1993, where both accounting (Return on Assets) and market based performance measures (Tobin's Q) were used.[48] Van *et al.,* found that equity ownership of management Board and supervisory Board does not affect performance.[49]

2.6.2 MANAGERIAL, INSTITUTIONAL, GOVERNMENT OWNERSHIP AND FIRM PERFORMANCE

For more than 70 years, since the classic work of Berle and Means which gave the proposition that ownership and control in the modern corporation have been separated, researchers have been trying to identify the optimal ownership structure and how it influences a firm's subsequent performance.[50] According to Jensen and Meckling, managerial ownership can be an effective governance mechanism because it can align the interests of managers and shareholders and hence a positive correlation is expected.[51] In consonance with this, Agrawal and Knoeber upheld ownership as an important CG mechanism.[52] In another study by Chrisotomos, it was observed that at low levels of shareholding by managers, managerial ownership binds managers and outside shareholders to pursue a common goal by decreasing managerial incentives for extravagant rewards, encouraging diligence and the launching of good projects *(alignment effect)*.[53] However, after some level of ownership, managers put in insufficient efforts, amass personal wealth and establish themselves at the cost of others *(entrenchment effect)*. Hence, managerial ownership as a governance mechanism can be used to control the actions of managers. According to Jensen and Meckling, there occur two opposing effects of managerial ownership - the interest and the entrenchment effect.[54] Under the interest effect, correlation between managerial ownership and firm's performance is positive as the managers have to share the cost of their actions. In the entrenchment effect, this association turns negative as managers have a large stake in the organization and thus overlook the interests of other shareholders. The seminal work by Morck *et al.,* studied the relationship between managerial ownership and Tobin's Q (proxy for market value).[55] An inconsistent relationship was observed as Tobin's Q increased with ownership, suggesting the convergence of the interests of agent and principal, whereas a decrease would have suggested entrenchment effect in play. According to Mudambi and Nicosia, ownership concentration and the extent of investor control have entirely dissimilar effects on a firm's performance.[56] They also found an inconsistent relationship between managerial stock-holding and firm performance, supporting both the *theories of entrenchment and interest*. A study by Welbourne and Cyr identified three types of ownership i.e., ownership by the Chief Executive Officer (CEO), by the top management and by all the employees of the firm.[57] The study suggested that an increase in ownership of all the employees will have a positive impact on a firm's performance, whereas increases in CEO and top management ownership will have a negative impact on firm's performance. Core and Larcker found that after a compulsory increase in managerial share ownership, prior to the adoption of the managerial share ownership plan, firms reported a lower performance as compared to other firms without such plans.[58] They also established that share price return was highest in the first half of the year in which the announcement of the managerial share ownership plan was made and that firm performance improves after managers with less stock ownership are required to mandatorily increase their stake. Jahmani and Ansari used accounting measures and correlation analysis (instead of stock returns) and observed no effect of ownership on a firm's performance, risk taking abilities of managers and on motivation levels of managers to work more competently.[59] Demsetz and Lehn did not find any significant relationship between profitability and ownership concentration.[60] However, Zeitun and Gang found that there was a positive impact of managerial ownership on a firm's performance in Jordan.[61] Another study by McConnell and Servaes studied the relationship between Tobin's Q and ownership, in which a significantly positive relationship was found.[62] Ming-Yuan Chen found that association of the family in management of the firm determines the option of ownership stakes in Taiwan.[63] It was also found that entrenchment effect engulfs incentive (interest) effect at a higher level of ownership. According to Short and Keasey, a non-linear relationship existed between managerial ownership and firm performance for UK companies due to possible *effects of alignment* and *entrenchment*.[64] However, the exact relationship between a firm's managerial ownership and performance is still ambiguous. The relationship is either positive or non-existent. This justifies the need for further research.

According to Chaganti and Damanpour, there exits limited research about the impact of institutional ownership on firm performance as it is assumed that there is no significant relationship between the two.[65] Capital structure and Return on Equity were found to be considerably related to the amount of shareholding by institutional investors. The stakes also impact firms' Return on Assets, and Price-Earnings Ratio in varying degrees. It was observed that ownership structure had no substantial impact on total stock return. Another study found the institutional ownership to be negatively related with growth but positively related with profitability.[66] Public ownership did not show any significant relationship with any of the performance variables. Financial Institutions' ownership showed significant and positive relation with assets creation. However, Roy found that the stake of financial institutions had a negative relationship with profitability.[67] Chhibber and Majumdar found that three types of state ownership exist in India: firstly, firms where the government has less than 26 per cent shareholding; secondly, where the government owns more than 26 per cent; and lastly, where state is the majority shareholder with more than 50 per cent share.[68] The study revealed that firms which do not have state as the majority shareholder performed better. But, another study by Ahuja and Majumdar, involving 68 state-owned firms revealed that the firms on average were less effective in employing their resources.[69] In India, Kumar studied more than 2,000 publicly traded enterprises and found that foreign shareholding does not influence the performance of the firm significantly, contrary to the other studies.[70] He also found that the extent of ownership by financial institutions positively influences a firm's performance. However, no significant difference was found in managerial ownership and firms' performance across group and stand-alone firms. According to Pant and Pattanayak, ownership in India is concentrated in the hands of family members and their relatives.[71] The findings suggested that when insider ownership increased from 0 per cent to 20 per cent, firm value also increased and as the stake increased further from 20 per cent, the entrenchment effect came into play so the performance deteriorated; further, when the ownership extended beyond 49 per cent, there was a convergence of interest with the firm and again the performance improved. According to Hambrick and Jackson, outside director holdings were actually associated with corporate performance changes subsequent to such holdings.[72]

2.6.3 INSIDE OWNERSHIP, CASH FLOW RIGHTS, AND TUNNELLING

Jensen and Meckling demonstrated that reduction in owner-manager's equity tends to encourage appropriation of corporate resources in the form of perquisites and consequently, reduction in the claim of stakeholders on the cash flow without equivalent reduction in control rights.[73] Such behaviour gives rise to agency costs. According to La Porta *et al.*, a need for higher cash flow ownership by managers shows a commitment to control expropriation and it is higher in countries with inferior shareholder protection.[74] Bertrand, Mehta and Mullianathan concluded that differential control and cash flow rights encourage undue appropriation or tunnelling of profits.[75] The authors focused only on firms belonging to large groups but controlled by an ultimate owner through a pyramidal ownership structures[*] and contend that transfer pricing which affects the operating profit of the firm is not an important source of tunnelling in India. They found significant amounts of tunneling, mostly via non-operating components of profits. Bennedsen and Wolfenzon argued that when investor protection is poor, dissipating control among several large investors might be useful to limit expropriation.[76] Bertrand, Mehta and Mullianathan reported that industry shocks result in 30 per cent lower earnings growth for business group firms than for stand-alone firms in the same industry.[77] The companies farther down the pyramidal structure were less affected by industry-specific shocks than those nearer the top, suggesting that shocks in the former are effectively buffered using the assets and cash flows of the latter, benefiting the

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[*] Pyramidal structures allow the ultimate owner to end up with control of all the firms in the pyramid with little or no cash flows. This is possible as the owner holds controlling share in one firm and then this firm holds controlling share in another firm and so on and so forth thus gaining control of a set of firms by having a controlling share in one firm at the head of the pyramid.

controlling shareholders at the cost of minority shareholders. On the other hand Khanna and Yafeh question how such a practice would insulate them from industry shocks in the long-term.[78] Moreover, according to Khanna and Palepu, companies associated with business groups outperform stand-alone companies.[79] Kali and Sarkar argued that diversified business groups help to increase the opacity within group fund flows, driving a broader wedge between control and cash flow rights, and providing more opportunities for tunnelling.[80] The authors further reported that business group companies with greater ownership opacity and a smaller disparity between control and cash flow rights than those in a group's core activity were likely to be located farther away in the pyramid from the core activity and hence were the most likely to receive tunnelled cash flows and assets. According to Saha, after controlling for other CG characteristics, firm performance was negatively associated with the extent of related-party transactions for group firms but it was positive for stand-alone companies – a circumstantial evidence on tunnelling and its adverse impacts.[81] The study further showed that group companies consistently report higher levels of related-party transactions than stand-alone companies. Most related-party transactions in India occur in case of joint ventures, subsidiaries and associate companies while in the US, the counterparties tend to be the firm's own management personnel.

2.6.4 CONTROL AND INVESTOR PROTECTION

La Porta *et al.,* argued that entrepreneur firms may wish to keep control of their firms with them when investor protection is poor.[82] Claessens *et al.,* examined 3,000 firms from nine East Asian economies and found that except Japan which has fairly good shareholder protection, family control and family management is pre-dominant with some state-control.[83]

2.6.5 OWNERSHIP CONCENTRATION, PERFORMANCE AND OTHER IMPLICATIONS

Gugler made a survey of the studies of US and UK firms and showed that owner-controlled firms (with a single block of equity exceeding 5 per cent or 10 per cent) significantly outperformed manager-controlled firms.[84] Cross-sectional analysis by Wruck indicated that the change in firm value on the announcement of a private sale is strongly correlated with the resulting change in ownership concentration i.e., it is positive when ownership concentration is high or low, but negative in the mid range.[85] A study of German firms by Thonet and Poensgren found that manager-controlled firms significantly outperformed owner-controlled firms in terms of profitability, but owner-controlled firms had higher growth rates.[86] Holderness and Sheehan found that the frequency of corporate-control transactions, investment policies, accounting returns and Tobin's Q were similar for majority shareholders owned and widely-held firms.[87] In India, shareholding patterns revealed a marked level of concentration in the hands of the 'promoters', i.e., the founding and controlling shareholders. Sarkar and Sarkar reported that promoters own over 50 per cent of a sample of almost 2,500 listed manufacturing companies.[88] Sarkar and Sarkar also reported that equity stakes above 25 per cent by directors and their relatives were associated with higher valuation of companies and there was no clear effect below that threshold.[89]

2.6.6 FAMILIAL OWNERSHIP, TAKEOVERS AND PERFORMANCE

According to McConaughy *et al.*, family-controlled firms in US had greater value, were operated more efficiently and had fewer debts than other firms.[90] However, Jacquemin and Ghellinck and Prowse reported no relationship between performance and familial ownership in case of French and Japanese firms.[91] Agrawal and Knoeber found that greater corporate control activity (number of takeovers within industry) was negatively related to performance.[92] Interestingly, Gugler had shown that there exists active markets for corporate control in the US and UK, unlike in Continental Europe or Japan.[93] According to Franks and Mayer, takeovers are an incomplete mechanism to solve the basic agency problem in large public corporations, say, in the US and hostile takeovers were attempted for other reasons than poor performance.[94] In Hong Kong, Ng found that family ownership affects a firm's performance.[95]

2.7 The Board of Directors

2.7.1 THE ROLE OF THE BOARD AND DIRECTORS

According to a survey by Dutta, Boards have no active role in the governance of a firm and Board members merely endorse their approval to proposals.[96] Also, the Nominee Directors are treated indifferently and they hardly have any say in the Board meetings. Directors in most of the companies are ineffective in monitoring the management's performance.[97] According to Varma and Dalal, the members of the Board do not play the role that they are supposed to play.[98] For instance, the existence of Audit Committees does not guarantee good CG. Zingales, La Porta *et al*., and Bebchuk argued that if entrepreneurs disperse control among many investors, then they give up the premium of private benefits in a takeover.[99] Two decades of research reveals that in any Board related decision making, when the Board has a majority of Independent Outside Directors, the outcome is more likely to favour shareholders.[100] Also the representations made by large shareholders on the Board have a positive impact on CG. Though frequent Board meetings facilitate better communication between management and directors, such frequency may distract Board members as they usually have a busy schedule. A very large Board can be dysfunctional and companies which enjoy the highest valuation seem to have compact Boards. As Shivdasani and Zenner put it: “Companies with the highest valuation multiples had Boards that include 8 or fewer people, while companies with Board membership of more than 14 displayed the lowest multiples”.[101] Further, directors should not serve on too many Boards. A person holding full-time employment is considered “busy” if he serves on more than 3 Boards and a retired person is considered “busy” if he serves on more than 6 Boards.

2.8 Board Characteristics

The most important internal CG mechanism is the Board because other internal governance mechanisms largely depend on the effectiveness of the Board. The widely studied Board characteristics are the size of the Board, proportion of Independent Directors in the Board and firm performance. The other factors like profile of the directors also figured in some studies.

2.8.1 BOARD MONITORING, QUALITY OF DECISION MAKING, SIZE OF BOARD AND FIRM PERFORMANCE

Monks and Minow argued that Board monitoring may lead to better quality of managerial decisions.[102] Fama and Jensen also argued that Boards can be effective mechanisms for monitoring management.[103] Boards effect appointments of management personnel and also their rewards, suspensions and dismissals and such managerial decisions have implications on corporate performance. A study by Weisbach was one of the earliest to report an association of Board turnover, firm performance and the presence of outside directors.[104] Fama argued that the viability of the Board might be enhanced by the inclusion of outside directors.[105] The Cadbury Committee Report UK, suggested more number of Non-Executive Directors in the Board in addition to the separation of the post of Chairman and CEO.[106] Weisbach found that performance measures are highly correlated with CEO turnover for firms in which outsiders dominate than insiders'.[107] Bhagat and Black also reported a positive impact of the number of outsiders.[108] Pearce and Zahra and Dalton *et al.*, found a positive association between the Board diversity and firm performance.[109] A larger Board with diverse backgrounds can bring knowledge and intellect to improve the quality of decisions. Simultaneously, as the larger Board will also have group dynamics, it can also diminish the Board effectiveness on account of problems of co-ordination. Goodstein *et al.*, Yermack, and Eisenberg *et al.*, supported this argument.[110]

In the Indian context, some research work has shown that the larger Boards improve performance till a threshold level, while others argue that larger Boards are inefficient. According to Kathuria and Dash, performance improves if the Board size increases.[111] Their results, however, failed to indicate any significant role of directors' equity ownership in influencing the performance. A larger Board size creates more opportunities and resources for better financial performance.[112] According to Kautilya, the Board size should be according to the requirements of place, time and nature of the work in view.[113] These findings are also supported by Dhawan.[114] According to him the size of the Board increases with the turnover but only up to certain level, beyond which the increasing turnover does not have any influence. The researcher found that effective integration of the skills and knowledge base of the Board is more important than size. Further, he advocated that there is no need to have informal meetings of the Board but it is vital to finalize the agenda in order to have effective Board meetings. The core competencies required for the directors are strategic thinking and leadership qualities besides honesty and integrity. Dwivedi and Jain also found a positive but weak relationship between Board size and firm value.[115] The results revealed that a higher proportion of foreign shareholding is associated with rising market value of the firm, while the association of Indian institutional shareholding with market value is not statistically significant. While directors' shareholding had a non-linear negative relationship with the firm value, the public shareholding had a linear negative association.

A few empirical results suggest that Board size exerts a negative influence on corporate performance irrespective of whether accounting performance or market based measures are considered.[116] Board size has been widely demonstrated as being negatively associated with lower returns to investors, suggesting larger boards are less effective monitors.[117] Such findings are supported by Bharadvaja, Visalaksha, Parasara and Pisuna.[118] Garg found that Board size and firm performance were inversely related.[119]

Kaur and Gill found that the results of one-way ANOVA test for the comparison of means for Board size categories reveals an inverse relationship between board size and corporate performance.[120] Prasanna, who employed factor analysis, suggested that Independent Directors bring brand credibility and better governance, contribute to effective Board functioning, and lead the governance committees' effectively.[121] The study supported two major recommendations of the Irani Committee i.e., one-third of the Board should be Independent Directors and nominees should not be considered as Independent Directors.[122] He also highlighted the need for a formal process of the appointment of Independent Directors and their periodic evaluation. Mayur and Saravanan studied the relationship between three Board parameters and performance of banks in India.[123] The authors indicated that bank value is not affected by Board size. According to Perry and Shivdasani, the Board of directors is one of the most important mechanisms used by the shareholders to monitor management.[124] They further state that "charged with hiring, evaluating, compensating and ongoing monitoring of the management, the Board of directors is the shareholder's primary mechanism for oversight of managers." According to Finegold *et al.*, firstly a Board performs an institutional function in which it links the firm and the external resources, secondly it is an important mechanism to check managerial opportunism and lastly, the Board performs a strategic role by involving itself in strategy formulation.[125] Hej and Mahoney argued that if a CG mechanism is in place, managers will probably formulate optimal strategic policies leading to sustainable competitive advantage else managers could end up making sub-optimal strategies.[126] Their research suggests a positive relationship between a firm's capabilities and its competitive behaviour but this relationship is moderated by CG mechanisms. Moreover, a positive relationship is indicated between competitive behaviour and firm's performance. As the Board can directly influence a firm's capability, it can influence a firm's competitive behaviour and hence the firm's performance positively. According to Barney, drawing on the *resource-based view* of the firm, a resource could be considered as a competitive advantage if it is rare, creates value for the firm, is inimitable and not easily substitutable.[127]

Erakovik and Goel argued that if the Board of Directors is involved in acquiring knowledge and in the provision of resources, it will lead to exchange of information, both inside and outside the Board, resulting in a more open and collaborative relationship between the Board and management.[128] This will build a unique CG structure, like a resource for the firm. According to Barney, the Board of Directors can work as a resource, leading to a competitive advantage for the firm and thereby enhancing performance of the firm.[129] Chahine and Filatochev found that Initial Public Offer (IPO) discount is negatively associated with Board independence.[130] IPO discount is also negatively associated with disclosure of information but up to a certain point. As more and more information was disclosed, investors thought it to be an attempt by the management to impress and induce them to acquire their shares. Raheja found that the Board size and composition could affect the performance of the firm.[131]

According to Warther, a Board is ineffective if there is no dissent in the Board.[132] Moreover, it was found that there is reluctance among the Board members in voting against the management but once an initiative is taken by somebody, it results into a bandwagon effect. It was also argued that the Board will be effective when it possesses more information which is possible when there are more outside directors on the Board.

Klein found that there is a negative relationship between the Audit Committee independence and Board independence vis-à-vis abnormal accruals.[133] If the number of Independent Directors on the Board or in the Audit Committee decreased, there was an increase in the abnormal accruals. Therefore, the independence of the Board and Audit Committee can increase the Board's effectiveness which can improve the firm's performance. Adjaoud *et al.*, found no significant relationship between Board characteristics and performance when traditional performance measures like Return on Assets (ROA), Return on Investments (ROI) and Earnings Per Share (EPS) were used.[134] However, this relationship was significant when performance was measured in terms of Market Value Added or Economic Value Added. Jensen found that large Boards can be less effective than small Boards.[135] When Boards members are as many as seven or eight, they are less likely to function effectively. Therefore, it can be said that size of Board affects the performance of the firm. Van *et al.*, Netherlands, found that size of management Board has no impact on performance, size of the supervisory Board had a negative impact on performance and the number of outsiders negatively affected performance.[136] In the Indian context, Tuteja recommended that Board size should neither be too small nor too large i.e., the ideal size should be from 6 to 10 directors.[137] An ideal Board is a judicious mix of inside and outside directors. In the Indian context, Garg reported a negative relationship between the Board independence and performance as well as between Board size and performance.[138] However, Haleblian and Finkelstein argued that a large Board has more problems solving capabilities.[139]

Several studies have been conducted to see how the characteristics of the Board impacts management and can enhance the performance of firms. However, there is no consistency in the findings. Some studies found a positive relationship between Board characteristics and firm performance; some reported no relationship, while other studies reported a negative relationship. This emphasizes the need for further research.

2.8.2 INDEPENDENCE OF THE BOARD AND FIRM PERFORMANCE

Baysinger and Butler, and Hambrick and Jackson found that the proportion of Independent Non-Executive Directors is positively correlated with the accounting measures of performance.[140] On the other hand, studies by Klein, Bhagat and Black, and Hermalin and Weisbach found that a high proportion of Independent Directors does not predict a better accounting performance.[141] Using accounting measures, Agrawal and Knoeber found a negative relationship between Board independence and firm's performance.[142] Hermalin and Weisbach, and Bhagat and Black used the approach of Tobin's Q as a performance measure on the grounds that it reflects the 'value added' of intangible factors and found that there is no noticeable relationship between the proportion of outside directors and Tobin's Q.[143] The study by Lawerence and Stapledon produced no consistent evidence that the preponderance of Independent Directors either adds or destroys value when corporate performance was assessed using accounting and share-price measures.[144] Hermalin and Weisbach found that the proportion of Independent Directors increased when performance of a company was poor.[145] Apparently, there is a link between Board size and independence. Perry and Shivdasani found that when the outside directors were in a majority, the likelihood that restructuring activities will be carried out was high and improvements were found in the performance of the firms subsequent to restructuring.[146] As pointed out by Lipton and Lorsch the norms of behaviour in most Boardrooms are dysfunctional as directors rarely criticize the policies of the top managers or hold candid discussions about corporate performance.[147] Believing that these problems increase with the number of directors, they recommended limiting the membership of Boards to ten members, with a preferred size of eight or nine. They, in a way, suggested that even if Board capacities for monitoring increase with the Board size, the benefits are less as slower decision making, less candid discussions about managerial performance and risk aversion are costly affairs. When Boards become too big, agency problems increase and the Board becomes more symbolic and less effective. Yermack, Eisenberg, Sundgren and Wells, Mak and Kusnadi, Alshimmiri, and Andres, Azofra and Lopez had also reported the inverse relationship between Board size and performance.[148] However, Dalton *et al.*, came up with contrary results.[149] Dalton and Kesner in a study of the 50 largest firms in the US, the UK, and Japan found that the proportion of insiders in Boards varied significantly between these three countries i.e., 30 per cent, 34 per cent, and 49 per cent respectively.[150] Beasley analyzed 75 fraud-hit and 75 no-fraud firms and indicated that no-fraud firms had Boards with a significantly higher percentage of outside members than fraud-hit firms.[151] Additionally, as outside director ownership in the firm and outside director tenure on the Board increased and as the number of outside directorships in other firms held by outside directors decreased, the likelihood of financial statement fraud also decreased. Geddes and Vinod and Weisbach found that with respect to the removal of poorly performing CEOs, a majority of independent Boards were likely to act more quickly.[152] McNulty and Pettigrew interviewed 108 UK directors and found that part-time Board members did not simply ratify decisions made by all powerful executives, and that they were able to influence the processes of strategic choice.[153] Mikkelson and Partch found a correlation between Board composition and CEO tenure during the high-takeover period of 1983-1988.[154] Rosenstein and Wyatt pointed out that a small increase in stock price was correlated with the addition of an outsider to the Board, which could be on account of a signalling effect.[155] However, Chugh, *et al.,* contend that an excessively autonomous Board with a high proportion of Independent Directors lowers profitability.[156] One possible rationale was that the Boards were expanded for political reasons to include politicians, environmental activists or consumer representatives, and they either reduced firm performance or failed to contribute positively. Baysinger and Hoskisson found that outsiders dominated Boards that emphasized financial controls in evaluating and rewarding top management.[157] These Boards increased the intensity of managerial efforts in maximizing short-term profits and they also avoided higher risk-return strategies that shareholders may prefer. According to Lin, Effective Monitor Theory argues that outsider-directors[*] are motivated to protect shareholders' interests and while doing so, they protect their reputation as experts in decision control.[158]

Westphal suggested that close relations between CEOs and Board members tended to improve corporate performance through significant informal advice.[159] In India as well as in the US, studies have linked larger corporate Boards to poor operating and stock-price performance. Large company Boards in India in the late '90s were slightly smaller than those in the US, with 9.46 members on average in India as compared to 11.45 in US.[160] But, the percentage of inside directors was almost identical (25.38 per cent as compared to 26 per cent in the US), with relatively fewer Independent Directors (just over 54 per cent as compared to 60 per cent in the US) and relatively more affiliated

[*] Non-Executive Directors.

outside directors (over 20 per cent versus 14 per cent in the US). Over 40 per cent of the Indian companies also had a promoter on the Board and in over 30 per cent of the companies, the promoter also served as the chair.

A review of above studies suggests that findings differ about outside directors as monitors and the optimal mix of inside and outside directors might differ across countries.

2.8.3 MULTIPLE DIRECTORSHIPS AND PERFORMANCE

Jayati Sarkar and Subrata Sarkar found that better and more efficient independent directors are the ones with multiple appointments.[161] These results are in consonance with the *resource-dependence perspective* i.e., directors with multiple appointments are experienced, networked and knowledgeable. In case of inside directors, excessive multiple directorships adversely impacts the company value.

2.8.4 NON-EXECUTIVE DIRECTORS AND PERFORMANCE

There is a positive association between the number of Non-Executive Directors and firm performance.[162]

2.8.5 INDEPENDENCE, ACTIVE REPRESENTATIONS AND EARNINGS

Xie *et al.*, concluded that a management with a lower level of earnings is associated with greater independent outside representations on the Board. Further, management with a lower level of earnings is also associated with more active Boards and more active Audit Committees.[163]

2.8.6 BOARD AND COLLABORATIVE POLITICS

Simmers (1998) found that quality and speed of the strategic decision-making process by the Board and the outcomes were strongly related to collaborative politics. However, goal achievement was weakly associated with collaborative politics.[164]

2.9 Audit Committee

2.9.1 AUDIT COMMITTEE AND FIRM PERFORMANCE

Al-Mudhaki and Joshi found that only 56.2 per cent of the firms had established an Audit Committee in their Board, despite the fact that it was already mandatory.[165] Of those firms which have the Audit Committees, 68.3 per cent had between three to six members on the Audit Committees. Almost all the firms had Non-Executive Directors in the committees but only 14.6 per cent of firms had Independent Non-Executive Directors indicating a lack of independent representation on the committees. 58.5 per cent of firms in the sample stated that Audit Committee met monthly and 29.5 per cent firms stated that committee met quarterly. Internal control and evaluation function of an Audit Committee is very much influenced by the frequency of its meetings and an improvement in internal control will definitely improve the external financial reporting system especially in large companies. Hence, frequent meetings of Audit Committee may help in improving the CG practices. The authors suggest that the functions of Audit Committees are quite diverse and are classified into three categories i.e., financial statements and reporting, audit planning, and internal control and evaluation. Collier found that among the listed companies in UK, Audit Committees strengthened audit independence and public confidence in the integrity of the financial reporting.[166]

2.9.2 ROLE OF AUDIT COMMITTEE IN CG

Varma and Dalal find that the members of the Board do not play their expected role and therefore, the existence of the Audit Committee may not guarantee good CG.[167] Yet, Green considers an Audit Committee as an essential part of CG.[168]

Rutteman found that without regard for quality or effectiveness, the mere existence of an Audit Committee could be used as evidence that directors took due care in performing duties.[169] Arthur Anderson's survey of all listed companies in Australia found that 48 per cent of companies had formed Audit Committees, while Ernst and Young reported that the formation of an Audit Committee to carry out the financial reporting responsibilities of a Board has become a well established part of CG.[170] Ernst and Young found that a majority of companies follow the Audit Committee practices in respect of adopting high-level Audit Committee charter, effective communication with the independent auditors, composition, reporting and meeting practices.[171] Similarly, KPMG's survey of 400 companies in Europe reported that more Audit Committees were established in the UK (100 per cent) than in the rest of Europe.[172] Compared to companies in Europe, UK companies had adopted standard practices in terms of establishing a charter (100 per cent), composition (3 to 4 members), and meetings more than twice a year involving independent non-executive members of companies, whereas across Europe, 39 per cent of Audit Committees met only twice a year. In the Canadian context, Scarbrough *et al.*, indicated that Audit Committees consisting of solely non-employee directors were more likely than Audit Committees with one or more insiders to (i) have frequent meetings with the Chief Internal Auditor, and (ii) to review the internal auditing program and results of internal auditing.[173] Vicknair *et al.*, examined the percentage of affiliated directors on Audit Committees for one hundred New York Stock Exchange firms between 1980 to 1987.[174] They found that more than one-quarter of all firms had Audit Committees with a majority of affiliated directors. Menon and Williams found that 156 firms from 200 National Association of Securities Dealers Automated Quotations firms had voluntarily formed Audit Committees.[175] However, 19 (12 per cent) of the Audit Committees had at least one inside director. Further, 57 per cent of Audit Committees did not meet or only met once a year. Klein found a similar lack of independence in Audit Committees in a sample of Standard and Poor's 500 firms, over a two-year period ending in 1993.[176] Therefore, it is apparent that in the initial period of the formation of Audit Committees, firms tend to include insider-directors[*] or directors from affiliated firms. This trend may not be different in developing countries like India. In another survey of Audit Committees, Price Waterhouse Coopers found that Audit Committees among European companies on an average met three to four times a year.[177] Among the major European companies, 70 per cent of Audit Committees had three to four members. Porter and Gendall found that 61 per cent of both listed companies and significant public sector entities in New Zealand had Audit Committees that were expected to play a broader role in CG.[178]

2.9.3 AUDITING, MANAGERIAL MONITORING, FIRM VALUATION AND CG

Jensen and Meckling contended that managerial ownership aligns the interests of managers and equity-holders and a positive relationship is expected between managerial ownership and firm valuation.[179] Stulz developed a model of firm valuation in which the entrenchment effect results in a negative relationship between managerial ownership and

[*] Executive Directors.

firm valuation at relatively high levels of managerial ownership.[180] Other studies have also investigated this relationship. For example, Morck *et al.,* and McConnell and Servaes found that their results supported both the positive alignment effect and the negative entrenchment effect.[181] The empirical models, however, do not account for the monitoring effects associated with external auditing. Palmrose, Francis and Wilson and DeFond in the US found a lack of convincing evidence linking management ownership and leverage relevant to auditor choice.[182] With a wide spectrum of governance mechanisms available to alleviate agency conflicts, the relative importance of external auditors is quite limited. According to Ghosh, in India, where conventional corporate control systems have begun to gain prominence only recently, it seems that independent external auditors could potentially act as important monitors controlling shareholders.[183] Moreover, such monitoring may improve the value of firms. If this is true, then the major benefits derived from external auditing activity should be reflected in the higher capitalized value of the ownership claims on the corporation. According to Fan and Wong, recent empirical evidence for East Asian economies highlighted the fact that external auditors played a monitoring and bonding role in order to mitigate the agency conflicts between controlling owners and outside investors.[184] According to Ganguli, in view of the changing business scenario a greater interaction or link between the auditors and the top echelon of management is needed.[185]

2.10 Remuneration

2.10.1 REMUNERATION COMMITTEE AND FIRM PERFORMANCE

Narasimhan and Jaiswall found that in family-owned and controlled firms, the remuneration committee had a limited role to play on both pay-setting process and impacting performance through top management pay.[186] They concluded that the remuneration committee plays an important role in mitigating the agency problem which is expected to be acute when family ownership is low or non-family members hold key positions. Moreover, management remuneration is determined on the basis of the financial accounting information. Also according to Bushman *et al.*, half of the managerial bonuses are found to be determined by corporate performance reflected in the financial accounts.[187] According to Klein, management has used accrual amounts to inflate the income in order to wangle hefty bonuses and salaries.[188] Ezzamel and Watson found that among UK companies the characteristics of remuneration committee did not result in a strong relationship between pay and performance.[189]

2.10.2 EXECUTIVE COMPENSATION AND CORPORATE PERFORMANCE

Firms need to pay well to attract talent and yet, excessive pay to managers will reduce the residual earnings for investors. As CG gained momentum, researchers started focusing on the impact of various CG parameters on executive compensation. According to Jensen and Murphy, the level of pay affects the quality of managers.[190] Bebchuk and Fried suggested that managers are in a position to decide their own pay and would do so in a way that would weaken the link between their pay and performance.[191] Core *et al.*, and Pukthuanthong *et al*., suggested that CG parameters like Board characteristics and ownership structures are major determinants of executive compensation.[192] Ramaswamy *et al*., found that firm performance was a significant explanatory variable in explaining CEO compensation.[193] However, the family-ownership of a firm is found to be negatively related with CEO pay. According to the authors, this relationship could be because family ownership and management significantly reduce the agency problem. The study further reveals that CEO-Chairman duality and the proportion of insider directors has no relationship to executive compensation in family-owned firms. However, these factors are key variables in explaining compensation in non-family owned firms.

In the Indian context, Ghosh suggested that CEO remuneration has a positive influence on corporate performance judged in terms of accounting measures.[194] Parthasarathy *at el*., found that the CEO compensation is not related to any of the profitability measures.[195] On the other hand, the size of firm is a significant determinant of CEO compensation. The results also suggested that CEOs who were the promoters of their firms, received significantly more compensation than their ordinary counterparts. In addition, the study also indicated that CEOs of Public Sector Units are significantly underpaid compared to their counterparts in the private sector. According to Fagernas, roughly 300 firms each year reported that the average total compensation of Indian CEOs increased almost three-fold between 1998 and 2004 in real terms.[196] During this period, the proportion of profit-based commission to total pay also rose steadily from 13.4 per cent to 25.6 per cent, and the percentage of CEOs with commission as a part of their pay package jumped from 34 per cent to 51 per cent. Further, executive compensation as a fraction of profit had almost doubled, from 0.55 per cent to 1.06 per cent. Interestingly, in the year 2000, the average US CEO compensation was 7.89 per cent of corporate profits for companies included in the 1500-Company ExecuComp Dataset.[197] CEO pay has become more performance-based over the past decade.[198] Also increased performance-pay linkage has been influenced by the introduction of the CG Code. Fagernas also reports that CEOs or directors related to the founding-family were paid more than other CEOs.[199]

Ghosh reported that during the period 1997-2002, the average Board compensation in India, based on a sample of 462 manufacturing firms, was around Rs. 5.3 Million with wide variation across firm size.[200] The average Board compensation was Rs. 7.6 Million for large firms and Rs. 2.5 Million for small firms. Board compensation was also higher, on average at Rs. 6.9 Million, when the CEO was related to the founding-family. Since, almost two-thirds of the largest 500 Indian companies are group affiliated, issues of CG in firms owned by business groups become vital.

According to Jensen and Meckling and Fama, as per *incentive constraint*, aligning the incentive of the CEO with the shareholders is the easiest way to circumvent moral hazard on the part of the CEO.[201] Thus, Hall and Liebman found a positive association between CEO compensation and financial performance.[202] Mehran found that firms exhibiting a positive and significant relationship between CEO compensation and performance will provide higher returns to shareholders vis-a-vis companies where this relationship is less sensitive.[203] According to Hall and Liebman and Main *et al.*, when stock options were considered, a stronger pay-performance link could be identified.[204] However, Ezzamel and Watson found that changes in executive pay were more closely related to external market comparison of pay levels than to change in either profit or shareholders wealth.[205] In a poll by KPMG, around 85 per cent of the respondents think that remuneration of CEOs should be significantly linked to company performance.[206]

According to Aggarwal and Samwick, executives' pay-performance sensitivity for executives of firms with the least volatile stock prices was greater than firms with the most volatile stock prices.[207]

Core *et al.*, found that firms with weaker governance structures had greater agency problems; the CEOs of such firms received a higher compensation and their performance was inferior.[208] CEOs' compensation was higher when the CEOs were also Board Chairmen and when Boards were larger with a greater percentage of outside directors appointed by the CEOs. Hermalin and Weisbach concluded that CEOs with interlocking Boards are paid more than otherwise similar CEOs and interlocking directorships provide the CEO with a degree of control over his Board that harms performance.[209] According to Cyert *et al.*, when stock holding by members of the compensation committee is large, such members are more involved in company affairs.[210] Exhibit 2.1 presents the impact of Employee Stock Options and measures on performance.

EXHIBIT 2.1

EMPIRICAL ANALYSES OF IMPACT OF EMPLOYEE STOCK OPTION (ESO)

AND MEASURES OF PERFORMANCE: A SELECTED CHRONOLOGY

Author(s), Year(s)	**Nature of Sample, Year(s)**	**Results**
Lewellen, Huntsman (1970)	50 US companies, 1942-63	Including long-term elements has little effect on reward-performance link.
Cosh (1975)	1,601 UK companies, 1969-71	Size more important than profitability in determining narrowly defined pay.
Meeks, Whittington (1975)	1,008 UK companies, 1969-71	Sales the best determinant of pay, but profit's significance reaffirmed.
Murphy (1985)	73 US companies, 1964-81	Performance more significant than size in explaining executive reward.
Deckop (1988)	108 US companies, 1977-81	Profit-sales ratio most powerful explanatory pay determinant.
Benston (1985)	29 US companies, 1970-75	Stronger performance-reward link when stock-related elements included.
Leonard (1990)	20,000 executives and managers in 439 large US companies, 1981-5	Link between long-term executive plans and return on equity. No ESO data.
Abowd (1990)	16,000 managers in 250 US companies, 1981-6	Correlation between pay and degree of sensitivity between previous year's pay and market performance.
Jensen , Murphy (1990)	1,688 executives, 1,049 US companies, 1974-86	Weak relationship between performance and remuneration. Incomplete ESO measure.
Szymanski (1992)	51 UK companies, 1981-91	Weak pay-performance link, but ESO valuation unclear.
Gregg, Machin, Szymanski (1993)	288 UK companies, 1983-91	Weak pay-performance link; strong pay-growth link. No ESOs.
Conyon, Gregg (1994)	170 highest-paid UK directors, 1985-90	Sales growth significantly more important pay determinant than performance. No ESOs.
Conyon, Leech (1994)	294 highest-paid UK directors, 1983-6	Weak pay-performance link. No ESOs.
Main, Bruce, Buck (1994)	59 UK companies, aggregate Board, and highest-paid directors, 1982-9	Inclusion of ESOs significantly increases pay-performance link.

Source: Adapted from Bruce, Alistair and Trevor Buck, "Executive Reward and Corporate Governance," in Kevin Keasey, Steve Thompson, and Mike Wright (Eds.), *Corporate Governance: Economic and Financial Issues*, Oxford University Press, New York, 1997, p. 94.

2.10.3 PERSONAL VARIABLES OF EXECUTIVES AND THEIR COMPENSATION

Only a few studies have focused on this research question. McKnight *et al.*, examined the impact of CEOs' age on executive pay in UK from 1992 to 1996 and found a significant relationship between CEOs' age and salary.[211] However, according to Veliyath and Ramaswamy, no significant impact of CEOs' personal characteristics on their pay was found.[212] Ghosh found the personal characteristics of the CEOs such as age and education ineffective in explaining CEOs' compensation.[213] However, he found in-firm experience of CEOs and their relationships with the promoter of the firm and group as the most important determinants of CEOs' compensation. Grunditz and Lindquist investigated 65 listed companies in Sweden and concluded that there was no significant effect of CEOs' age on their bonus.[214] A study in UK by Mcknight and Tomkins, revealed no significant relationship between tenure and CEO compensation (salary + bonus) from 1992 to 1997.[215] Hijazi and Bhatti analyzed the determinants of executive compensation of 63 executives from 54 different organizations in Pakistan and revealed that work experience and education level of CEOs were positively and significantly related with the executive compensation.[216] Kang, and Payal found that age, qualification, tenure and experience of executive directors are not significant determinants of executive compensation.[217] The foregoing review of literature reveals that there is no clear-cut relationship between the personal characteristics of the executives and their remuneration.

2.11 Separation of Chief Executive Officer and Chairman

Matteo Tonello concluded that companies which had 'split' the roles of Chairman and CEO increased Board's independence from management and it led to better monitoring and oversight.[218] However, Baliga *et al.*, found weak evidence on the link between duality of Board Chairman and CEO and long-term performance of US companies.[219]

2.12 Institutional Investors

2.12.1 INSTITUTIONAL INVESTORS, CORPORATE PERFORMANCE AND OTHER IMPLICATIONS

The basic objective of an institutional investor is to maximize its own shareholders' wealth and not to monitor the activities of the companies in which it has invested.[220] In consonance with the above view, Admati, Pfleiderer and Zechner, Black, Coffee, and Monks argued that absence of appropriate incentives and the free rider problem hinder institutional activism.[*221]

Khanna and Palepu and Varma infer that institutional investors in India have played a passive role in CG.[222] Similarly, Sarkar and Sarkar observed that the Development Financial Institutions (DFIs) play a passive role in CG when their combined holding is less than 25 per cent.[223] However, the authors found that when the debt exposures of the DFIs are high, they play an active role in monitoring the performance of the companies. It is more cost effective for institutional investors to

[*] Free rider problem means if one institutional investor intervenes in the decisions (CG) of a company, the other investors also get the benefits but at a cost solely to the institutional investor and hence this discourages active intervention the by institutional investors.

remain passive without taking the trouble to acquire information to exercise voting rights meaningfully.[224] Mohanty found that in India, the short-term performance measures of the fund managers force them to become very short-term oriented.[225] Charkham divides the institutional investors into two categories i.e., Type-A and Type-B. Type-A institutions have a portfolio of a very small number of companies but their stake in each individual company is very large.[226] Type-B institutions, on the other hand, manage a widely diversified portfolio. Hence, CG fails as most institutions fall in Type-B because only the Type-A institutional investors have an incentive for active monitoring as it affects their portfolio value substantially. Cordtz argues that the institutional investors lack the expertise and ability to serve as effective monitors.[227] However, Shleifer and Vishny observed that institutional investors, by virtue of their large stockholdings would have greater incentives to monitor corporate performance as they derive greater benefits of monitoring.[228]

Ajinkya, Bhojraj, and Sengupta found a positive relationship between financial analysts' ratings of corporate disclosure practices with institutional stock ownership.[229] Brickley, Lease, and Smith found that institutional investors are more likely to vote against harmful amendments that reduce shareholders' wealth.[230] Agarwal and Mandelkar found a positive relationship between institutional ownership and shareholders wealth.[231] McConnell and Servaes found a positive relationship between institutional ownership and productivity.[232]

However, Holderness and Sheehan, and Denis and Denis found no evidence about any relationship between institutional holdings and CG.[233] Black concludes that American institutional shareholder activism had no effect on firm performance.[234] A study by California Public Employees Retirement System (CalPERS) concluded that many corporate assets are poorly managed and that resources spent on identifying and rectifying these assets can create substantial opportunity and premium returns for active shareholders.[235] Moreover, a steep erosion of shareholder value, on a cumulative basis, involving 142 companies, essentially stopped after the Public Employees Retirement System became involved. Karpoff and Romano concluded that shareholder activism results in small changes in some firms' governance structures.[236] However, the evidence as a whole does not suggest that shareholder activism leads to improvement in firm performance or value. According to Shleifer and Vishny, large investors represent their own interests, which need not coincide with the interests of other investors in the firm, or with the interests of employees and managers.[237] Short and Keasey found that in the absence of other large external shareholders, institutional investors had a significant positive effect on firm performance.[238] According to Agrawal and Knoeber, no significant relationship was found between performance and institutional stockholding.[239] Del and Hawkins, Gillan and Starks, John and Klein and Karpoff, Malatesta and Walkling observed that institutional activism had negligible impact on the performance of the companies.[240] Daily *et al.*, studied 13 US activist funds and their holdings in 197 large companies and found that institutional activism had no appreciable effect on firm performance and stock price.[241]

In the Indian context, Sarkar and Sarkar suggested that lending institutions start monitoring the firm effectively only after equity holdings cross a substantial limit.[242] Besides this, the monitoring process is reinforced by the extent of debt exposures of these institutions. Further, the study found that foreign equity ownership has a beneficial effect on company value. Mohanty also corroborated these findings.[243] He found that development financial institutions have lent money to firms with better CG measures. Besides, mutual funds have also invested money in firms with a better CG record. He concluded that investment by mutual funds and development financial institutions has improved the financial performance of companies. Patibandla also broadly presents similar conclusions, though using a different methodology.[244] Further, he found that the increasing presence of foreign institutional investors proved to be having a positive effect on corporate performance. Ali Khan was also of the view that domestic institutional investors do not really help in improving performance of the firms.[245] The author indicated that the nominee directors are concerned only about safeguarding their institutional interest in the companies rather than protecting all shareholders. Further, the nominee directors do not play a satisfactory role in the Board meetings i.e., in contributing to better management practices and effective functioning of the firm. Besides, the role of institutional investors, such as mutual funds and pension funds is not active. In this context, a working group on CG stated that "the institutional investors of public companies should see themselves as owners and not as investors".[246] The Kumar Mangalam Birla Committee on CG emphasized that "that the institutional shareholders put to good use their voting power".[247]

2.13 Stakeholders, Corporate Social Responsibility and Performance

Crowther argued that the emergence of the World Wide Web has facilitated the dissemination of information and exerted more pressure on companies as business is accountable to stakeholders.[248] Ogden and Watson found considerable improvement in the customer service since the privatization of UK water supply industry in 1989 and higher returns to shareholders, consistent with the *Stakeholder Theory*.[249] Crowther revealed that firms with good financial performance are also good at social responsibility. Hence, social responsibility and shareholder value creation appear to be related.[250]

According to Verschoor, 26.8 per cent of the 500 largest US corporations with a commitment to ethical behaviour in forms of social and ethical accounting, auditing and reporting in the annual reports had a higher overall financial performance than those which did not assume explicit undertakings.[251] According to Coffey and Wang, Boards with more inside directors had shown more support for corporate philanthropic behaviour than diverse Board having more outsiders.[252]

2.14 Disclosures

2.14.1 FIRM PERFORMANCE, VALUATIONS, DISCLOSURES AND OTHER IMPLICATIONS

Over the last two decades, more precisely after the *Cadbury Committee Report* UK, transparency and disclosures about companies have become paramount.[253] Transparency is crucial to stakeholders as it is the principal norm by which companies can be held more accountable. According to Solomon and Solomon, disclosures can be viewed from two perspectives – corporate disclosure and financial accounting disclosure.[254]

Montgomery and Kaufman identified CG disclosures as the link between management and the shareholders and hence disclosures are also a part of CG.[255] According to Healy and Palepu, disclosures have many more objectives other than being a CG mechanism.[256] The topic of disclosures is one of the oldest research streams in finance.

According to Diamond and Verrecchia, and Kim and Verrecchia, previous research had reported that investors evince interest in relevant and reliable disclosure of a company's performance.[257] According to Kothari, Bushman and Smith, regulated disclosure provides new and relevant information for investors which ultimately reflects transparency.[258]

Financial accounting information has been given more importance by the Cadbury Committee Report UK, but, later on, it was realized that financial accounting information represents only one aspect of corporate disclosure.[259] According to Healy and Palepu, disclosure comprises all forms of voluntary corporate communications.[260] For example, management forecasts, some information placed on websites of companies and other statements and reports such as value added statements, funds flow statement, analysis of strengths, weaknesses, opportunities and threats, and corporate social responsibility or social accounting of companies also constitute disclosures. According to Chahine and Filatotchev, disclosure indicates the quality of the firm's product and business model, its growth strategy and market positioning, as well as the risk element.[261] According to the Cadbury Committee Report better disclosure results in more transparency, which is vital for good CG.[262] According to Jensen and Meckling, improved disclosure reduces agency cost, which is the bone of contention between the principal and the agent.[263] Farrar and Hannigan stated that when better information flows from the company to the shareholders, it results in less information asymmetry and hence improved disclosures.[264] According to Healy and Palepu, the importance of disclosure can be observed from the perspective of Agency Theory because the contract between principal and agent requires the agent to disclose relevant information which enables the principal to monitor the agent's compliance with the contractual agreement.[265] Further, Healy and Palepu, point out that disclosure of information enables the shareholders to know the efficiency of management and status of returns to investors.[266] Lang and Lundholm found that firms which had more disclosures, have a larger pool of potential investors leading to improved market capitalization.[267] These investors had more accurate beliefs about the future performance of firms. Collet and Hrasky have revealed that the voluntary disclosure of corporate information is positively associated with raising equity capital but not with debt capital.[268] Chahine and Filatotchev concluded that too much disclosure of propriety information may lead investors to believe that such disclosure may harm the firm's value.[269] Chandler opined that companies are sometimes reluctant to disclose information which could tarnish their image, as for instance, the salary of the employees at the lower level and higher level in the hierarchy.[270]

There has been ample research which documents the positive relationship between disclosure and firm performance. Lang and Lundholm had reported that analysts' ratings of corporate disclosure are positively related to earnings.[271] Similarly, Botosan concluded that increased disclosures create benefits for companies.[272] Further, disclosure policies were found to have a positive effect on the cost of capital but not on stock market liquidity. Moreover, Healy *et al.*, using a sample of US, companies found that after controlling for earnings performance and other potential relevant variables such as risk, growth and firm size, expanded voluntary disclosure is associated with an increase in stock performance, growth in institutional ownership, increased stock liquidity and higher analysts' coverage.[273] Healy and Palepu had reported that firms have incentives to engage in voluntary disclosure in order to reduce information asymmetry.[274] Therefore, it reduces the cost of external financing through reduced information risk and hence leads to better performance. Bushman and Smith had reported that financial accounting information can affect the investments, productivity and value-addition of firms.[275] Khanna e*t al.,* found a positive relationship between capitalization and the overall transparency scores.[276] They concluded that past performance can also affect the degree of disclosure. For instance, profitable firms may be more willing to disclose information to outside investors compared with less profitable firms. Hence, the findings do not indicate the causal relationship between disclosure and a firm's performance. It is not clear from the studies as to which causes what, between disclosure and firm's performance. Increased enforcement of accounting standards through auditing, and increased disclosure may improve eamings transparency.[277] CalPERS' approach to improving portfolio returns by engaging management of poorly performing companies to rethink governance and strategy continues to work. Despite underperforming their respective benchmarks by 83.3 per cent for the five years up to the initiation of CalPERS' shareholder activism, the 142 companies that were targeted from 1987 to the fall of 2008 have outperformed by 12.7 per cent over the subsequent five-year period.[278] A *McKinsey* study had shown that global investors are willing to pay more for better governed companies.[279] Simultaneously, better CG also helps to reduce bribery practices at the firm level, which can potentially further increase the value of firms. Kohli concludes that better CG leads to value creation for all the stakeholders.[280]

Two cross-country studies in the year 2003 have put India among the worst nations in terms of earnings opacity and management.[281] Accounting Standards in India provide companies considerable flexibility in financial reporting and these standards differ from International Accounting Standards or International Financial Reporting Standards in numerous ways. Hence, interpreting Indian financial statements is relatively challenging.

A few studies have highlighted the negative relationship between corporate disclosure and firm-level performance. Archambault and Archambault had documented an inconsistent relationship between firm's size as measured by total assets and total disclosure score.[282] However, according to Holder-Webb *et al.*, large firms have richer information environments and they are also exposed to more political costs.[283] According to Cheung *et al.*, large firms have more resources to undertake additional CG initiatives as they are well known to the investing public and they are expected to disclose more information.[284] Based on observations of the Securities and Exchange Board of India from a consolidated compliance report prepared by Bombay Stock Exchange and National Stock Exchange in 2003, the compliance level with respect to requirements related to the remuneration committee and Board procedures is low or not satisfactory and the compliance related to Board of Directors, audit committee and shareholders' grievance committee is high.[285] So companies should enhance their standards in terms of disclosures to sustain their revenues and profits internationally. Gupta *et al.*, studied 30 Indian companies listed on the Bombay Stock Exchange and indicated that though the firms have provided information related to all the dimensions, there was considerable variance in the extent and quality of such disclosures.[286] In Australia, Ramsay and Hoad found that the extent and quality of disclosures are typically better for larger companies than for smaller ones.[287] Brown and Caylor in US, considered internal and external CG factors and found that Gov-Score[*] was significantly and positively associated with firm valuation (using Tobin's Q).[288]

Arcot and Bruno examined the effectiveness of the 'comply or explain' approach to CG in the UK and found increased compliance with the combined code and simultaneously a frequent use of standard and uninformative explanations by the firms when departing from best practices.[289] This smacks of compliance in letter but not in spirit. Bhuiyan and Biswas examined CG practices in Bangladesh and computed a Corporate Governance Disclosure (CGD) Index and found a significant difference among the CGD indices of various sectors.[290] Financial sector firms engaged in more intensive CG disclosures than non-financial sector firms. In general, companies were found to be more active in making financial disclosures rather than non-financial disclosures. CGD Index was significantly influenced by local ownership, notification of the Securities Exchange Commission (of Bangladesh) and the size of the company. Irrespective of whether a financial or non-financial institution, the size of the Board of Directors was not found to have any significant impact on CG disclosures. According to Holder-Webb *et al.*, smaller firms offered fewer disclosures pertaining to Board independence, Board selection procedures, and oversight of management.[291] The Boards that were less independent provided fewer disclosures on independence and management oversight matters; whereas, large firms provided more disclosures of independence standards, Board selection procedures, audit committee matters, management control systems, other

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[*] Broad summary measure of Corporate Governance.

committee matters and whistle-blowing procedures. Yet, their information environment was not found to be better than smaller firms. Javed and Iqbal indicated that CG does matter in Pakistan.[292] Board composition, ownership and shareholding pattern were found to enhance firm performance, whereas disclosure and transparency had no significant effect on firm performance. According to Gill and Sai, there is no unambiguous answer to the relationship between the CG disclosures and a firm's performance, though the literature on corporate disclosures provides substantial support.[293]

2.14.2 INDEPENDENT DIRECTORS AND DISCLOSURES

Chen and Jaggi found a positive correlation between the proportion of Independent Directors on corporate Boards and comprehensiveness of financial disclosures.[294] However, this association is weaker for family-controlled firms compared to non-family controlled firms.

2.15 Other Committees

2.15.1 NOMINATION COMMITTEE FOR NOMINATING BOARD MEMBERS AND CORPORATE PERFORMANCE

According to Wallace and Cravens, large public companies in the US with a nomination committee displayed both a market and accounting-quantified performance better than companies without such a committee.[295]

2.15.2 OVERSIGHT BOARD COMMITTEE AND FIRM VALUE

Klein found no apparent correlation between share prices and the composition of specific oversight Board committees.[296]

2.16 Miscellaneous

2.16.1 LEGAL PROTECTION AND DIVIDEND

Faccio *et al.*, held that strong legal protection leads to higher dividend payouts.[297]

2.16.2 DEBT, PERFORMANCE AND CG

According to Berger *et al.*, entrenched CEOs avoided debt financing and leverage levels declined when the CEOs were longer in office and did not face pressure from either ownership and compensation incentives or active monitoring of the Board.[298] According to Agrawal and Knoeber, more debt financing was negatively related to performance.[299]

2.16.3 THE MARKET FOR CORPORATE CONTROL AND CG

According to Chakrabarti *et al.*, a freely functioning market for corporate control is another important force for more effective governance that has failed to emerge in India.[300] Though Indian regulators were resistant to hostile acquisitions earlier, it is now more open.[301] At present the market for corporate control in India is not limited by geography and therefore it has improved prospects for CG.

2.16.4 PRIVATIZATION, PROFITABILITY AND CG

A study by Nandini Gupta of 47 partial privatizations found that despite government control, privatization has had positive effects on the profitability, productivity and investment of the privatized Public Sector Enterprises.[302] Hence, privatization can promote good CG.

2.17 Impact of Internationalization

Sanders and Carpenter found that most of the large firms in the US coped with the information processing demands and agency issues arising from internationalization through larger Boards, thereby acquiring greater expertise across functions and geographical areas.[303] Apart from this, other practices in the aforesaid corporate environment include higher longer-term CEO pay as a recognition of more challenging jobs, aligning CEO self-interest with corporate performance, separation of the chairperson and CEO positions and more inside directors with multiple interactions between the Board and company.

The foregoing review of the literature reveals that though the value of CG has received much wider attention worldwide, more research is required, especially in India.

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CHAPTER 3

CORPORATE GOVERNANCE: REGULATIONS, OPERATION AND IMPLEMENTATION

3.1 Introduction

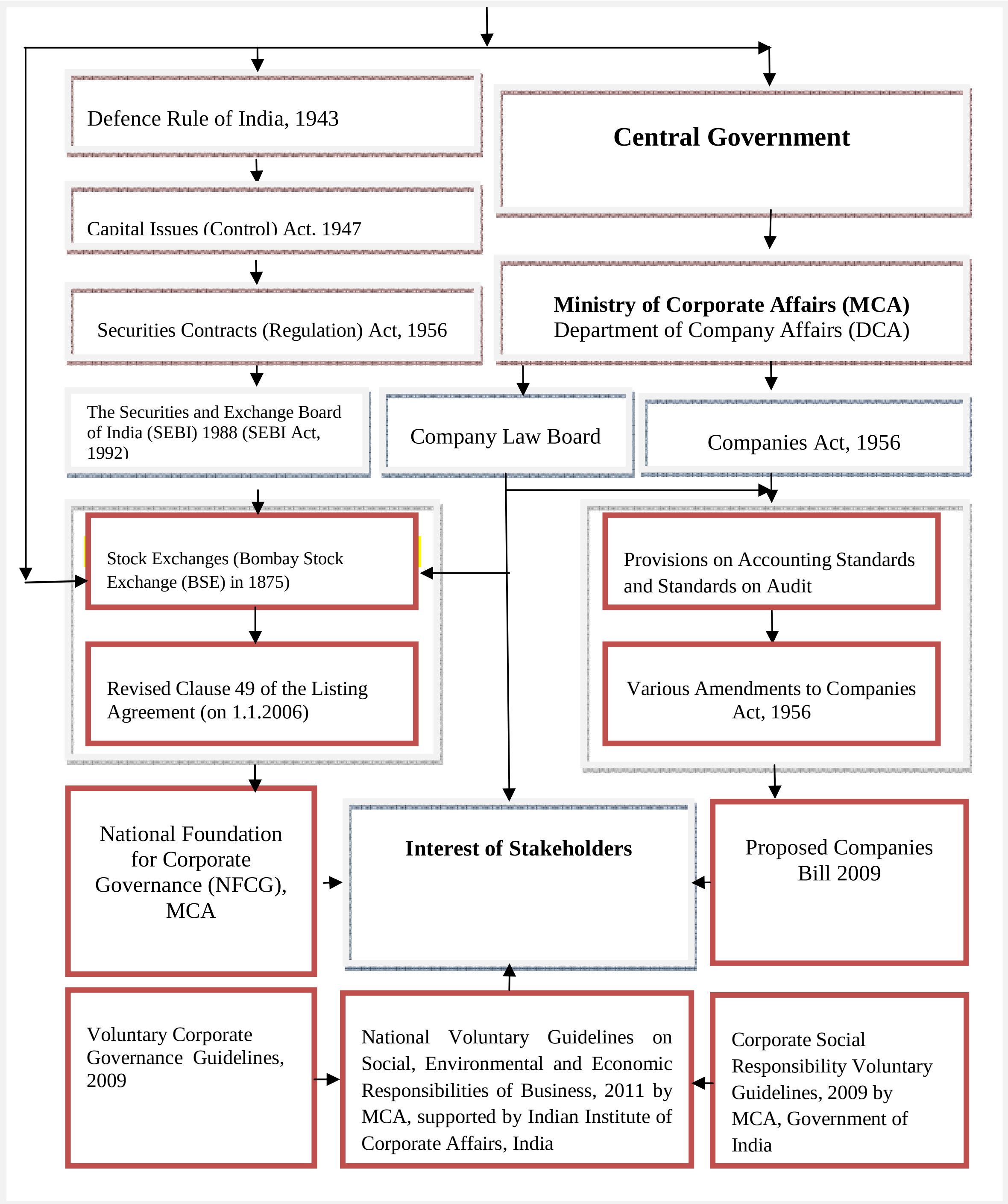
Corporate Governance (CG) aims at protecting the interest of stakeholders, mainly equity shareholders, who provide capital to companies without any assurance of returns. The corporate form of business has entailed huge amounts of capital, which are mobilized by firms in the financial markets.

3.1.1 ISSUE OF CAPITAL AND CG

Adequate regulation of financial markets will also facilitate CG regulations. It is apparent that that CG emerged mainly on account of corporate frauds and also as a part of economic reforms. The frauds related to deceit in issue of capital, expropriation or tunnelling of corporate resources, inadequate disclosures of assets and liabilities etc. The factors which triggered an improvement in regulation in the Indian capital market, especially after economic reforms, were a lack of a developed secondary market, price manipulation, inadequate financial disclosure and insider trading, to name a few.[1] A well-developed capital market facilitates trading and brings down the cost of capital for companies. In a broader sense, measures that provide for adequate transparency and disclosures for proper control and regulations of various aspects of issue of capital are part of CG regulations. Exhibit 3.1 presents a snapshot of laws pertaining to the issue of capital in India.

EXHIBIT 3.1

ISSUE OF CAPITAL AND CG: A REGULATORY FRAMEWORK



3.1.1.1 Defence Rule of India, 1943. During World War II, the Defence Rule of India, 1943 was in force to monitor and restrict capital flow into production of essential commodities.[2]

3.1.1.2 The Capital Issues (Control) Act 1947. The office of the Controller of Capital Issues (CCI) was set up to implement this Act. The CCI was empowered to administer all matters of the capital market in relation to type, size, timing and price of issue.[3] Some objectives of this Act were: ensuring growth of capital market, encouraging growth of companies with a strong capital structure, safety of investors and avoiding bunching of public issues.

3.1.1.3 The Securities Contracts (Regulation) Act, 1956. Due to the growth of the capital market, the Capital Issues Control Act, 1947 proved inadequate; the government felt the need for improved regulation.[4] So it came up with the Securities Contracts (Regulation) Act, 1956 to monitor matters relating to issue of capital. The main objective of this Act has been to support Indian industry as per five-year plans and to infuse confidence among industrialists and other investors. The Act has undergone amendments relating to prospectus, disclosures of accounting and financial matters and listing of securities.

3.1.1.4 Company Law Board. The Company Law Board (CLB) was established to resolve grievances related to stock exchanges, companies and brokers.[5] The CLB gave rulings in consonance with the Companies Act in order to protect interests of the investors. For instance, cases of default in payment of interest or principal by the companies are referred to the CLB. Since the commencement of the Companies (Second

Amendment) Act, 2002, the CLB stood dissolved and all matters or cases pending before the CLB were transferred to the National Company Law Tribunal.[6]

3.1.1.5 Companies Act, 1956. The Companies Act, 1956 has been one of the stellar legislations introduced in India. It is virtually a Bible for companies.[7]

3.1.1.6 SEBI Act, 1992. The SEBI was established in 1988 by an ordinance and its primary function is to govern the capital market with special emphasis on protecting the interest of small investors.[8] It was formally established by the SEBI Act, 1992. Since its creation, SEBI has been vigorously active and has produced detailed guidelines for Initial Public Offers, Issue of Bonus Shares and Insider Trading to name a few areas.

3.1.2 CG REGULATIONS

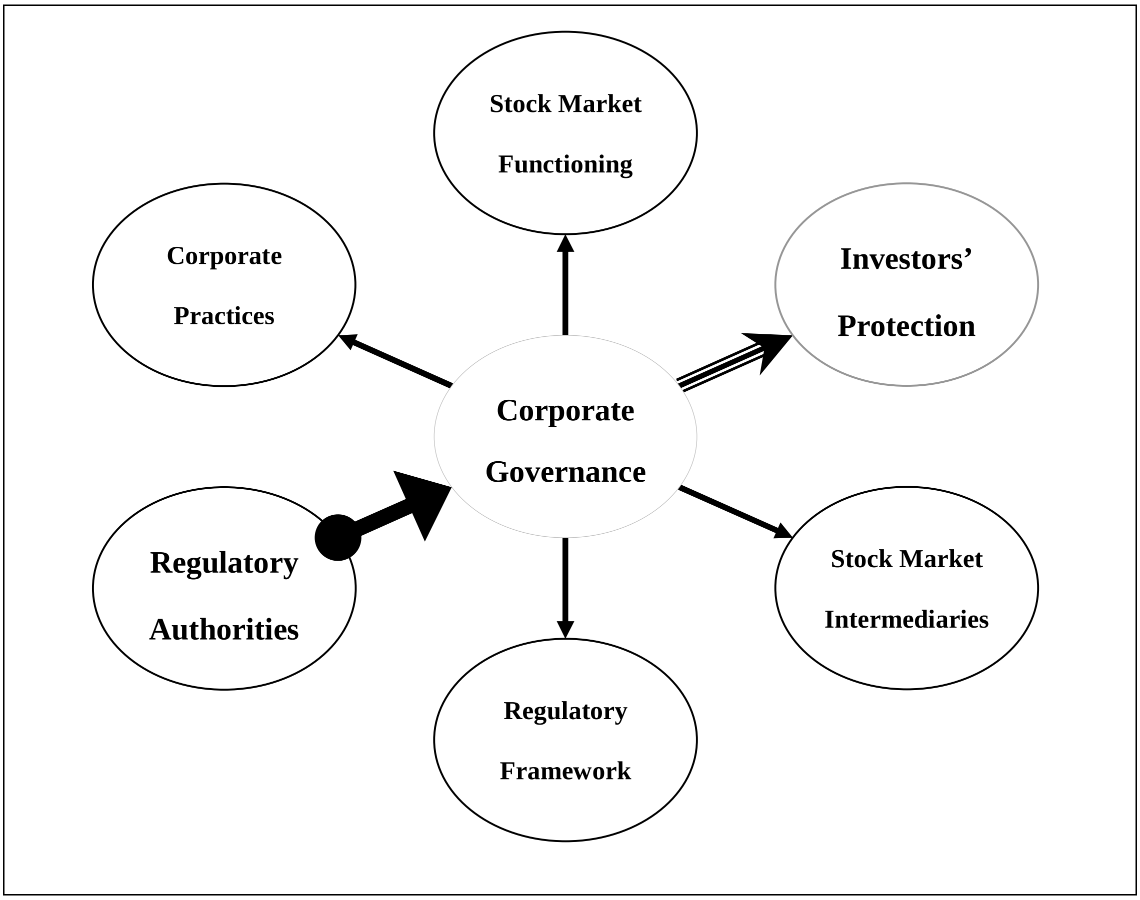
'Rules' are typically believed to be simpler to adhere to than principles, as they demarcate a clear line between acceptable and unacceptable behaviour.[9] Rules also limit discretion on the part of individual managers and auditors. However, in practice rules can be more complex than principles. Even if clear rules are followed, one can still find a way to get around their underlying purpose. However, this is more difficult if one is bound by a broader principle. 'Principles', however, are a form of self-regulation. Principles facilitate in determining standards that are acceptable or otherwise. Rules may be inadequate to deal with new transactions or issues which are not covered by the code. A code is a set of written rules which state how people in a particular organization or country should behave.

It is necessary for companies to adhere to the codes or principles and requirements of CG and to provide relevant information to all stakeholders regarding the performance, policies and procedures of a company in a transparent manner.[10] There should be satisfactory financial and non-financial disclosures by the companies relating to, for example, remuneration package, financial reporting, auditing and internal controls. There are some areas that need special attention viz., quality of audit, which is at the root of effective CG, role of Board of Directors, accountability of the Chief Executive Officers (CEOs), of the Chief Financial Officers (CFOs), and quality and effectiveness of the legal, administrative and regulatory framework.

A robust regulatory framework and its enforcement is the foundation for ensuring good CG. The regulatory environment provides norms for the functioning of stock market, conduct of stock market intermediaries, corporate practices and CG (Exhibit 3.2). It is the responsibility of the regulatory authorities to ensure that the interests of stakeholders are protected, in particular the shareholders. The regulatory authorities direct and control CG through regulatory framework in the form of mandatory compliance. Brokers represent an important link between various investors. The effectiveness of capital market also depends upon fair practices by brokers. Among other things, investors feel protected when conduct of brokers is investor-friendly. To achieve this, effective functioning of the stock market is also important. Therefore, stock exchanges must ensure that integrity is maintained in the transaction process between the transacting parties.

EXHIBIT 3.2

STOCK MARKET INTERMEDIARIES, REGULATORY FRAMEWORK, CORPORATE PRACTICES AND CG



Source: Adapted from Sharma, J. P. and Gurcharan Sachdeva, "Corporate Governance: Investors' Perspective," research paper at the 21st CEA Annual Conference, available at http://www.ceauk.org.uk/2010-conference-papers/full-papers/Sharma.pdf; website accessed on 14.10.2010, 9.10 p.m.

CG codes and regulations have been developed in different countries and issued by stock exchanges, corporations, institutional investors, associations/institutes of directors, various committees and also by regulatory and international organizations (Exhibit 3.3). Compliance with CG recommendations is mostly mandatory, except in a few countries. For example, companies whose stocks trade on the London and Toronto

Stock Exchanges need not formally adhere to the recommendations of their respective national codes.[11] However, they must disclose whether they follow the recommendations failing which, they should provide explanations. Such disclosure requirements put considerable pressure on companies for compliance. In the United States of America (US), companies are primarily regulated by the state in which they are incorporated and also by the federal government. Further, if such companies are public companies, then they are expected to adhere to norms of their stock exchanges. The highest numbers of companies are registered in Delaware, including over half of the Fortune 500. This is due to Delaware's conducive corporate legal environment and the existence of a state court dedicated exclusively to business issues.[12] Most states generally follow the American Bar Association's Model Business Corporation Act while Delaware does not, but considers its provisions.[13]

The instance of the General Motors Board Guidelines reflects the company's efforts to improve its CG.[14] Such CG guidelines, may have a wider demonstration effect inspiring other companies to adopt standards of best practice. As for exemplary committees, it is the Cadbury Committee (1991) established in United Kingdom (UK).[15] The Organization for Economic Co-operation and Development (OECD) also framed influential principles of CG in 1999 which were revised in 2004.[16]

The OECD's work has been the basis for other international organizations such as the United Nations Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting which has a produced voluntary guidance on 'Good Practices in Corporate Governance Disclosure'.[17]

The World Business Council for Sustainable Development has also contributed to CG, particularly on accountability and reporting, which in 2004 culminated in an 'Issue Management Tool' i.e., 'Strategic Challenges for Business in the use of Corporate Responsibility Codes, Standards, and Frameworks'.[18]

3.1.3 ORGANIZATIONAL FRAMEWORK FOR CG IN INDIA

The organizational framework for CG initiatives in India consists of the MCA and the SEBI. A self-regulatory code was recommended by the *Confederation of Indian Industries* (CII) in 1997 (Exhibit 3.3). The first formal regulatory framework for listed companies in CG was established by the SEBI in February 2000, pursuant to the recommendations of the Kumar Mangalam Birla Committee Report.[19] It materialized as Clause 49 of the Listing Agreement. The DCA also appointed a committee on 'Corporate Audit and Governance' in 2002 headed by Mr. Naresh Chandra to examine various CG issues. It offered recommendations on two important aspects of CG (i) financial and non-financial disclosures; and (ii) independent auditing and Board oversight of management. Subsequently, SEBI set up another committee headed by Mr. N. R. Narayana Murthy to review Clause 49 of the Listing Agreement and to suggest measures for uplifting CG standards. Some of the key recommendations of the committee pertained to Audit Committees, audit reports, Independent Directors, related party transactions, risk management, directorships and director compensation, codes of conduct and financial disclosures.

Global accounting scandals in the West produced a spate of regulations.[20] CG reform has been a key priority for policy-makers around the world; it is reflected in the enactment of legislations, most notably the Sarbanes Oxley (SOX) Act of 2002 in the US and Clause 49 in India.[21] MCA also set up the NFCG (Exhibit 3.3) in association with the CII, Institute of Chartered Accountants of India (ICAI), Institute of Company Secretaries of India and National Stock Exchange as a not-for-profit trust. The objective is to provide a forum to discuss issues, experiences and ideas relating to CG and to impress upon corporate leaders the importance of good CG practices.[22]

EXHIBIT 3.3

LIST OF SELECTED CODES AND REGULATIONS FOR CG

Committee/ Legislation	Achievement	Background
1. Foreign Corrupt Practices Act, 1977 United States (US)[1]	The Act provided for the maintenance and review of systems of internal control in an organization.	To prevent US firms from bribing Government officials of foreign countries.
2. Securities and Exchange Commission, 1977 (US)	Mandatory reporting on internal financial controls.	-Do-
3. Cadbury Committee, 1991 United Kingdom (UK), set up by London Stock Exchange, 'Code of Best Practices', December, 1992	It emphasized the accountability of the Board of Directors to shareholders and the society. Its recommendations are considered to be a landmark in the emergence of CG and is very often referred as the 'foundation stone of CG'.	Several corporate scandals in 1980s and 1990s (collapse of famous corporations such as PollyPeck, Bank of Credit and Commerce International, Robert Maxwell's Mirror Group International)
4. Greenbury Committee, 1995 (UK)	The committee addressed the issue of directors' remuneration.	An attempt for further reforms in the area of CG focusing specifically on remuneration of directors with the background of Cadbury Committee.
5. Hampel Committee, 1998 (UK)	The emphasis was on the extension of directors responsibilities to all relevant control objectives including business risk assessment and minimizing fraud.	To keep the momentum by assessing the impact of Cadbury Report and to suggest further guidelines.
6. Combined Code, 1998 introduced by London Stock Exchange (UK)	London Stock Exchange (UK) introduced the Combined Code, as part of Listing Agreement for compliance by listed British companies. It was predominantly based on the Cadbury and Greenbury Committee Reports.	Since the publication of Cadbury and Greenbury Committee Reports, there was pressure from various quarters to convert the voluntary codes into compulsory provisions through Listing Agreement.
7. OECD Principles of Corporate Governance, 1999	OECD suggested the principles of CG both for its member governments and for its non-member governments in order to help them to bring out	The guidelines were evolved in recognition of growing awareness of the importance of good CG among OECD

		improvements in their legal, institutional and regulatory framework for facilitating good CG. These principles were first introduced internationally and were recognized as good benchmarks for improvement of CG.	countries in 1998.
8.	The SOX Act, 2002 (US)	Both internal and external control systems have been tightened. There is a provision for 'oversight'. This is considered to be a very stringent piece of legislation aimed at efficient management of corporations.	Corporate scandals of companies such as Xerox, Enron and Worldcom during 2000-2001 prompted the US Government to enact the legislation.
9.	National Task Force by CII in 1997, chaired by Rahul Bajaj 'Desirable Corporate Governance : A Code', India	CII was first to promote the ideal of CG in India to meet the demand for greater disclosure, transparent explanation for major decisions and increased shareholder value. The task force recommended a voluntary code for CG.	Following the liberalization in 1991, it was aimed at increasing the competitive position of Indian industries in the international markets.
10.	Kumar Mangalam Birla Committee, 1998 set up by SEBI, India	Its comprehensive recommendations comprised two parts- (i) mandatory and (ii) non-mandatory (voluntary) CG requirements.	SEBI set up this committee to promote and raise standards of CG in India.
11.	Amendment of Companies Act, 1998 and 2000, India	Several important provisions were legislated to improve the transparency and accountability of companies in India. Examples are Sections 211(3A) and (3B), 217(2AA), 275, 292A.	Prevailing corporate environment in the world motivated the government to take such measures.
12.	Clause 49 of the Listing Agreement in 2000 under SEBI Act, 1992, India	SEBI introduced Clause 49 of the Listing Agreement through the stock exchanges in India for compliance by the listed companies. It was based on several recommendations of the Kumar Mangalam Birla Committee, 2000.	Raising the standards of CG practices among listed companies was main objective of SEBI.
13.	Naresh Chandra Committee, 2002 set by the DCA, Government of India	It emphasized corporate audit and role of Independent Directors. Many recommendations of the committees were incorporated in the Companies (Amendment) Bill, 2003.	The enactment of SOX Act, 2002 in US and concerns about CG prompted government to set up the committee.
14.	Narayan Murthy Committee, 2003 set up by the SEBI, India	The committee reviewed the performance of CG in the country, the role of companies in responding to rumours and other price sensitive market information to enhance the transparency and integrity of the market. On many matters (e.g. Independence of Directors, Audit Committee and certification by CEOs and CFOs) the committee concurred with the Naresh Chandra Committee. It made two sets of CG recommendations: mandatory and non-mandatory.	SEBI's concern to expeditiously promote the effectiveness of CG practices in India and protect the interest of the investors promoted setting up of this committee.

15. J. J. Irani Committee, 2004 set up by Government of India	The committee evaluated structurally the views of several stakeholders in revamping the Companies Act in India. Many of its recommendations have found place in the Companies (Amendment) Bill, 2005. If enacted, will go a long way in achieving sustainable corporate growth.	Revamping the Companies Act, 1956 (simplification and rationalization) was long overdue. Successive governments made abortive attempts to restructure the Companies Act (e.g. Companies Bill, 1997, Companies Bill, 2002 and 2005.
16. Revised Clause 49 of the Listing Agreement in 2004, India	SEBI's circular on Listing Agreement (October, 2004) was used by the stock exchanges to revise Clause 49 to make its provisions internationally competitive for raising the standards of CG practices among listed companies and corporate bodies in India.	Many of the provisions of the revised clause were derived from SOX Act, 2002 of US.
17. National Foundation for Corporate Governance established by MCA, Govt. of India[2]	Established by Government of India, MCA in partnership with CII, Institute of Company Secretaries of India, ICAI, Institute of Costs and Works Accountants of India and National Stock Exchange.	To support and improve enforcement to extant CG norms in India.
18. Corporate Governance Guidelines for Public Sector Enterprises, 2007, India[3]	CG Guidelines for Public Sector Enterprises prescribed by Central Government	Apart from mandatory provisions of Clause 49, Corporate Governance Guidelines for Public Sector Enterprises, 2007 are to be complied with voluntarily.
19. Corporate Governance Voluntary Guidelines, 2009 by MCA, India[4]	Recommended voluntary guidelines for good CG over and above mandatory and non-mandatory requirements of Clause 49.	To not restrict the spirit of CG to mandatory compliance i.e., Clause 49.
20. Corporate Social Responsibility (CSR) Voluntary Guidelines, 2009 by MCA, Government of India[5]	Recommended voluntary CSR Guidelines 2009 emphasizing social well-being of stakeholders.	To promote socially responsible business practices.
21. National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business, 2011 by MCA, supported by Indian Institute of Corporate Affairs, India[6]	Recommended voluntary guidelines for good corporate management from wider perspective.	To promote an enlightened approach to business that encourages sustainable development.

Sources: [1]Adapted from Banerjee, Bhabatosh, "Corporate Governance", *Fundamentals of Financial Management*, PHI Learning Pvt. Ltd., New Delhi, 2008, pp. 558-560.

[2] http://www.nfcgindia.org/aboutus.htm,website accessed on 18.12.2011, 5.30 p.m.

[3] www.dpe.nic.in

[4] http://www.mca.gov.in/Ministry/guideline_archieve.html, website accessed on 18.12.2011, 6 p.m.

[5] http://www.mca.gov.in/Ministry/guideline_archieve.html, website accessed on 18.12.2011, 6 p.m.

[6] http://www.nfcgindia.org/home.html, website accessed on 18.12.2011, 5.35 p.m.

3.1.4 SALIENT FEATURES OF CLAUSE 49 OF THE LISTING AGREEMENT*

The salient features of Clause 49 comprise mandatory and non-mandatory norms of CG.[23]

3.1.4.1 Mandatory Provisions.

I. Board of Directors

(A) Composition of Board

In case of a Non-Executive Chairman, at least one-third of the Board should comprise Independent Directors and in case of an Executive Chairman, at least half the Board should comprise Independent Directors.

(B) Non-Executive Directors' Compensation and Disclosures

All fees/compensation paid to Non-Executive Directors, including Independent Directors shall be fixed by the Board of Directors with approval by shareholders in general meeting except approval for payment of sitting fees to Non-Executive Directors if it is paid within limits prescribed by the Companies Act, 1956. Limits shall be set for the maximum number of stock options that can be granted to Non-Executive Directors including Independent Directors in any financial year and in the aggregate.

(C) Other Provisions as to Board and Committees

(i) The Board meeting shall be held at least four times a year, with a maximum time gap of four months between any two meetings.

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*Clause 49 of Listing Agreement, applicable to companies' with effect from 1st January, 2006 is considered for the study.

(ii) A director shall not be a member in more than ten committees or act as chairman of more than five committees across all companies in which he is a director.

(D) Code of Conduct

(i) The Board of a company to lay down the code of conduct for all Board members and senior management of a company. This code of conduct shall be posted on the website of the company.

(ii) All Board members and senior management personnel shall affirm compliance with the code on an annual basis. The annual report of the company shall contain a declaration to this effect signed by the CEO.

II. Audit Committee

(A) Qualified and Independent Audit Committee

(i) The Audit Committee shall have minimum three directors as members; two-thirds of the members of Audit Committee shall be Independent Directors;

(ii) all members of Audit Committee shall be financially literate and at least one member shall have accounting or related financial management expertise;

(iii) the Chairman of the Audit Committee shall be an Independent Director;

(iv) the Chairman shall be present at Annual General Meeting to answer shareholder queries;

(v) the Audit Committee should invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of the committee, but on occasions it may also meet without the presence of any executives of the company. The finance director, head of internal audit and a representative of the statutory auditor may be present as invitees for the meetings of the Audit Committee;

(vi) the Company Secretary shall act as the secretary to the Audit Committee.

(B) Meeting of Audit Committee

The Audit Committee shall meet at least four times a year. Not more than four months should elapse between two meetings. The quorum shall be either two members or one third of the members of the Audit Committee, whichever is greater but there should be minimum of two Independent Directors present.

(C) Powers of Audit Committee

The Audit Committee shall have powers to (1) investigate any activity within its terms of reference; (2) to seek information from any employee; (3) to obtain legal or other professional advice from outside; and (4) to secure attendance of outsiders with relevant expertise, if it considers necessary.

(D) Responsibilities of Audit Committee

1. Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statements are correct, sufficient and credible.

2. Recommending the appointment and removal of external auditor, fixation of audit fee

and also approval for payment for any other services.

3. Reviewing the annual financial statements with the management before submission to the Board. The focus would primarily be on;

(a) any changes in accounting policies and practices, (b) major accounting entries based on exercise of judgment by management, (c) qualifications in draft audit report, (d) significant adjustments arising out of audit, (e) the going concern assumption, (f) compliance with Accounting Standards, (g) qualifications in the draft audit report.

4. Reviewing, the annual financial statements with the management before submission to the Board for approval, with particular reference to:

a. Matters required to be included in the Director's Responsibility Statement to be included in the Board's report in terms of Clause (2A) (a) of Section 217 of the Companies Act, 1956;
b. Changes, if any, in accounting policies and practices and reasons for the same;
c. Major accounting entries involving estimates based on the exercise of judgment by management; significant adjustments made in the financial statements arising out of audit findings;
d. Compliance with listing and other legal requirements relating to financial statements;
e. Disclosure of any related party transactions;
f. Qualifications in the draft audit report.

5. Reviewing, the quarterly financial statements with the management before submission to the Board for approval.

5A. Reviewing, with the management, the statement of uses/application of funds raised through an issue (public issue, rights issue, preferential issue, etc.), the statement of funds utilized for purposes other than those stated in the offer document/prospectus/notice and the report submitted by the monitoring agency monitoring the utilization of proceeds of a public or rights issue, and making appropriate recommendations to the Board to take steps in this matter.

6. Reviewing, the performance of statutory and internal auditors and adequacy of the internal control systems with the management.

7. Reviewing the adequacy of internal audit function, if any, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit.

8. Discussion with internal auditors on significant findings and follow-up thereon.

9. Reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the Board.

10. Discussion with statutory auditors before commencement of the audit, about the nature and scope of audit as well as post-audit discussion to ascertain any area of concern.

11. To look into the reasons for substantial defaults in the payment to the depositors, debentureholders, shareholders (in case of non-payment of declared dividends) and creditors.

12. To review the functioning of the Whistle-Blower mechanism, if existing.

12A. Approval of appointment of CFO i.e., the Whole-Time Finance Director or any other person heading the finance function or discharging that function, after assessing the qualifications, experience and background of the candidate.

13. Carrying out any other function as mentioned in the terms of reference of the Audit Committee.

(E) Review of Information by Audit Committee

1. Management Discussion and Analysis (MD&A) of financial condition and results of operations;
2. Statement of significant related party transactions
   (as defined by the Audit Committee), submitted by management;
3. Management letters/letters of internal control weaknesses issued by the statutory auditors;
4. Internal audit reports relating to internal control weaknesses; and
5. The appointment, removal and terms of remuneration of the Chief Internal Auditor shall be subject to review by the Audit Committee.

III. Subsidiary Companies

(i) At least one Independent Director on the Board of Directors of the holding company shall be a director on the Board of Directors of a material non-listed Indian subsidiary company.

(ii) The Audit Committee of the listed holding company shall also review the financial statements, in particular, the investments made by the unlisted subsidiary company.

(iii) The minutes of the Board meetings of the unlisted subsidiary company shall be placed at the Board meeting of the listed holding company. The management should periodically bring to the attention of the Board of Directors of the listed holding company, a statement of all significant transactions and arrangements entered into by the unlisted subsidiary company.

IV. Disclosures

(A) Basis of Related Party Transactions

(i) A statement in summary form of transactions with related parties in the ordinary course of business shall be placed periodically before the Audit Committee.

(ii) Details of material individual transactions with related parties which are not in the normal course of business shall be placed before the Audit Committee.

(iii) Details of material individual transactions with related parties or others, which are not on an arm's length basis, should be placed before the Audit Committee, together with management's justification for the same.

(B) Disclosure of Accounting Treatment

Where in the preparation of financial statements, a treatment different from that prescribed in an Accounting Standard has been followed, that fact shall be disclosed in the financial statements, together with the management's explanation as to why it believes such alternative treatment is more representative of the true and fair view of the underlying business transaction in the CG report.

(C) Board Disclosures – Risk Management

The company shall lay down procedures to inform Board members about the risk assessment and minimization procedures. These procedures shall be periodically reviewed to ensure that executive management controls risk through means of a properly defined framework.

(D) Proceeds from Public Issues, Rights Issues and Preferential Issues

When money is raised through public issues, rights issues, or preferential issues, it shall disclose to the Audit Committee, the uses/applications of funds by major category (capital expenditure, sales and marketing, working capital, etc), on a quarterly basis as a part of their quarterly declaration of financial results. Further, on an annual basis, the company shall prepare a statement of funds utilized for purposes other than those stated in the offer document/prospectus/notice and place it before the Audit Committee. Such disclosure shall be made only till such time that the full money raised through the issue has been fully spent. This statement shall be certified by the statutory auditors of the company. Where the company has appointed a monitoring agency to monitor the utilization of proceeds of a public or rights issue, it shall place before the Audit Committee the monitoring report of such agency, upon receipt, without any delay. The Audit Committee shall make appropriate recommendations to the Board to take steps in this matter.

(E) Remuneration of Directors

(i) All pecuniary relationships or transactions of the Non-Executive Directors vis-à-vis the company shall be disclosed in the annual report.

(ii) Further the following disclosures on the remuneration of directors shall be made in the section on CG of annual report:

a. All elements of remuneration package of individual directors summarized under major groups, such as salary, benefits, bonuses, stock options and pension.

b. Details of fixed component and performance-linked incentives, along with the performance criteria.

c. Service contracts, notice period and severance fees.

d. Stock option details, if any – and whether issued at a discount as well as the period over which accrued and over which exercisable.

(iii). The company shall publish its criteria of making payments to Non-Executive Directors in its annual report. Alternatively, this may be put up on the company's website and reference drawn thereto in the annual report.

(iv). The company shall disclose the number of shares and convertible instruments held by Non-Executive Directors in the annual report.

(v). Non-Executive Directors shall be required to disclose their shareholding (both own or held by / for other persons on a beneficial basis) in the listed company in which they are proposed to be appointed as directors, prior to their appointment. These details should be disclosed in the notice to the general meeting called for appointment of such director.

(F) Management

i. As part of the directors' report or as an addition thereto, a MD&A report should form part of the annual report to the shareholders. MD&A should include a discussion on the following matters within the limits set by the company's competitive position: (1) industry structure and developments; (2) opportunities and threats; (3) segment-wise or product-wise performance; (4) outlook; (5) risks and concerns; (6) internal control systems and their adequacy; (7) discussion on financial performance with respect to operational performance; (8) material developments in human resources / industrial relations front, including the number of people employed.

ii. Senior management shall make disclosures to the Board relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large (for e.g., dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives etc.)

(G) Shareholders

i. In case of the appointment of a new director or re-appointment of a director, the shareholders must be provided with the following information:

a. A brief resume of the director;

b. Nature of his expertise in specific functional areas;

c. Names of companies in which the person also holds directorships and the membership of committees of the Board; and

d. Shareholding of Non-Executive Directors as stated in Clause 49 (IV) (E) (v) above.

ia. Disclosure of relationships between directors inter-se shall be made in the annual report, notice of appointment of a director, prospectus and letter of offer for issuances and any related filings made to the stock exchanges where the company is listed.

ii. Quarterly results and presentations made by the company to analysts shall be put on company's website, or shall be sent in such a form as to enable the stock exchange on which the company is listed to put it on its own website.

iii. A Board committee under the chairmanship of a Non-Executive Director shall be formed to specifically redress complaints of shareholders and investors relating to transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends etc. This committee shall be designated as 'Shareholders/Investors Grievance Committee'.

iv. To expedite the process of share transfers, the Board of the company shall delegate the power of share transfer to an officer or a committee or to the registrar and share transfer agents. The delegated authority shall attend to share transfer formalities at least once in a fortnight.

V. CEO/CFO Certification

The CEO, i.e., the Managing Director or Manager appointed in terms of the Companies Act, 1956 and the CFO i.e. the Whole-Time Finance Director or any other person heading the finance function discharging that function shall certify to the Board that:

a. They have reviewed financial statements and the cash flow statement for the year and that to the best of their knowledge and belief :

    i. these statements do not contain any materially untrue statement nor omit any material fact nor contain statements that might be misleading;

ii. these statements together present a true and fair view of the company's affairs and are in compliance with existing Accounting Standards, applicable laws and regulations.

b. There are, to the best of their knowledge and belief, no transactions entered into by the company during the year which are fraudulent, illegal or violate the company's code of conduct.

c. They accept responsibility for establishing and maintaining internal controls for financial reporting and that they have evaluated the effectiveness of internal control systems of the company pertaining to financial reporting and they have disclosed to the auditors and the Audit Committee, deficiencies in the design or operation of such internal controls, if any, of which they are aware and the steps they have taken or propose to take to rectify these deficiencies.

d. They have indicated to the auditors and the Audit Committee:

i. significant changes in internal control over financial reporting during the year;

ii. significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and

iii. instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or any employee having a significant role in the company's internal control system over financial reporting.

VI. Report on CG

i. There shall be a separate section on CG in the annual reports of company, with a detailed compliance report on CG. Non-compliance of any mandatory requirement of Clause 49 with reasons thereof and the extent to which the non-mandatory requirements have been adopted should be specifically highlighted. The suggested list of items to be included in this report is given in Annexure: 1 (IC) and the list of non-mandatory provisions given a few paragraphs later, under 3.1.4.2.

ii. The companies shall submit a quarterly compliance report to the stock exchanges within 15 days from the close of quarter as per the format (Annexure: 1(IB)). Such report shall be signed either by the compliance officer or the CEO of the company.

VII. Compliance

1. The company shall obtain a certificate from either the auditors or practicing Company Secretaries regarding compliance of norms of CG as stipulated in Clause 49 and annex the certificate with the Directors' Report, which is sent annually to all the shareholders of the company. The same certificate shall also be sent to the Stock Exchanges along with the annual report filed by the company.
2. The non-mandatory requirements may be implemented as per the discretion of the company. However, the disclosures of the compliance with mandatory requirements and adoption (and compliance) /non-adoption of the non-mandatory requirements shall be made in the section on CG of the annual report.

3.1.4.2 Non-Mandatory Provisions.

1. The Board

In the Board, a Non-Executive Chairman may be entitled to maintain a chairman's office at the company's expense and also be allowed reimbursement of expenses incurred in the performance of his duties. Independent Directors may have a tenure not exceeding, in the aggregate, a period of nine years, on the Board of a company. The company may ensure that the person who is being appointed as an Independent Director has the requisite qualifications and experience which would be of use to the company and which, in the opinion of the company, would enable him to contribute effectively to the company in his capacity as an Independent Director.

2. Remuneration Committee

i) The Board may set up a Remuneration Committee to determine on their behalf and on behalf of the shareholders with agreed terms of reference, the company's policy on specific remuneration packages for Executive Directors including pension rights and any compensation payment.

ii) To avoid conflicts of interest, the Remuneration Committee, which would determine the remuneration packages of the Executive Directors may comprise at least three directors, all of whom should be Non-Executive Directors, the Chairman of the committee being an Independent Director.

iii) All the members of the Remuneration Committee should be present at the meeting.

iv) The Chairman of the Remuneration Committee could be present at the Annual General meeting, to answer the shareholder queries. However, it would be up to the Chairman to decide who should answer the queries.

3. Shareholder Rights

A half-yearly declaration of financial performance including a summary of the significant events in last six months, may be sent to each household of shareholders.

4. Audit Qualifications

Company may move towards a regime of unqualified financial statements.

5. Training of Board Members

A company may train its Board members according to the business model and the risk profile of the company, their responsibilities as directors, and the best ways to discharge them.

6. Mechanism for Evaluating Non-Executive Board Members

The performance evaluation of Non-Executive Directors could be done by a peer group comprising the entire Board of Directors, excluding the director being evaluated. Peer group evaluation could be the mechanism to determine whether to extend/continue the terms of appointment of such directors.

7. Whistle-Blower Policy

The company may establish a mechanism for employees to report to the management about unethical behavior, actual or suspected fraud or violation of the company's code of conduct or ethics or policy. This mechanism could also provide for adequate safeguards against victimization of employees who avail of the mechanism and also provide for direct access to the chairman of the Audit Committee in exceptional cases. Once established, the existence of the mechanism may be appropriately communicated within the organization.

3.1.5 SELECTED PROVISIONS OF THE COMPANIES ACT 1956 WITH RESPECT TO CG

The important legislations for regulating the entire corporate domain and for dealing with various aspects of companies are given in the Companies Act, 1956 and various Companies Bill. These laws have been amended from time to time, to bring more transparency and accountability in the provisions. Some provisions of Companies Act, 1956 (hereinafter, "the Act") are as follows.[24]

1. Board of Directors

1.1 Minimum Number of Directors

According to Section 252 (1), every public company, other than a public company which has become such by virtue of Section 43(A) shall have at least three directors. (2) Every other company shall have at least two directors.

1.2 Number of Directorships

According to Section 275, after the commencement of this Act, no person shall, save as otherwise provided in Section 276, hold office at the same time as director in more than twenty companies.

1.3 Board Meetings

According to Section 285, in the case of every company, a meeting of its Board of Directors shall be held at least once in every three months and at least four such meetings shall be held in every year provided that the Central Government may, by notification in the Official Gazette, direct that the provisions of this Section shall not apply in relation to any class of companies or shall apply in relation thereto with exceptions.

1.4 Remuneration of Directors

According to Section 309 (3) a director who is either in the whole-time employment of the company or a Managing Director, may be paid remuneration either by way of a monthly payment or at a specified per cent of the net profits of the company or partly by one way and partly by the other provided that except with the approval of the Central Government as per Section 643a such remuneration shall not exceed five per cent of the net profits for one such director, and if there is more than one such director, ten per cent for all of them together.

(4) A director who is neither in the whole-time employment of the company nor a Managing Director may be paid remuneration either (a) by way of a monthly, quarterly or annual payment with the approval of the Central Government; or (b) by way of commission if the company by special resolution authorizes such payment provided that the remuneration paid to such director, or where there is more than one such director, to all of them together, shall not exceed -

(i) one per cent of the net profits of the company, if the company has a Managing or Whole-Time Director, [managing agent, secretaries and treasurers] or a manager;

(ii) three per cent of the net profits of the company, in any other case provided further that the company in general meeting may, with the approval of the Central Government, authorize the payment of such remuneration at a rate exceeding one per cent or, as the case may be, three per cent of its net profits.

(5) The net profits referred to in sub-sections (3) and (4) shall be computed in the manner referred to in Section 198, sub-section (1).

Fees for meetings of the Board and any committee thereof, attended by a director are paid on a monthly basis; such fees may continue to be paid on that basis for a period of two years after such commencement or for the remainder of the term of office of such director, whichever is less.

1.5 Term of Managing Director

According to Section 317 (1) no company shall, after the commencement of this Act, appoint or employ any individual as its Managing Director for a term exceeding five years at a time.

(2) Any individual holding at the commencement of this Act the office of Managing Director in a company shall, unless his term expires earlier, be deemed to have vacated his office immediately on the expiry of five years from the commencement of this Act.

(3) Nothing contained in sub-section (1) shall be deemed to prohibit the re-appointment, reemployment, or the extension of the term of office, of any person by further periods not exceeding five years on each occasion: provided that any such re-appointment, re-employment or extension shall not be sanctioned earlier than two years from the date on which it is to come into force.

2. Audit Committee

2.1 Composition of Audit Committee

Section 292A applies to all public companies having a paid-up capital of Rs. 5 Crore or more.

a) The Audit Committee to consist of

i) Not less than 3 directors.

ii) 2/3rd of which shall be directors other than Managing or Whole Time Directors.

b) Chairman to be elected by the members.

c) Chairman to attend Annual General Meeting.

d) Director in-charge of finance, internal auditor and statutory auditor shall attend the meetings without any right to vote.

2.2 Meetings of Audit Committee

Frequency of meetings is not specified in Section 292A**.** However, it states that Audit Committee should have periodical discussions with auditors regarding scope of audit and review of half-yearly and annual financial statements before submission to the Board and also ensuring compliance of internal control systems.

2.3 Quorum

No quorum has been specified in Section 292A. The quorum should, thus, be as per Articles of Association of the company.

2.4 Powers of Audit Committee

According to Section 292A (7), following are the powers of Audit Committee:

i) To investigate any matter in relation to items specified in Section 292A or referred to it by the Board.

ii) To have full access to information contained in the records of the company.

iii) To seek external professional advice if necessary.

3. Remuneration of Managerial Personnel

According to Section 387, the manager of a company may, subject to the provisions of Section 198, receive remuneration either by way of a monthly payment, or by way of a specified per cent of the "net profits" of the company calculated in the manner laid down in Sections 349 and 350 or partly by the one way and partly by the other provided that except with the approval of the Central Government such remuneration shall not exceed in the aggregate five per cent of the net profits.

4. Loans to Directors

According to Section 295 (1) save as otherwise provided in sub-section (2), no company (hereinafter in this Section referred to as "the lending company") without obtaining the previous approval of the Central Government in that behalf shall, directly or indirectly, make any loan to, or give any guarantee or provide any security in connection with a loan made by any other person to, or to any other person

by -

(a) any director of the lending company, or of a company which is its holding company or any partner or relative of any such director;

(b) any firm in which any such director or relative is a partner;

(c) any private company of which any such director is a director or member;

(d) any body corporate at a general meeting of which not less than twenty-five per cent of the total voting power may be exercised or controlled by any such director, or by two or more such directors together; or

(e) any body corporate, the Board of Directors, Managing Director, or manager whereof is accustomed to act in accordance with the directions or instructions of the Board, or of any director or directors, of the lending company.

5. Disclosure of Interest by Director

According to Section 299 (1) every director of a company who is in any way, whether directly or indirectly, concerned or interested in a contract or arrangement, or proposed contract or arrangement, entered into or to be entered into, by or on behalf of the company, shall disclose the nature of his concern or interest at a meeting of the Board of Directors.

(2) (a) In the case of a proposed contract or arrangement, the disclosure required to be made by a director under sub-section (1) shall be made at the meeting of the Board at which the question of entering into the contract or arrangement is first taken into consideration, or if the director was not, at the date of that meeting, concerned or interested in the proposed contract or arrangement, at the first meeting of the Board held after he becomes so concerned or interested.

6. Board’s Report

According to Section 217 (1) there shall be attached to every balance sheet laid before a company in general meeting, a report by its Board of Directors, with respect to -

(a) the state of the company's affairs;

(b) the amounts, if any, which it proposes to carry to any reserves in such balance sheet;

(c) the amount, if any, which it recommends should be paid by way of dividend;

(d) material changes and commitments, if any, affecting the financial position of the company which have occurred between the end of the financial year of the company to which the balance sheet relates and the date of the report;

(e) the conservation of energy, technology absorption, foreign exchange earnings and outgo, in such manner as may be prescribed.

(2) The Board's report shall, so far as is material for the appreciation of the state of the company's affairs by its members and will not in the Board's opinion be harmful to the business of the company or of any of its subsidiaries, deal with any changes which have occurred during the financial year -

(a) in the nature of the company's business;

(b) in the company's subsidiaries or in the nature of the business carried on by them; and

(c) generally in the classes of business in which the company has an interest.

(2A)(a) The Board's report shall also include a statement showing the name of every employee of the company who -

(i) if employed throughout the financial year, was in receipt of remuneration for that year which, in the aggregate, was not less than such sum as may be prescribed; or

(ii) if employed for a part of the financial year, was in receipt of remuneration for any part of that year, at a rate which, in the aggregate, was not less than such sum per month as may be prescribed ;

(iii) if employed throughout the financial year or part thereof, was in receipt of remuneration in that year which, in the aggregate, or as the case may be, at a rate which, in the aggregate, is in excess of that drawn by the Managing Director or Whole-Time Director or manager and holds by himself or along with his spouse and dependent children, not less than two per cent, of the equity shares of the company.

(b) The statement referred to in clause (a) shall also indicate, -

(i) whether any such employee is a relative of any director or manager of the company and if so, the name of such director, and

(ii) such other particulars as may be prescribed.

Explanation: "Remuneration" has the meaning assigned to it in the explanation to section 198.

(2B) The Board's report shall also specify the reasons for the failure, if any, to complete the buyback of equity shares within the time specified in sub-section (4) of section 77A.

(3) The Board shall also be bound to give the fullest information and explanations in its report aforesaid, or in cases falling under the provisions to Section 222, in an addendum to that report, on every reservation, qualification or adverse remark contained in the auditors' report.

7. Voting by Shareholders

7.1 Proxies

According to Section 176 (1) any member of a company entitled to attend and vote at a meeting of the company shall be entitled to appoint another person (whether a member or not) as his proxy to attend and vote instead of himself; but a proxy so appointed shall not have any right to speak at the meeting.

7.2 Voting to Be by Show of Hands in First Instance

According to Section 177 at any general meeting, a resolution put to the vote of the meeting shall, unless a poll is demanded under Section 179, be decided on a show of hands.

7.3 Demand for Poll

According to Section 179 (1) before or on the declaration of the result of the voting on any resolution on a show of hands, a poll may be ordered to be taken by the chairman of the meeting of his own motion, and shall be ordered to be taken by him on a demand made in that behalf by the persons or person specified below, that is to say, -

(a) in the case of a public company having a share capital, by any member or members present in person or by proxy and holding shares in the company -

(i) which confer a power to vote on the resolution not being less than one-tenth of the total voting power in respect of the resolution, or

(ii) on which an aggregate sum of not less than fifty thousand rupees has been paid up.

8. Quorum for Meetings of the Board

According to Section 287 (1) in this Section - (a) "total strength" means the total strength of the Board of Directors of a company as determined in pursuance of the Act, after deducting therefrom the number of the directors, if any, whose places may be vacant at the time; and (b) "interested director" means any director whose presence cannot, by reason of Section 300, count for the purpose of forming a quorum at a meeting of the Board, at the time of the discussion or vote on any matter.

(2) The quorum for a meeting of the Board of Directors of a company shall be one-third of its total strength (any fraction contained in that one-third being rounded off as one), or two directors, whichever is higher provided that where at any time the number of interested directors exceeds or is equal to two-thirds of the total strength, the number of the remaining directors, that is to say, the number of the directors who are not interested, present at the meeting being not less than two, shall be the quorum during such time.

9. Powers of SEBI

As per Section 55A, the provisions contained in 55 to 58, 59 to 84, 108 to 110, 112, 113, 116 to 122, 206, 206A and 207, so far as they relate to issue and transfer of securities and non-payment of dividend shall -

(a) in case of listed public companies;

(b) in case of those companies which intend to get their securities listed on any recognized stock exchange in India, be administered by the SEBI ; and

(c) in any other case, shall be administered by the Central Government.

Explanation - for the removal of doubts, it is hereby declared that all powers relating to all other matters including those relating to prospectus, statement in lieu of prospectus, return of allotment, issue of shares and redemption of irredeemable preference shares shall be exercised by the Central Government [the Tribunal] or the Registrar of Companies, as the case may be.

EXHIBIT 3.4

COMPARATIVE REVIEW OF SELECTED PROVISIONS OF THE CLAUSE 49 OF THE LISTING AGREEMENT AND THE COMPANIES ACT 1956 RELATED TO CG

Requirement as per Clause 49 of the Listing Agreement	**Requirement as per Section of Companies Act, 1956**
Composition of Board of Directors I (A) At least 50 per cent of the total number of directors should be Non-Executive Directors. If chairman is an Executive Director, at least half of the total number of directors should be Independent Directors. If the chairman is a Non-Executive Chairman, at least 1/3rd of the total number of directors should comprise Independent Directors.	**Composition of Board of Directors** No such requirement under the Companies Act, 1956. In fact, the Companies Act, 1956 does not use the expressions 'Independent Directors' or 'Non-Executive Directors' or 'Executive Directors' or 'Executive or Non-Executive Chairman'. As per Section 252 (1) at least three directors for a public company.*
Directors Compensation and Disclosures I(B) and IV(E) The remuneration of Non-Executive Directors including Independent Directors to be decided by the Board of Directors with prior approval of shareholders in general meeting except approval for payment of sitting fees if such sitting fees is paid within limits prescribed by the Companies Act, 1956. All pecuniary relationship or transactions of the Non-Executive Directors vis-à-vis the company should be disclosed in annual report.	**Directors Compensation and Disclosures** Section 309(1) of the Companies Act requires the remuneration of directors (whether Managing or Whole-Time Director) to be determined as per provisions of Section 198 either by articles or resolution or if articles require then by special resolution.* The Section 299 (1) requires disclosure by directors of their interests in contracts and arrangements with the company. It is only a disclosure of information (Form 24AA) and there is no requirement of stating the same in annual report as it is under Clause 49 except the disclosures to be made pursuant to Accounting Standard - 18: Related Party Disclosures.
II (A) **Composition of Audit Committee** a) The Audit Committee should consist of i) Minimum of 3 members, all being Non-Executive Directors. ii) 2/3rd should be Independent Directors. iii) All should be financially literate, bur at least one director having financial and accounting knowledge. b) Chairman to be an Independent Director. c) Chairman to attend Annual General Meeting. d) Committee to invite Finance Director, head of internal audit, and representative of statutory	**Section 292A** applies to all public companies having a paid-up capital of Rs. 5 Crore or more. **Composition of Audit Committee** a) The Audit Committee to consist of i) not less than 3 directors. ii) 2/3rd of which shall be directors other than Managing or Whole Time Directors. b) Chairman to be elected by the members. c) Chairman to attend Annual General Meeting. d) Director in-charge of finance, internal auditor and statutory auditor shall attend the meetings without any right to vote.

auditor to attend the meetings. e) Company Secretary to act as Secretary to the committee.	
Meetings of Audit Committee i) To meet at least four times in a year. ii) Not more than four months to elapse between two meetings. **Quorum** Two members or one-third of the members of the Audit Committee, whichever is higher but a minimum of two Independent Directors.	**Meetings of Audit Committee** Frequency of meetings is not specified in Section 292A. However, it states that Audit Committee should have periodical discussions with auditors regarding scope of audit and review of half-yearly and annual financial statements before submission to the Board and also ensuring compliance of internal control systems. **Quorum** No quorum has been specified in Section 292A. The quorum should, thus, be as per Articles of Association of the company.
II(C) **Powers of Audit Committee** i) To investigate any activity within its terms of reference. ii) To seek information from any employee. iii)To obtain outside legal or other professional advice . iv)To secure attendance of outsiders with relevant expertise if necessary.	292A(7) **Powers of Audit Committee** i) To investigate into any matter in relation to items specified in Section 292A or referred to it by the Board. ii)To have full access to information contained in the records of the company. iii)To seek external professional advice if necessary.
I(C) **Frequency of Board Meetings** The Board meetings shall be held at least four times a year, with a maximum time gap of four months between any two meetings.	**Frequency of Board Meetings** As per Section 285, the Board meeting to be held once in every three months and at least four such meetings to be held every year. The gap between two meetings could be more than 4 months.
VI **Report on Corporate Governance** The company shall have a separate section on corporate governance in annual reports of company, with a detailed compliance report on corporate governance. Non-compliance of any mandatory requirement i.e., which is part of the Listing Agreement with reasons thereof and the extent to which the non-mandatory requirements have been adopted to be specifically highlighted.	**Report on Corporate Governance** No separate report on corporate governance is required under the Companies Act, 1956.
VII **Corporate Governance Compliance Certificate** The company has to — a) Obtain a certificate from auditors or company secretary of company regarding compliance of conditions of corporate governance as stipulated in this clause. b) Such certificate is to be annexed with directors' report, which is sent annually to all shareholders. c) Send same certificate to Stock Exchanges along with annual returns filed by company.	**Corporate Governance Compliance Certificate** No such requirement under the Companies Act, 1956.

Sources: Adapted from Makhija Ashish, "Corporate Governance Practices – Self regulation vis-à-vis legislation," *The Chartered Accountant*, September 2004, pp. 296-298.

*Puliani Ravi, and Mahesh Puliani, *Corporate Laws*, 23rd ed.; Bharat Law House Pvt. Ltd., New Delhi, 2011, p. 1.238 and 1.279.

3.1.6 SELECTED PROVISIONS OF PROPOSED COMPANIES BILL, 2009 WITH RESPECT TO CG

1. Board of Directors

Under Section 132 (1 to 6) every company shall have a Board of Directors consisting of only individuals as directors and shall have a minimum number of three directors in the case of a public company and a maximum of twelve directors, excluding the directors nominated by the lending institutions. One of the directors shall at least be a person ordinarily resident in India. The Central Government may prescribe the minimum number of Independent Directors in case of other public companies and subsidiaries of any public company. Independent Director in relation to a company, means a Non-Executive Director of the company, other than a nominee director.[*]

[*]Section 132 (5) of Companies Bill 2009, defines "Independent director", in relation to a company, as a non-executive director of the company, other than a nominee director-
(*a*) who, in the opinion of the Board, is a person of integrity and possesses relevant expertise and experience;
(*b*) who, neither himself nor any of his relatives-
(*i*) has or had any pecuniary relationship or transaction with the company, its holding, subsidiary or associate company, or its promoters, or directors amounting to ten per cent. or more of its gross turnover or total income during the two immediately preceding financial years or during the current financial year;
(*ii*) holds or has held any senior management position, position of a key managerial personnel or is or had been an employee of the company in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed;
(*iii*) is or has been an employee or a partner, in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed, of-
(*A*) a firm of auditors or company secretaries in practice or cost auditors of the company or its holding, subsidiary or associate company; or
(*B*) any legal or a consulting firm that has or had any transaction with the company, its holding, subsidiary or associate company amounting to ten per cent. or more of the gross turnover of such firm;
(*iv*) holds together with his relatives two per cent. or more of the total voting power of the company; or
(*v*) is a Chief Executive or director, by whatever name called, of any nonprofit organization that receives twenty-five per cent. or more of its income from the company, any of its promoters, directors or its holding, subsidiary or associate company or that holds two per cent. or more of the total voting power of the company; or
(*c*) who possesses such other qualifications as may be prescribed.
Explanation - For the purposes of this section, "nominee director" means a director nominated by any institution in pursuance of the provisions of any law for the time being in force, or of any agreement, or appointed by any Government, to represent its shareholding.
Source: http://www.mca.gov.in/ministry/companies_act.html

An Independent Director shall not be entitled to any remuneration, other than sitting fee, reimbursement of expenses for participation in the Board and other meetings and profit-related commission and stock options as may be approved by the members.

1.1 Minimum Number of Directors

As mentioned previously, according to Section 132 (1) every company shall have a Board of Directors consisting of only individuals as directors and shall have - (a) a minimum number of three directors in the case of a public company, two directors in the case of a private company, and one director in the case of a One Person Company; and (b) a maximum of twelve directors, excluding the directors nominated by the lending institutions.

(2) One of the directors shall at least be a person ordinarily resident in India.

Explanation - for the purposes of this sub-section, ordinarily resident in India means a person who stays in India for a total period of not less than one hundred and eighty-two days in a calendar year.

1.2 Number of Directorships

Under Section 146 (1) no person, after the commencement of this Act, shall hold office as a director, including any alternate directorship, in more than fifteen public limited companies at the same time.

(2) Where a person accepts an appointment as a director in contravention of sub-section (1), he shall be punishable with fine which shall not be less than five thousand rupees but which may extend to twenty-five thousand rupees for every day during which the contravention continues.

1.3 Term of Managing Director

According to Section 174 (1) no company shall appoint or employ at the same time a Managing Director and manager.

(2) No company shall appoint or re-appoint any person as its Managing Director, Whole-Time Director or manager for a term exceeding five years at a time provided that no re-appointment shall be made earlier than one year before the expiry of his term.

(3) No company shall appoint any firm, body corporate or other association as its manager.

(4) No company shall appoint or continue the employment of any person as its Key Managerial Personnel who - (a) is below the age of twenty-one years or has attained the age of seventy years provided that appointment of a person who has attained the age of seventy years may be made by passing a special resolution;

(b) is an undischarged insolvent or has at any time been adjudged an insolvent;

(c) has at any time suspended payment to his creditors or makes, or has at any time made, a composition with them; or

(d) has at any time been convicted by a court of an offence involving moral turpitude.

(5) A Managing Director, Whole-Time Director or manager shall be appointed by the Board of Directors at a meeting with the consent of all the directors present at such meeting, which shall be subject to approval by a special resolution at the next general meeting of the company provided that a notice convening Board or general meeting for considering such appointment shall include the terms and conditions of such appointment, remuneration payable and such other matters including interest, if any, of a director or directors in such appointments, if any.

(6) Subject to the provisions of this Act, where an appointment of a Managing Director, Whole-Time Director or manager is not approved by the company at a general meeting, any act done by him before such approval shall be deemed to be invalid.

1.4 Board Meetings

Under Section 154 (1) every company shall hold the first meeting of the Board of Directors within thirty days of the date of its incorporation and thereafter hold a minimum number of four meetings of its Board of Directors every year in such a manner that not more than 120 days shall intervene between two consecutive meetings of the Board except that the Central Government may, by notification, direct that the provisions of this sub-section shall not apply in relation to any class or description of companies or shall apply with modifications or conditions as may be specified in the notification.

1.5 Directors' Remuneration

Under Section 176 (1) a director who is neither a Whole-Time Director nor a Managing Director of a company may be paid remuneration in the form of -

(a) fee for attending meetings of the Board or committees thereof in accordance with the articles; and (b) profit-related commission with the prior approval of members by a special resolution.

(2) If any director draws or receives directly or indirectly by way of remuneration any sum in excess of the amount under sub-section (1), he shall refund such sum to the company within thirty days.

2. Board Committees

2.1 Audit Committee

Under Section 158 (1) the Board of Directors of every listed company and such other class or description of companies, as may be prescribed, shall constitute an Audit Committee.

(2) The Audit Committee shall consist of a minimum of three directors with Independent Directors forming a majority and at least one director having knowledge of financial management, audit or accounts.

(3) The Chairman of an Audit Committee shall be an Independent Director.

(4) Every Audit Committee of a company existing immediately before the commencement of this Act shall, within one year of such commencement, be reconstituted in accordance with sub-sections (2) and (3).

(5) Every Audit Committee shall act in accordance with the terms of reference specified in writing by the Board which shall include, among other things, the recommendation for appointment of auditors of the company, examination of the financial statements and the auditors' report thereon, transactions of the company with related parties, valuation of undertakings or assets of the company, wherever it is necessary, evaluation of internal financial controls and related matters.

(6) The Audit Committee may call for the comments of the auditors about internal control systems, the scope of audit, including the observations of the auditors and review financial statements before their submission to the Board.

(7) The Audit Committee shall have authority to investigate into any matter in relation to the items specified in sub-section (5) or referred to it by the Board and for this purpose shall have power to obtain professional advice from external sources and have full access to information contained in the records of the company.

(8) The auditors of a company and the Key Managerial Personnel shall have a right to attend the meetings of the Audit Committee when it considers the auditor's report but shall not have the right to vote.

2.2 Remuneration Committee

Under Section 158 (1) the Board of Directors of every listed company and such other class or description of companies, as may be prescribed, shall constitute a Remuneration Committee of the Board.

(10) The Remuneration Committee shall consist of Non-Executive Directors as may be appointed by the Board out of which at least one shall be an Independent Director.

(11) The Remuneration Committee shall determine the company's policies relating to the remuneration of the directors, including the remuneration and other perquisites of the directors, Key Managerial Personnel and such other employees as may be decided by the Board.

2.3 Stakeholders Relationship Committee

Under Section 158 (13) Stakeholders Relationship Committee shall consider and resolve the grievances of stakeholders.

3. Remuneration of Managerial Personnel

Under Section 175 (1) a Managing or Whole-Time Director or a manager of a company may be paid remuneration either by way of a monthly payment or at a specified per cent of the net profits of the company, computed in the manner prescribed, or partly by monthly payment and partly by the per cent of net profits.

(2) Where any insurance is taken by a company on behalf of its Managing Director, Whole-Time Director, manager, CEO, CFO or Company Secretary for indemnifying any of them against any liability in respect of any negligence, default, malfeasance, breach of duty or breach of trust for which they may be guilty in relation to the company, the premium paid on such insurance shall not be treated as part of the remuneration payable to any such personnel.

(3) Any director who is in receipt of any commission from the company and who is a Managing or Whole-Time Director of the company shall not be disqualified from receiving any remuneration or commission from any holding company or subsidiary company of such company subject to its disclosure by the company in the Board's report.

(4) Every person who contravenes the provisions of this section shall be punishable with fine which shall not be less than One Lakh Rupees but which may extend to Five Lakh Rupees.

4. Related Party Transaction

Under Section 166 (1) except with the consent of the Board of Directors of a public company accorded by a resolution passed at a meeting of the Board and subject to such conditions as may be prescribed, no such company shall enter into any contract or arrangement with a related party with respect to -

(*a*) sale, purchase or supply of any goods or materials, investments of company to be held in its own name;

(*b*) selling or otherwise disposing of, or buying, property of any kind;

(*c*) leasing of property of any kind;

(*d*) availing or rendering of any services;

(*e*) appointment of any agents for purchase or sale of goods, materials, services or property;

(*f*) appointment to any office or place of profit in the company or its subsidiary company; and

(*g*) underwriting the subscription of any securities or derivatives thereof, of the company;

provided that no contract or arrangement, in the case of a company having a paid-up share capital of not less than such amount, or transactions not exceeding such sums, as may be prescribed, shall be entered into except with the prior approval of the company by a special resolution.

5. Loans to Directors

According to Section 163 (1) save as otherwise provided in this Act, no company shall, directly or indirectly, advance any loan, including any loan represented by a book debt, to any of its directors or to any other person in whom he is interested or give any guarantee or provide any security in connection with any loan taken by him or such other person provided that nothing contained in this sub-section shall apply to-

(a) the giving of any loan to a Managing or Whole-Time Director-

(i) as a part of the conditions of service extended by the company to all its employees; or

(ii) pursuant to any scheme approved by the members by a special resolution;

(b) a company which in the ordinary course of its business provides loans or gives guarantees or securities for the due repayment of any loan and in respect of such loans an interest is charged at a rate not less than the bank rate declared by the Reserve Bank of India (RBI).

6. Disclosure of Interest by Director

According to Section 162 (1) every director shall at the first meeting of the Board in which he participates as a director and thereafter at the first meeting of the Board in every financial year or whenever there is any change in the disclosures already made, then at the first Board meeting held after the change, disclose his concern or interest in any company or companies or bodies corporate, firms, or other association of individuals which shall include the shareholding, in such manner as may be prescribed.

7. Prohibition of Insider Trading

According to Section 173 (1) no director or Key Managerial Personnel shall either on his own behalf or on behalf of any other person, deal in securities of a company, or counsel, procure or communicate, directly or indirectly, about any non-public price-sensitive information to any person, provided that nothing contained in this sub-section shall apply to any communication required in the ordinary course of business or profession or employment or under any law.

8. CFO Certification

Under Section 117 (1) the financial statement shall give a true and fair view of the state of affairs of the company or companies as at the end of the financial year and these statements must comply with the Accounting Standards notified under Section 119 and shall be in such form as may be prescribed.

(6) Where any company contravenes the provisions of this Section, the Managing Director, the Whole-Time Director in charge of finance, the CFO or any other person

charged by the Board with the duty of complying with the requirements of this Section and in the absence of any of the officers mentioned above, all the directors shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than fifty thousand rupee but which may extend to five lakh rupee, or with both.

9. Board's Report

As per Section 120 (1) the financial statement, including consolidated financial statement, if any, shall be approved by the Board of Directors before they are signed on behalf of the Board at least by the Chairman where he is authorized by the Board or by two directors out of which one shall be Managing Director or CEO or, in the case of a one-person Company, only by one director, for submission to the auditor for his report thereon provided that such financial statements shall be authenticated in such manner as may be prescribed.

(2) The auditors' report shall be attached to every financial statement.

(3) There shall be annexed to every financial statement laid before a company in general meeting, a report by its Board of Directors, which shall include-

(a) the extract of the annual return as provided under sub-section (2) of Section 82,

(b) number of meetings of the Board,

(c) Directors' Responsibility Statement,

(d) declaration by Independent Directors where they are required to be appointed under sub-section (3) of Section 132,

(e) report of the committee on directors' remuneration,

(f) explanations or comments by the Board on every qualification, reservation or adverse remark made by the auditor in his report,

(g) particulars of loans, guarantees or investments under sub-section (2) of Section 164, and

(h) particulars of contracts or arrangements under sub-section (1) of Section 166.

(4) The Directors' Responsibility Statement referred to in sub-section (3).

10. Voting by Shareholders

10.1 Proxy

According to Section 94, any member of a company entitled to attend and vote at a meeting of the company shall be entitled to appoint another person as a proxy to attend and vote at the meeting on his behalf in writing or by electronic mode in such manner and subject to such conditions as may be prescribed provided that a proxy shall not have the right to speak at such meeting and shall not be entitled to vote except on a poll.

10.2 Voting by Show of Hands

As per Section 96 (1) at any general meeting, a resolution put to the vote of the meeting shall, unless a poll is demanded under Section 98 or the voting is carried out electronically, be decided on a show of hands.

(2) A declaration by the Chairman of the meeting of the passing of a resolution or otherwise by show of hands under sub-section (1) and an entry to that effect in the books containing the minutes of the meeting of the company shall be conclusive evidence of the fact of passing of such resolution or otherwise.

10.3 Voting through Electronic Means

As per Section 97 unless the articles provide otherwise, a member may exercise his vote at a meeting by electronic means in the manner as may be prescribed.

10.4 Demand for Poll

As per Section 98 (1) before or on the declaration of the result of the voting on any resolution on show of hands, a poll may be ordered to be taken by the Chairman of the meeting on his own motion, and shall be ordered to be taken by him on a demand made in that behalf.

10.5 Postal Ballot

Under Section 99 (1) notwithstanding anything contained in the Act, a company - (a) shall, in respect of such items of business as the Central Government may, by notification, declare to be transacted only by means of postal ballot; and (b) may, in respect of any item of business, other than ordinary business and any business in respect of which directors or auditors have a right to be heard at any meeting, transact by means of postal ballot in such manner as may be prescribed, instead of transacting such business at a General Meeting.

(2) If a resolution is assented to by the requisite majority of the shareholders by means of a postal ballot, then it shall be deemed to have been duly passed at a General Meeting convened in that behalf.

11. Class Action

According to Section 216 (1), any one or more members or class of members or one or more creditors or any class of creditors may, if they are of the opinion that the management or control of the affairs of the company are being conducted in a manner prejudicial to the interests of the company or its members or creditors, file an application before the Tribunal on behalf of the members and creditors for seeking all or any of the following orders, namely -

(*a*) to restrain the company from committing an act which is *ultra vires* the Articles or Memorandum of the company;

(*b*) to restrain the company from committing breach of any provision of the company's Memorandum or Articles;

(*c*) to declare a resolution altering the Memorandum or Articles of the company as void if the resolution was passed by suppression of material facts or obtained by misstatement to the members or creditors;

(*d*) to restrain the company and its directors from acting on such resolution;

(*e*) to restrain the company from doing an act which is contrary to the provisions of the Act or any other law for the time being in force;

(*f*) to restrain the company from taking action contrary to any resolution passed by the members.

12. Quorum for a meeting of the Board

As per Section 155 (1) the quorum for a meeting of the Board of Directors of a company shall be one-third of its total strength or two directors, whichever is higher, and the participation of the directors by video conferencing or by other electronic means shall also be counted for the purposes of quorum under this sub-section.

(2) Where at any time, the number of interested directors exceeds, or is equal to, two-thirds of the total strength of the Board of Directors, the number of directors who are not

interested directors and present at the meeting, being not less than two, shall be the quorum during such time.

13. Auditor Not to Render Certain Services

As per Section 127, an auditor appointed under this Act shall provide the company only such other services as are approved by the Board of Directors or the Audit Committee, as the case may be, but which shall not include any of the following services, namely:-

(*a*) accounting and book-keeping services; (*b*) internal audit; (*c*) design and implementation of any financial information system; (*d*) actuarial services; (*e*) investment advisory services; (*f*) investment banking services; (*g*) rendering of outsourced financial services; and (*h*) management services.

14. Powers of SEBI

As per Section 22, (a) in so far as they relate to issue and transfer of securities and non-payment of dividend by listed companies or those companies which intend to get their securities listed on any stock exchange in India, shall, except as provided under this Act, be administered by the SEBI by making regulations;

(b) in any other case, shall be administered by the Central Government.

Explanation - For the removal of doubts, it is hereby declared that all powers relating to all other matters including those relating to prospectus, return of allotment, issue of shares and redemption of preference shares shall be exercised by the Central Government, the Tribunal or the Registrar, as the case may be.

3.1.7 COMPARATIVE REVIEW OF EXISTING COMPANIES ACT 1956 AND PROPOSED COMPANIES BILL, 2009

In the light of the changes worldwide, the expectations from the proposed Companies Bill, 2009 (hereinafter, “the Bill”) relate to setting of certain standards, deregulation and simplification.[25] The Bill contains provisions requiring certain corporate entities to have a Remuneration Committee which would frame the remuneration policy for managerial personnel and other directors/employees. The Remuneration Committee would also be required to furnish in an annual report, particulars of remuneration which would form part of the Directors’ Report to shareholders. Apparently, the proposed provisions are based on the Irani Committee report.[26] The Irani Committee also suggested that there should be a clear link between responsibility and performance in relation to remuneration and that the policy underlying the directors’ remuneration should be properly communicated to the stakeholders. The recommendations of the Irani Committee and provisions of the Bill are at par with the norms prevailing in developed economies, e.g., the UK. This would enhance transparency in the matter of management remuneration.

The Parliamentary Standing Committee on Finance - 2010 (PSCF) has suggested to the MCA to insert provisions in the Bill for the mandatory rotation of the audit firm every five years, with an interval of three years before re-appointment. The proposed provisions seek to rotate the audit partner every three years, with an interval of three years before re-appointment.

Companies of many advanced economies are required to have a Nomination Committee for selecting directors. To be at par with international practices, the PSCF has recommended a change in the Bill so as to bring in the provision of the Nomination Committee. The provisions for fixed term for Independent Directors and committee for selection of Independent Directors are commendable. Oversees, performance evaluation of directors is not a new idea and it features in CG norms.

The extant Companies Act necessitates the approval of the Central Government for certain related party transactions but the Bill does away with the need for obtaining such approval. The Bill aims to widen the scope of a 'related party', since 'Key Managerial Personnel', apart from Whole-Time Directors will also include the Company Secretary and the CFO. The term 'relative' is extended to include all lineal ascendants or descendants, related by marriage or adoption. Further, it requires increased disclosures for related party transactions. The Bill has also introduced the concept of 'associate company' i.e., a company in which another company has 26 per cent or more voting power or ability to control business decisions by virtue of an agreement. Further, the proposed ceiling of tenure for Independent Directors is six years while Clause, 49 prescribes a term of nine years. On the lines of Clause 49, the MCA Voluntary Guidelines on Corporate Governance, 2009 recommends a maximum tenure of six years.

After the global financial meltdown in 2008-09, the SEBI has attempted to deal with the issue of companies' solvency in a number of ways.[27] For instance, it is proposed that for entities which submit annual audited results in lieu of last quarter's unaudited financial results with limited review, audited annual results on stand-alone as well as consolidated basis shall be disclosed within 60 days, instead of 90 days at present, from the end of the financial year. Further, companies will now have to disclose their asset-liability and solvency positions, at specified intervals. The regulator has also determined that limited review and statutory audit reports will be furnished only by those auditors who have undergone peer review process of ICAI and hold a certificate given by the Peer Review Board to enhance the quality of audit.

On a different front, the SEBI has made it mandatory for companies to submit an auditors' certificate at the time of seeking approval for the scheme of amalgamation, mergers and reconstruction to establish that the accounting treatment is in accordance with the Accounting Standards. Moreover, listed entities with subsidiaries have been given the choice to submit their consolidated financial results as per International Financial Reporting Standards.

The new Companies Act will make internal audit mandatory.[28] The internal auditor shall be either a Chartered Accountant or a Cost Accountant. The Voluntary Code of Corporate Governance issued by the MCA in the year 2009 stipulates that the internal auditor should not be an employee of the company. Reading together the above two provisions, it may be concluded that in coming years, the practice of outsourcing of internal audit function will gain momentum. Internal audit covers audit of operations, audit of internal and external information system, audit of risk management system and also audit of management decisions.

Perhaps, the PSCF wants the Companies Bill to include provisions of CG rather than leave such regulations of listed companies to SEBI.[29] In doing so, instead of taking a hard look at the CG mechanisms administered by SEBI, the PSCF has simply sought to adopt whatever SEBI has recommended. Worse, the MCA is now being given a greater say under company law on defining the role of Independent Directors - a provision in the Companies Bill will state that the role, duties and functions of Independent Directors shall be such as may be prescribed by the Central Government. Therefore, this is one of the 235 areas in which the MCA has been given powers to be 'prescriptive' on the role of Independent Directors. The PSCF wants the MCA to do more in this area. Curiously, SEBI and the RBI were heard by the PSCF about the need to avoid regulatory overlap.

It has been pointed out that provisions of Companies Bill, 2009 are even stricter than those contained in Clause 49 of SEBI's Listing Agreement. Some voluntary provisions have been accommodated in the proposed law.[30]

Besides the Listing Agreement of SEBI, certain provisions of the Companies Act 1956 and Companies Bill 2009 should be complementary to Clause 49 of the Listing Agreement.[31]

3.2 CG in Operation

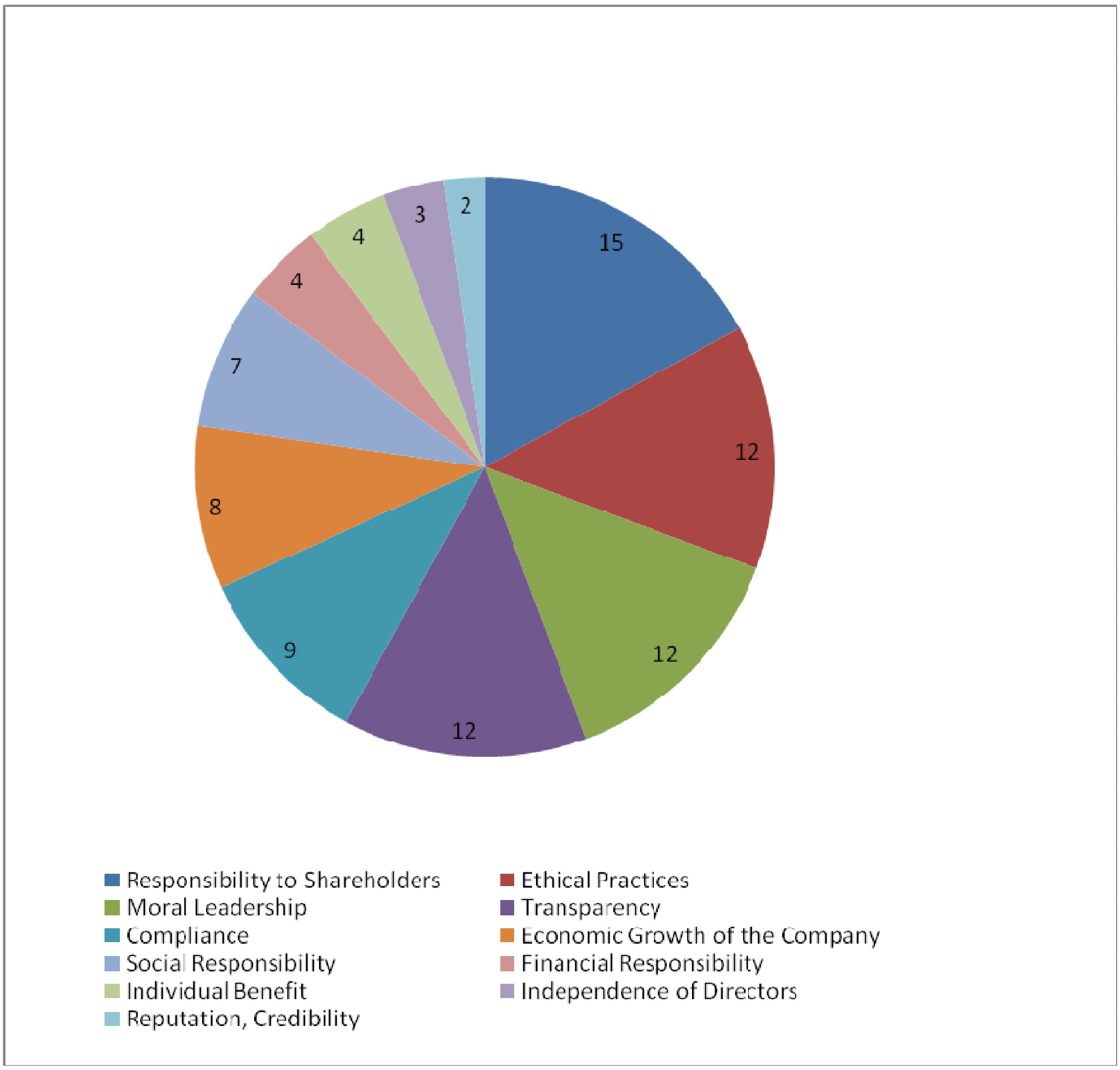
Good CG requires that a company incorporate such elements as Clause 49 of Listing Agreement into its operational fabric.[32] While most listed Indian companies have not reaped the benefits of true CG, several high-performance organizations have implemented initiatives that are noteworthy.

At a seminar on Board leadership, directors belonging to medium-sized companies were surveyed about their understanding of CG.[33] It was found that CG was interpreted variedly. Less than half thought that CG meant leadership; several felt Clause

49 to be an imposition by the SEBI while several others candidly stated their belief that business is all about money, control and power (Exhibit 3.5).

EXHIBIT 3.5

RESPONSE OF DIRECTORS AND SENIOR MANAGERS TO WHAT THEY THOUGHT CG MEANT



Source: Kar, Pratip, "More than Compliance – Corporate Governance Codes Work Only where Firms Believe Working in a Legal, Ethical and Transparent Fashion also Means Good Business," *Business Standard*, Ahmedabad, 14th December, 2009, p. 12.

In a similar attempt, a survey was carried out among over 30 CFOs from diverse sectors. They were asked to assign weights to corporate functions corresponding to the importance of such corporate functions in the management of companies (Exhibit 3.6).

EXHIBIT 3.6

PERCENTAGES OF RESPONDENTS (CHIEF FINANCIAL OFFICERS) RANKING CORPORATE FUNCTIONS

Corporate Functions	**Weights***
Corporate Governance	33
Functional Roles	19
Management Information System	15
Treasury and Risk Management	11
Investor Relations	11
Others	11
Capital Structure	07
Mergers & Acquisitions	07

*Weights by respondents don't add up to 100 per cent since some respondents' ranked more than one area as most important.

Source: "Introducing: Friend, Philosopher and Guide," The Economic Times CFO Survey, *The Economic Times*, Ahmedabad, 19th March, 2004, p. 5.

The data appearing in Exhibit 3.6 are presented in Figure 3.1 below.

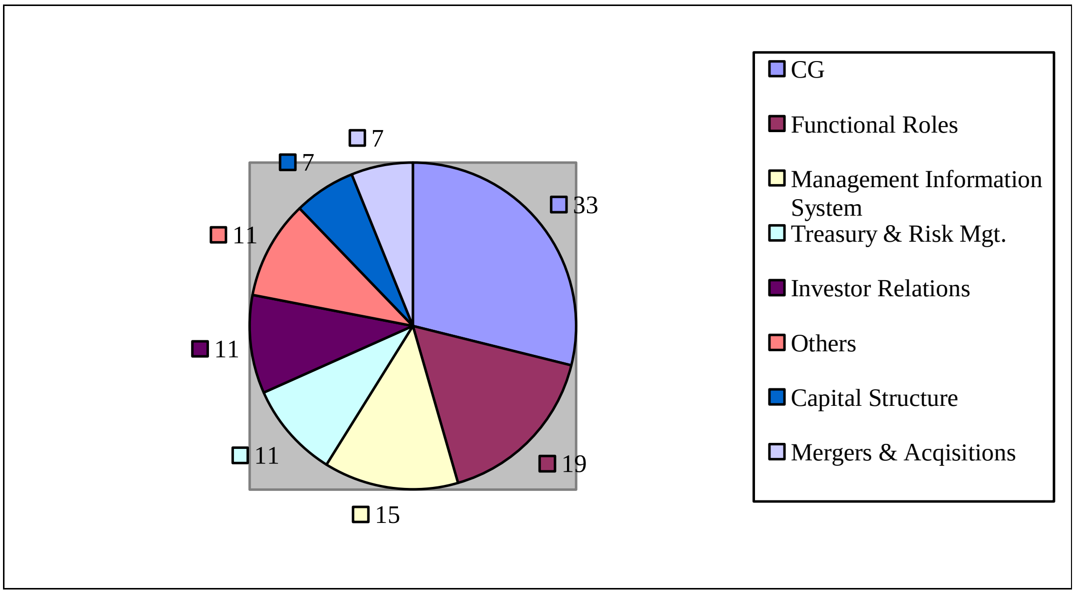


FIGURE 3.1

CG: Top of the Agenda

Apart from CG being an important function for companies, it enables the company to align its own interests with that of stakeholders. While government intervention has certainly increased the level of CG awareness among Board members and executives, it has unfortunately not extinguished corporate frauds.[34] Although technology companies and other companies have focused on revisiting and updating Board-level policies and procedures by implementing the revised Clause 49 of the Listing Agreement, this continues to be a mechanical, "tick-the-box" exercise for many companies. The best example in India can be Satyam Computers; an award-wining company for CG which turned out to be a shocker (Exhibit 3.7). The focus of most organizations has been on achieving legal compliance, for instance, introducing the appropriate mix of Executive and Non-Executive Directors on their Boards. But beyond this, not much has been done. Most listed companies continue to view CG as a compliance-driven exercise i.e., an effort to ensure that they implement the "minimum required" that can keep them out of legal implications such as penalties.

A study entitled "Early Warning Signals of Corporate Frauds" conducted by the Pune - based India Forensic Consultancy Services, a forensic accounting and education firm, from January to August, 2008 has brought out shocking revelations about corporate frauds.[35] According to the study, at least 1,200 companies out of 4,867 companies listed on the BSE and 1,288 companies listed on the National Stock Exchange as on 31st March 2007, including 25-30 companies in the benchmark Sensex and Nifty indices have manipulated their financial statements. The motive for committing accounting statement frauds, according to 73 per cent of 340 Chartered Accountants, who were respondents, was to surpass expectations of the stock market. Other reasons for the fraud include the manipulation of data by unscrupulous firms in applications for bank credit, in order to avail finance. Even with all the in-built checks and balances and the oversight of the working of companies across India by the DCA and other arms of the government, it is baffling that about 20 per cent of listed companies produced financial statements that were fraudulent.

EXHIBIT 3.7

HALL OF SHAME IN INDIA

Company / Scandal	**Details in Brief**
Securities Scam (1992) by Harshad Mehta	Some banks were involved and the stock market nosedived, after a meteoric rise.[1]
Vanishing Companies (1993- 94) Scam	Cases of price manipulation, distortion, insider trading and cheating investors. 3,911 companies which raised over Rs. 25,000 Crore vanished or did not set up their projects.
Plantation Companies (1995- 96)	About Rs. 50,000 Crore were mopped up from gullible investors seeking higher returns from plantation companies and the companies vanished.
Non–banking Finance Companies Scam (1995- 97)	About Rs. 50,000 Crore were raised from investors seeking higher returns; companies vanished.
Global Trust Bank (2002- 03)	Audited accounts showed profit of Rs. 40 Crore while RBI Report revealed negative net worth. Then the bank was forced to merge with Oriental Bank of Commerce. It was a case of mismanagement of bank assets for personal gains by top officials, fraudulent financial reporting and audit failure (Rs. 13,000 Crore were involved).
Satyam Computers Fraud (2008- 09)	Fudged the company's accounts to the tune of Rs. 7,200 Crore.[2]

Sources: [1]Adapted from *Accounting Review*, Fernando, A. C., *Corporate Governance Principles, Policies and Practices*, Pearson, Delhi, pp. 4-6, and B. Banerjee, *Corporate Creative Accounting in India: Extent and Consequences* cited in Banerjee, Bhabatosh, *Fundamentals of Financial Management*, PHI Learning Pvt. Ltd., New Delhi, 2008, p. 557.
[2] "A New Chapter in Satyam Saga Starts Today," *Business Standard*, Ahmedabad, 2nd November, 2010, p. 11.

The capital markets regulator, SEBI was preparing to take action against five public sector undertakings for non-compliance with Clause 49.[36] Reportedly, the stock exchanges sent a list of nearly 20 Public Sector Units (PSUs), which included some of the *Navratnas* for not complying with Clause 49. In an unexpected move, SEBI initiated adjudication proceedings for the first time against 20 companies, including five PSUs. While the companies' identities were not revealed, the action against the PSUs has been on the issue of non-compliance with provisions relating to Board composition.

Earlier, various PSUs had been served show-cause notices from SEBI for non-compliance with Clause 49.[37] One reason for the delay in the follow-on public offer of Steel Authority of India Limited was that it did not have an adequate number of Independent Directors. The company had just four Independent Directors against the required twelve. Earlier the public offer of another company, viz., National Hydropower Corporation was delayed by several months on the same grounds.

Some years ago, BSE came down harshly on 52 companies, threatening to suspend trading in their stocks from September 20, 2006 for non-compliance with listing norms.[38] However, the exchange gave an opportunity to the companies to mitigate the punishment. If the companies complied with the listing norms prior to the date of suspension, then the companies would be suspended for only five trading days till September 26, 2006.

In 2007, the BSE served show cause notices to about 800 companies for infractions of the Listing Agreement, that also includes CG norms.[39] For violating the norms the exchange recommended to SEBI to take action against companies as the exchange did not have the authority to impose penalty. According to the BSE, 1,213 companies had not submitted the CG compliance report for the period ended March 2008.[40] That works out nearly to one fourth of 4,895 companies listed on the BSE which need to establish that they are abiding by CG norms. Many of 1,213 companies were in the Z group of the BSE, notable for thin trading and dubious dealings which do not even have a proper Board.[41] Most of them were listed in the 1990s, when listing norms were deficient and unscrupulous promoters raised money for doubtful projects.

3.3 CG – Implementation

Judicious enforcement helps to maintain the overall credibility of a regulatory system. But, zealous enforcement is not always desirable. It can dampen valuable risk-taking abilities of firms. Unlike traditional Boards, enlightened Boards do not feel constrained by the rules and regulations, say, compliance with Clause 49 of the Listing Agreement in India or SOX Act, 2002 in US.[42] They do not need Clause 49 of the Listing Agreement or SOX Act to preserve values and ethics or monitor their CEO's performance. Unlike the typical Board that will focus on complying with regulations, enlightened Boards deem compliance with regulations as merely a minimum threshold for Board performance.[43] Enlightened Boards regard their mission as providing supportive assistance to management in leading the company. Enlightened directors strongly believe that it is their responsibility to engage in an intellectual exercise of charting the company's future path. CG, and its implementation in India, is not only being seen as a sequel to recent corporate frauds, but also as a corollary to the strong emergence of the Indian economy.[44] With greater global integration, Indian companies appreciate the need to be robust, ethical and transparent in their operations.

3.3.1 SCHEDULE OF IMPLEMENTATION OF CLAUSE 49 OF THE LISTING AGREEMENT RECOMMENDED BY THE KUMAR MANGALAM BIRLA COMMITTEE

The committee recognized that compliance with its recommendations would entail restructuring the existing Boards of companies. It also recognized that some companies, particularly the smaller ones, may experience difficulty in immediately complying with these conditions.[45] The Committee recommended that while its recommendations should be applicable to all the listed companies or entities, there is a need for phasing the implementation as follows.

i) By all entities seeking listing for the first time, at the time of listing.

ii) During the financial year 2000-2001, but not later than March 31, 2001 by all entities, which are included either in Group ‘A’ of the BSE or in Standard and Poor’s (S&P) CNX Nifty Index as on January 1, 2000. However to comply with the recommendations, these companies may have to initiate the process of implementation as early as possible. These companies would cover more than 80 per cent of the market capitalization.

iii) Within the financial year 2001-2002, but not later than March 31, 2002 by all the entities which are presently listed, with paid up share capital of Rs. 10 Crore and above, or net worth of Rs 25 Crore or above any time in the history of the company.

iv) Within the financial year 2002-2003, but not later than March 31, 2003 by all the entities which are presently listed, with a paid-up share capital of Rs 3 Crore and above. This was a mandatory recommendation of the said committee.

Clause 49 of the Listing Agreement for CG in February 2000 has been amended several times.[46] It was amended twice in 2000, thrice in 2001 and again in 2003. Further, Clause 49 amended on 29th October, 2004 contained major changes with regard to (1) definition of Independent Directors; (2) strengthening the responsibilities of Audit Committees; (3) improving the quality of financial disclosures including those pertaining to related party transactions and proceeds from public/rights/preferential issues, and (4) requiring Boards to formally adopt a code of conduct; (5) requiring CEO/CFO certification of financial statements and for improving disclosures to shareholders. Also included are some non-mandatory clauses like whistle-blower policy and restriction of the term of Independent Directors.[47] After notifying Clause 49 of the Listing Agreement in 2004, SEBI declared that it was to come into effect from April 1, 2005.[48] However, since SEBI was apprised that large companies were still not geared to adhere to such a clause, its implementation was further deferred. Thus revised Clause 49 came into effect from January 1, 2006.

It has been pointed out that the true value of CG goes beyond just ensuring compliance with regulations. In fact, India's policy makers, through the framework of the revised Clause 49, require companies to assess and manage the total risks.[49] While these practices do not guarantee that fraud will not occur, they do provide reasonable assurance that the interests of a company's stakeholders will be protected by the management on a proactive basis. This is the true spirit of risk management and good CG - one that India Inc. needs to embrace as it continues gain prominence on the global business stage.

One view is that faster growing firms are more likely to raise equity capital and may benefit more from the commitment to good CG prescribed by Clause 49.[50] Cross-listed firms may attract more investment by foreign investors inclined to CG. The positive reception to Clause 49 contrasts with the negative reaction to the SOX Act, 2002 in US. Some legal scholars have argued that SOX Act is tantamount to regulatory over-kill (e.g., Ribstein, Romano).[51] Interestingly, though a number of key elements of Clause 49 are comparable to SOX Act, 2002.

3.3.2 PRESENT SCHEDULE OF IMPLEMENTATION OF CLAUSE 49 OF LISTING AGREEMENT

The provisions of the revised Clause 49 shall be implemented as per the schedule of implementation given below.[52]

a) For entities seeking listing for the first time, at the time of seeking in-principle approval for such listing.

b) For existing listed entities which were required to comply with Clause 49 which is being revised i.e., those having a paid up share capital of Rs. 3 Crore and above or net worth of Rs. 25 Crore or more at any time in the history of the company, by April 1, 2005.[*]

[*]Include public sector units and body corporate i.e. private and public sector banks, financial institutions, insurance companies and exclude mutual funds. Source: FAQs on Corporate Governance, January 2006, available at www.nseindia.com

3.3.3 BARRIERS TO CG REFORMS

Despite considerable reforms for furtherance of CG in India, there still are barriers, as described below.

3.3.3.1 Varying Provisions of CG by SEBI and MCA.

It has been pointed out that the SEBI and government have overstepped in their enthusiasm to coax corporations into adopting CG practices, resulting in overlapping of mandatory regulations.[53] Further, in India, besides SEBI, MCA has also appointed committees on CG and has amended the voluminous Companies Act, 1956 in the year 2000. These amendments have resulted in a codification of CG practices, which differ from that of SEBI. For example, company law does not require shareholders' approval for related party transactions whereas SEBI is empowered to issue appropriate directions in order to secure the best interests of investors.[54] The inconsistency in the codified practices has triggered confusion among corporations and it only emphasizes the need to have only one authority to frame CG practices.

3.3.3.2 Frequent Amendments to CG Norms. Frequent amendments to CG norms can interfere with effective implementation of CG. It is not good to come out with changes in CG provisions after every corporate fraud whether such fraud is in India or elsewhere.

3.3.3.3 Lack of Board Independence in Family-Controlled Companies. In a survey, Moody's and ICRA Limited have observed that family-controlled companies globally are characterized by specific CG deficiencies.[55] These include: (i) comparatively fewer checks and balances on their actions (ii) leadership transition risks, and the emergence of conflicting visions and strategies (iii) limited transparency on matters such as ownership, control and related party transactions (iv) slowness to adapt, or respond to emerging business challenges (v) propensity towards higher leverage. The Indian corporate sector is dominated by companies controlled and run by family groups. For instance, 17 of the 30 Sensex companies are family-controlled.[*] A lack of clarity on ownership and the financial position of unlisted family-controlled holding companies (with significant debt in their capital structure to fund the group) pose financial risks. This is a symptom of an anxiety to try avoid losing control while the families pursue their aggressive growth plans.[ϒ] Despite regulations aimed at an independent Board of Directors, the families retain significant control over listed companies - and sometimes seem to be acting mainly to benefit their group or themselves. Therefore, the difficulty in fathoming the true independence of directors is a big CG challenge.

3.3.3.4 Absence of Fully-Consolidated Financial Accounts. Companies listed on stock exchanges need to prepare consolidated financial statements in compliance with the Listing Agreement as per SEBI.[56] However, such a consolidation does not present a true picture of firms. If the parent company which is controlled by a family is not listed, vital information to stakeholders is not available. Sometimes a listed subsidiary may have no

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[*] The Sensex is the common name for the Bombay Stock Exchange Sensitive Index, comprising the 30 largest and most actively traded stocks.

[ϒ] Interestingly, dual classes of shares may emerge in future cases where companies issue convertible bonds, but want to avoid dilution of family control should conversion occur. Both Tata Motors and Tata Steel have recently issued Convertible Alternate Reference Securities that are intended to convert into shares with different voting rights from equity shares.

debt, but it is possible that its unlisted holding company might be highly leveraged. So based on publicly available information, it may not be easy to carry out a thorough financial analysis of the group by investors and stakeholders.

3.3.3.5 Inappropriate Size of Boards. According to Moody's opinion, for medium and large companies, the appropriate Board size is usually eight to twelve.[57] Board size should be balanced because if Board size is small then it is hard to have adequate representations of members on required committees and the prospects of deliberations get reduced; conversely with a large, unwieldy Board, co-ordination in Board meetings becomes an uphill task. The Board size is recommended at between 6 and 8 directors by Jensen, about 8 to 9 by Lipton and Lorsch and 6 directors by Garg.[58]

3.3.3.6 Weak Boards. Several Indian companies including listed ones, are large and family owned.[59] In a survey involving a sample of 32 Indian companies run by 16 family-controlled business groups it was ascertained that in only about 25 per cent of the companies was the role of CEO and Chairman separated.[60] Additionally, in the sub-set, the chairman was either a former CEO or a nominee of the controlling family. These statistics highlight the dimension of anaemic Boards. About 67 per cent of the companies were having a family-linked person as Chairman and CEO. There was no presence of an independent professional Chairman and CEO in any of the companies.

One view is that in practice, companies apparently do not prefer a monitoring Board of Directors.[61] The executive management would prefer a passively advisory Board, rather than one which scrutinizes them. CG should not result in too many controls so as to threaten managerial entrepreneurship and innovation. The consequence would be to diminish the actual and expected gains to shareholders.

Enhanced financial disclosures reduce information asymmetry and probability of earnings management which in turn can facilitate monitoring by stakeholders. In this regard, the role of Audit Committee is vital. It should be made accountable for non-compliance of accounting aspects and practices of earnings management if any.[*]

According to a study, over seven of the 10 Independent Directors on the Boards of listed companies are members of the controlling family.[62] Nearly 75 per cent of all Independent Directors are family members aligned with the promoters and so are not independent, as per the study by the research firm Prime Database, which administers the website, *directorsdatabase.com*, a joint initiative with the BSE. Even if the family members - who include relatives, friends and neighbours are qualified, they cannot presumably act independently because of their links with the promoters, added the study which looked at the profiles of Independent Directors. The study further points out that very few women are Independent Directors i.e., about 2.5 per cent of the 6,443 functionaries engaged by listed companies. Further, the report mentions that only 15 per cent of the Independent Directors on the listed companies are capable of making effective contributions in Board meetings. These include lawyers, finance professionals and technocrats. The Prime Database study also added that 48 per cent of Independent Directors are above 60, while a few of them are in their nineties! The advanced age itself gives rise to certain concerns about their capabilities. Moreover, while 245 Independent Directors are below 35 years, as many as 20 are under 25 years of age.

[*] Earnings management means fictitious disclosures of earnings in the interest of management of company.

A concern expressed on the move to appoint former bureaucrats as Independent Directors is that it may constrict the autonomy of PSUs in long run.[63] As such officials have been associated with government it may be difficult for them to express independent views. According to current practice, administrative ministries indirectly control such appointments in PSUs.

3.3.3.7 Unsatisfactory Performance of Independent Directors. An assertion that has been made is that Independent Directors have so far failed to perform their monitoring role effectively.[64] The reason offered is that 'Board independence' is an idea that has just emerged in India and is gaining currency. Further, another reason is that the talent pool of Independent Directors is limited. It was observed that the cross-directorship phenomenon was also prevalent. In such cases, their effectiveness and independence have been doubted. CG has not yet considered the 'cross-directorship' phenomenon while defining the criteria for appointment as an Independent Director.

Boards are required to have a majority of non-executive or "outside" directors as per the listing norms of several stock exchanges.[65] Bringing about Board reforms does not guarantee active involvement by members in Board meetings. Better CG regulatory measures may help to define Board structure and composition but accountability and responsibility are of individual members. Effective CG can be fostered when there are sincere deliberations and candid discussions in Board meetings coupled with free exchange of information between the management and Board members. If companies understand the importance of good CG and regulators play their role then the quality of CG may improve. The following quote of Professor Sonnenfeld drives home the point:

“We will be fighting the wrong war if we tighten the procedural rules for Boards and ignore their pressing need - to be strong high functioning work groups whose members trust and challenge one another and engage directly with senior managers on critical issues facing corporations”.[66]

The twin roles of Independent Directors are to monitor the executive management; and to add value in Board meetings.[67] The case of Satyam, however, is apparently regarded as an instance of dereliction of responsibility by Independent Directors, according to the Standing Committee relating to The Companies Bill, 2009. The failure of Satyam is a failure of Independent Directors and many Experts endorse this view. But, it is also conceded that Independent Directors performed the second role effectively and that is the why Satyam could be brought back on track so fast. Usually, in Board meetings during a disagreement among Board members, the majority view prevails, therefore, if the proportion of Independent Directors stays at one-third, then a company can get any agenda item approved by the Board. Independent Directors will not be able to thwart decisions which they regard as undesirable for shareholders; at best they can only register dissenting views. Most Independent Directors would be wary of being branded as dissenters, so one may not hear of frequent dissents in the Board room. Therefore, Independent Directors may be unable to do justice to their monitoring role, unless a whistle-blowing mechanism is put in place. Although there is forward movement on introducing such a provision, it remains to be seen as to whether the mechanism will be used well. The MCA has also agreed that no individual shall have more than two tenures as Independent Director in any company. The limit is conceived on the assumption that closeness to the executive management will corrupt their independence.

3.3.3.8 Negligence by Independent Directors. Questions arose again on the role of Independent Directors serving the Boards of public sector banks and other state-run entities following the arrest of M. S. Johar, a Chartered Accountant who was a director on the Board of Central Bank of India.[68] Satyam Computers was an earlier instance; further, other companies vanished with shareholders money. So Independent Directors have been lax and have allowed companies to indulge in unfair practices to some extent. The new Company's Bill, is expected to inject reforms and clean up the appointment process of Independent Directors. It is also expected to determine responsibility of these directors so that they perform the role expected of them.

Apparently, the Board of Directors have fallen short in their monitoring responsibility.[69] The reasons are, though, directors are to be appointed by shareholders, in practice the management makes these appointments. Further, the directors so appointed and having rich and varied expertise, may not succeed in improving CG. These are instances of CG failures in companies which have had reputed members on their Boards despite having Audit Committees responsible for managing risk. But, sincere and committed Independent Directors in progressive companies can enhance performance.

3.3.3.9 Paucity of Independent Directors. As per data compiled by *directorsdatabase.com*, about 340 Independent Directors stepped down from various listed firms in 2009.[70] They became hesitant about taking up responsibility as they felt unable to express dissenting views against the founders. The role of Independent Directors was highlighted when Satyam founder B. Ramalinga Raju made a $ 1.6 billion bid to acquire a firm promoted by his relative. The deal angered investors and regulators questioned the role of Independent Directors. Till the Satyam scam, they served on the Boards of 4-5 companies with inadequate involvement in Board matters while collecting sitting fees. But after the scam they have turned cautious about accepting such positions. It has been pointed out by no less than the Secretary (Disinvestment), Sumit Bose that the absence of the required number of Independent Directors is a major obstacle in listing central public sector enterprises.[71] Further, according to Housing Development Finance Corporation Chairman Deepak Parekh, there is a shortage of Independent Directors in Indian companies and further, if the government proceeds against them for industrial accidents or for lapses for which they are not directly accountable, then the directors would retreat from accepting such assignments.[72] To alleviate the problem for Government companies, it is proposed to relax the stipulation of Independent Directors from 50 per cent to one-third of the Board size of the company.[73]

The Chairman and Managing Director of Oil and Natural Gas Corporation (ONGC), also demanded that the proportion of Independent Directors on PSU Boards be reduced to one-third, since the Board becomes 'too large to manage' if Independent Directors are to constitute 50 per cent.[74] According to SEBI guidelines, 50 per cent of the company's Board should consist of Independent Directors and it does not recognize government nominee directors on the PSUs Board as Independent Directors. ONGC has not been able to meet the CG guidelines as the oil ministry has failed to approve the names of Independent Directors to be appointed on its Board for years.

3.3.3.10 Non-Evaluation of Board of Directors. The evaluation of the performance of Board of Directors is not a mandatory requirement as per Clause 49 of the Listing

Agreement. CG provisions alone cannot ensure transparency unless people are ethical in business conduct and are evaluated for work assigned to them.

3.3.3.11 Inadequate Attendance in the Board Meetings. Regular attendance by Independent Directors is expected in Board meetings. The absence of Independent Directors, on account of any reason, matters, as decisions taken by other Board members may not best serve the interest of stakeholders particularly equity shareholders.

3.3.3.12 Inadequate Participation in Board Meetings. The presence of Independent Directors will be useful if they do ask pertinent questions in the Board meetings. However, they may balk from doing so as it can jeopardize their relationship with other Board members and also, their stakes are minimal.

3.3.3.13 Ambiguity in Role and Responsibilities of Independent Directors. Former NASSCOM President, Kiran Karnik has expressed need for clarity on the legal liabilities of Independent Directors vis-à-vis Whole-Time Directors.[75] Similarly, former Chairman of Life Insurance Corporation of India S. B. Mathur said that Independent Directors ought not to be held responsible for any mishap in those companies where they serve on the Boards as they are not privy to day-to-day information and are dependent on executive management. They ought to be held accountable only if their negligence can be established.

3.3.3.14 Unremunerative Sitting Fees or Compensation. If compensation is too high, Independent Directors may refrain from asking probing questions or from dissenting on any decision taken by the Board as they may fear losing the Board position. On the other hand if it is too low, they may not bother much, as such compensation is too little to motivate regular attendance and participation in Board meetings. Moreover, establishment of the Remuneration Committee is not a mandatory requirement as per Clause 49 of the Listing Agreement. So, to decide suitable remuneration becomes a tricky matter. For instance, it is tantamount to expropriation if remuneration is decided by nepotism. This can take place in the absence of a Remuneration Committee as it is left to one person's discretion to decide.

3.3.3.15 Deficient Performance of Auditors. According to Mehta, a managing partner of a firm, several lessons emerge from the Satyam debacle, some of which are as follows: (a) the Audit Committee need to be more efficient and accountable; (b) persuade the auditors to place more reliance on direct external audit evidence; (c) mandatory mechanism of whistle-blower policy for companies.[76] He further says that effective Joint-audit and quality review of audit firms by ICAI seems very desirable. Further, there is increased need to establish the independence of auditors according to Sugata Sircar, Chairman – CII's CFO Forum 2009 and Finance Director, Gujarat Gas Company Limited.[77] CII has suggested to ICAI to standardize disclaimers given by the auditors.

Recognizing the existing deficiencies perhaps, a new set of Accounting Standards (International Financial Reporting Standards) is expected to improve CG by increasing disclosure standards.[78] Similarly, on January 7, 2011 the Financial Reporting Council of UK has issued a discussion paper entitled 'Effective Company Stewardship – Enhancing Corporate Reporting and Audit'.[79]

3.3.3.16 Rotation of Audit Partner or Audit Firm. An important question is whether to rotate the audit partner or audit firm to improve the quality of audit. One possibility is the rotation of an audit partner.[80] Another option is the rotation of audit firms. However, the options for companies are limited to the big four international firms and a handful of Indian firms. Concerns have been expressed that mandatory rotation of audit firms may impair audit quality.[81] Further, the experience of some countries such as Austria, Canada and France have prompted them to discard the idea of rotation of audit firms, while retaining the idea of rotation of partners.[82] Studies in Europe reveal that auditor rotation had resulted in the erasure of past cumulative knowledge.

3.3.3.17 The Costs of Rotating Audit Partners or Audit Firm.

Only a few recognized audit firms or audit partners are available as mentioned above. Medium-sized companies may find it difficult to hire them, as they may charge hefty audit fees.[83] Moreover, recognition of audit firms or partners now requires approval by the Peer Review Board, so the availability of audit firms or partners will remain limited.

3.3.3.18 Possibility of Defaults in Joint Audit. Internationally, each joint auditor is responsible for the entire balance sheet but under Indian Standards, each joint auditor responsibility is limited to the work done by him.[84] A person perusing a balance sheet cannot make the distinctions and in a complex situation grey areas and issues could easily complicate the efforts to determine accountability.

3.3.3.19 Efficacy of Audit Committee Meetings. It has been asserted that the frequency of Audit Committee meetings has an important impact on the internal control and evaluation function of a company.[85] More meetings tend to improve this function as judgment and time is required in the evaluation of this function.

3.3.3.20 Inferior Quality of Audit. Under the Companies Auditor's Report Order of 2003, the auditor has to report on whether the company has an internal audit system commensurate with the size and nature of business.[86] Thus, a system that reviews the work of the internal auditor is already in place. According to Bhattacharyya it is apparent that the internal control system has not worked well. He stresses that effective enforcement of extant laws can produce desired results rather than seeking to make new laws. Clause 49 mandates the Audit Committee to review the internal audit reports and to ascertain internal control weaknesses if any apart from the appointment, removal, and remuneration of the Chief Internal Auditor. The Audit Committee is responsible for good audit practices to fortify internal control. But, the performance of the Audit Committee has been deficient thereby impairing audit quality. Therefore, Bhattacharyya believes an agency independent of the ICAI to review the auditors is one possibility in this regard.

3.3.3.21 Absence of Board Oversight of Audit. India does not have any independent oversight Board which is necessary for India to be treated at par with other developed countries. The oversight board is an European Union (EU) requirement and it will impact Indian auditors whose companies are listed at EU exchanges.[87] Incidentally, India boasts of firms which audit more than 200 companies listed at various EU Exchanges. Therefore as pointed out by Rahul Roy, an independent oversight body when formed could seek membership of the International Forum of Independent Audit Regulators, thus internationally integrating the Indian profession.

3.3.3.22 Flawed Design of Remuneration and Incentives Package. Kar believes that it is desirable to have a Compensation or Remuneration Committee to draw up remuneration packages.[88] The committee is to be accountable to the Board. For this the Board can set compensation criteria in consultation with the committee. At the same time, companies should be transparent to shareholders in these matters.

3.3.3.23 Principal-Agent Conflict. Eun and Resnick point out that increasing managerial ownership may lift the firm value initially since the interests of managers and owners become better aligned.[89] But if managerial ownership exceeds a certain point, the firm value may actually begin to decline as managers with larger shareholdings may effectively thwart takeover bids and can appropriate disproportionately larger benefits at the cost of outside investors. However, if the managerial ownership stake keeps on increasing then the alignment effect may become dominant again. As managers become larger shareholders it does not make sense to exploit themselves.

3.3.3.24 Constraints on Proxy-Voting. Bhattacharyya points out that a proxy cannot participate in discussions at General Meetings and can vote only in a poll.[90] According to prevailing corporate practice, voting is done by a show of hands unless a poll is demanded. Therefore in most situations a proxy is unable to exercise the voting right.

3.3.3.25 Lack of Investor Protection. In the case of Optionally Fully Convertible Debentures (OFCDs) of two Sahara group companies, SEBI declared that it would not be able to provide redress to any investor on any complaint involving the instruments.[91] The reason offered was that the OFCDs issued by these companies had not been done in compliance with the Companies Act, 1956 and the SEBI norms relating to public issues.

3.3.3.26 Lack of Provisions for Class-Action Suits. Class-Action Suits (CAS) allow shareholders to sue on a violation of any provision of a company's Memorandum or Articles. Such suits can render void a resolution altering the Memorandum or Articles if passed by concealment of material facts.[92] CAS provide for restraining a company and its directors from proceeding on such a malafide resolution. These suits discourage a company from committing any act contrary to provisions of the law. Presently there is no such right available to shareholders but it is included in the Companies Bill, 2009 (and its updated versions up to 2011) which is yet to be approved.

3.3.3.27 Inadequate and Delayed Legal Mechanisms. Under the Companies Act, the powers and duties of directors are laid out in various sections such as 291, 297, 299, 397, 398, 408 and 629A. They emphasize directors' fiduciary duties to shareholders, to act with due care, skill and good faith.[93] Unfortunately the Act does not offer a proper remedial mechanism, providing for cancellation of unscrupulous transactions, compensation for corporate and stakeholder losses, recovery of ill-gotten gains, etc.

In the wake of globalization and increased competition in India, there is a need for institutional support to improve the legal system and law enforcement. The score for Rule of Law Index in case of India stood at 4.17 in 1998 which was significantly inferior to the English-origin average countries i.e., 6.46.[94] Contract enforcement through courts of law is also a long-drawn process in India. Moreover, courts in India assign priority to criminal cases over civil cases. So there are further delays in the resolution of business disputes. An unfortunate feature of the Indian court system is the inordinate delay in court proceedings, which typically could take up to 20 years.[95] In addition to this, the number of judges per Million citizens is slightly over 10 in India, which is significantly lesser than other countries; for instance, in the case of US it is 107 and in Britain it is over 50.[96] Lack of alternative options of dispute resolution and paucity of judges drags disputes for several years. Hence, this imposes serious constraints on the Indian judicial system.

3.3.3.28 Tunnelling. Tunnelling seems to be widespread mostly via the non-operating components of profits. Market prices do not seem to incorporate tunneling; for example, on January 7, 2009 when the Satyam fraud was revealed, 9 out of 50 Nifty stock prices suddenly fell by more than 10 per cent, the median price decline of nine stocks was 15 per cent and the Nifty Index fell by 6 per cent. By the end of February, Nifty had fallen by 11 per cent and the median price decline of nine stocks was 37 per cent.[97] However, at least one research study offers a somewhat different view.[98]

3.3.3.29 Free Rider Problem. Institutional investors are prone to intervene in the CG of the company and while doing so they have to bear the cost of intervention in order to protect their interests. In this process, minority shareholders will ride free at the cost of institutional investors. Under such a situation, if, at all, they prefer to exit the company by selling their equity shares instead of intervening, it will not promote good CG.

3.3.3.30 Passive Role of Institutional Investors. Studies reveal that institutional investors in India have played an inert role in the CG system of Indian companies.[99]

3.3.3.31 The Hazard of Accounting Legerdemain. It has been pointed out that Brand Value and Goodwill Accounting are areas in which calculations can be treacherous.[100] Brand Value is an intangible asset that represents a premium ascribed to a company by virtue of its brand and reputation. One may compute a value utilizing a standard model based on free cash flow, profits before interest and taxes and sales projections. Yet, Brand Value goes beyond that. It is generally accepted that trust and consistency, are the foundations of Brand Equity, created by a sound ethos of dedication to customers, in terms of quality, service and so on, rather than by glib talk and impression management.

However, there are financial conmen who cast aside common sense and concoct misleading numbers of brand value of a relatively young enterprise on the basis of financial projections of the ensuing 10 years. This is what Jeff Skilling of Enron termed "hypothetical future value accounting" and convinced Wall Street analysts about it.[101] Attractive valuations, though based on shaky grounds entice investors, especially when alternative investment avenues are scarce. When enterprises fail, Board members are known to have sought shelter under the excuse that the matter was not brought before the Board and so they were unaware.

In case, dummy revenues are recorded from the (fictitious) sale of goods or services, it will result in inflated profits. Another possibility is by debiting dummy expenditure in the books of accounts and simultaneously misappropriating an equal amount of cash. Another concern is that window dressing and secret reserves are possible even within the framework of Accounting Standards. For instance, with Depreciation Accounting, Accounting Standard-6 allows a change in the method of depreciation, and a differing amount of depreciation will either increase or decrease profits. Hence by a change in the method of deprecation, accounts can be falsified. In short, accounting legerdemain is an important concern of CG.

3.3.3.32 Recurring Insider Trading. On March 11, 2011 the SEBI barred three Independent Directors of Pyramid Saimira from sitting on the Board of any listed company for two years for giving false and misleading statements.[102] Such problems could be linked to the lucrative remuneration associated with Independent Directorships; each Board meeting can yield up to Rs. 20,000 for a director. The law permits one per cent of the profit to be distributed amongst the Independent Directors, and there is no restriction on the stock options that can be offered. According to Prithvi Haldea of Prime Database a retired bureaucrat earned Rs. 2.2 Crore in 2007-08 from his directorships in ten listed companies and two foreign companies. His income from four unlisted companies was extra. In all probability, promoters would not prefer strangers on the Board, and Independent Directors may often be happy to be acquiescent.

A view that has been expressed is that the work of the market regulator and auditors cannot be assigned to Independent Directors. The question posed is whether they have the tools and the expertise to detect frauds. Satyam is a good example of how even Independent Directors were lax.[103] The Independent Directors on its Board were criticized because they had no clue of Raju's misdeeds practiced over seven long years. Subsequent to the scam, over 2,000 Independent Directors have reportedly resigned which is not a good sign.

3.3.3.33 Corruption, and Incomplete or Delayed Investigation. Corruption prevalent in a country also affects enforcements of corporate regulations especially CG which advocates transparency and disclosures of business transactions in a country (Exhibit 3.8).

EXHIBIT 3.8

TRANSPARENCY INTERNATIONAL'S CORRUPTION INDEX RANKINGS

Country	Corruption Perceptions Index (CPI) RANK		CPI SCORE	
	2008	2007	2008	2007
Denmark	1	1	9.3	9.4
Singapore	4	4	9.2	9.3
Australia	9	11	8.7	8.6
Hong Kong	12	14	8.1	8.3
UK	16	12	7.7	8.4
Japan	18	17	7.3	7.5
US	18	20	7.3	7.2
France	23	19	6.9	7.3
South Korea	40	43	5.6	5.1
South Africa	54	43	4.9	5.1
Mexico	72	72	3.6	3.5
China	72	72	3.6	3.5
Brazil	80	72	3.5	3.5
India	**85**	**72**	**3.4**	**3.5**
Russia	147	143	2.1	2.3

Note: Ranks go from 1 to 180 with 1 being least corrupt and 180 being most corrupt.
Scores go from 1 to 10 with 1 being most corrupt and 10 being least corrupt.

Source: Transparency International cited by Gajra, Rajesh, "Corruption Counter," *Business World*, December 1, 2008, p. 24.

The Serious Fraud Investigation Office (SFIO) was set up under the MCA to, among other things, look into cases of substantial involvement of public interest in terms of the size of monetary misappropriation and persons affected. However, the agency appears to be ineffective in implementation.[104] Incidentally, as pointed out, the SFIO, is not even a statutory body and so lacks powers of search and seizure and of interrogation.[105] Even the documents seized from Satyam's offices have not been shared with the SFIO.

3.3.3.34 Undesirable Consequences of Mandatory CSR. The MCA has been favouring a mandatory provision for every company having a turnover of Rs. 1,000 Crore or more, or a net worth of Rs. 500 Crore or more, or a net profit of Rs. 5 Crore in a year to spend at least 2 per cent of their average net profits during the three preceding financial years on CSR.[106] If this provision is approved then the scope for corruption increases as the meaning of CSR can be widely applied. Further, many firms may manipulate profits on this account and even if they claim to have spent 2 per cent of such average profits on CSR, it cannot be verified unless it is audited. Firms are not happy with the proposal as a mandatory requirement since government intervention will increase, and shareholders' interests will suffer.

3.3.3.35 Divergence in Emphasis among CG Models. Definitions of CG focus on interests of shareholders as well as on interests of stakeholders. The issue is that there is no commonly acceptable definition of CG among various countries. According to Allen and Gale, Anglo-Saxon countries viz., US and UK equate CG with firms pursuing the interests of shareholders whereas in countries like Japan, Germany and France, CG focuses on the interests of a wider set of stakeholders, including employees, customers and shareholders.[107] Therefore, arriving at an objective definition of CG is itself a critical issue.

3.3.3.36 Sham Compliance. Debacles in the financial sector such as Satyam and other IPO related scams demonstrate that increased regulation has not improved the quality of CG.[108] CG is being adhered to in letter but not in spirit.

Apart from the barriers stated above there are a few others such as insufficient guidance from authorities on CG enforcements, integrity of directors and auditors. For instance, it has been pointed out that in risk management framework and CEO/CFO certification of internal control evaluation, the lack of adequate guidance from regulators and other agencies has resulted in inconsistent implementation of CG.[109] Moreover, many corporate frauds have been committed in companies having high-profile directors as well as in good companies having reputed audit firms.

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CHAPTER 4

RESEARCH DESIGN

4.1 Research Design

To glean insights about Corporate Governance (CG) practices, it was initially decided to utilize primary as well as secondary data. Primary data were solicited with the help of a questionnaire which was mailed to the sample companies. Prior to finalizing the questionnaire, a pilot survey had been carried out and it involved five Vadodara-based publicly listed companies. For secondary data, a request letter was sent by post to the sample companies described under Methodology seeking their annual reports. It was also decided that other modes of collecting secondary data would be used, if the need arose.

4.2 Methodology

The Securities and Exchange Board of India regulations relating to CG viz., Clause 49 of the Listing Agreement are applicable to listed companies. Clause 49 contains mandatory and non-mandatory CG norms. Listed companies fulfilling certain criteria are to adhere to mandatory CG norms while adherence to non-mandatory CG norms is voluntary.[*] A total of fifty companies, whose equity shares comprise the Standard and Poor's (S&P) CNX NIFTY Index, or more popularly, the Nifty, were chosen for the study. These

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[*] i) By all entities seeking listing for the first time; ii) by all listed companies having a paid up share capital of Rs. 3 Crore and above or net worth of Rs. 25 Crore or more at any time in the history of the entity; and such listed companies include public sector units and body corporate i.e. private and public sector banks, financial institutions, insurance companies and exclude mutual funds.
Source: FAQs on Corporate Governance, January 2006, available at www.nseindia.com

companies are subject to compliance with CG norms and their credibility among investors is pertinent and vital. Another reason for choosing the sample companies is that they are comparatively medium to large in size. The extent and degree of disclosures have been found to be better in larger companies.[1] Also, a possible argument offered is that larger firms have more resources for undertaking additional CG initiatives as they draw considerable attention from the investing public, and so have to disclose more information.[2] It has also been argued that disclosures by companies in their annual reports should be considered as the most important source of information.[3] Accordingly, the approach of this study is consistent with other studies in which CG practices were examined from the annual reports of companies.[4] Therefore, the findings of the study are based on the information derived from annual reports of the sample companies. An in-depth study of such companies can bring out model practices in CG for other companies to emulate.

4.3 Scope of the Study

The scope of the study covers three financial years viz., 2005-06, 2006-07, and 2007-08. The financial year-end i.e., 31.03.2006 is also considered as reporting on CG practices was made mandatory since then. Fifty companies comprising the S&P CNX NIFTY in each of the years feature in the study, considering the criteria and schedule of implementation of CG requirements. As these being generally reputed companies, it was thought that the findings and recommendations of this study may serve to project exemplary CG practices for other companies to emulate.

4.4 Sources of Data

The sources of data and information for the study were the websites of selected companies and Prowess database accessed from the Smt. Hansa Mehta Library of The Maharaja Sayajirao University of Baroda, Vadodara.

4.5 Sampling Plan

Purposive (deliberate or judgment) sampling technique was used for deciding the sample for the study. As mentioned before, the sample consists of fifty companies pertaining to different sectors which comprise S&P CNX NIFTY Index.

4.6 Data Collection

The response to the endeavour to generate primary data was inadequate. Therefore, the work proceeded on the basis of secondary data. Secondary data and information were culled from annual reports which were obtained from different sources. Some annual reports were received directly from the selected companies on request. As only some of the companies sent their annual reports, others were downloaded via the internet, i.e., from the websites of selected companies and in the process, Prowess database was also accessed for the required information. The data and information used from annual reports for the study was for the three financial years viz., 2005-06, 2006-07 and 2007-08.

4.7 Data Processing and Analysis

Calculation of percentages to analyze data and appropriate statistical techniques to test relevant hypotheses were employed by using the data obtained from secondary sources in order to achieve the objectives of the study.

4.8 Limitations

The results of the study should be viewed in the background of limitations such as sample size, sampling technique, prevalent laws and the duration of the study. Publicly disclosed information e.g., in the annual reports is considered as correct, regardless of whether the company followed it or not in actual practice.

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CHAPTER 5

ANALYSIS AND INTERPRETATIONS

5.1 Introduction

This chapter presents data, application of statistical tests and outcomes and interpretations of data pursuant to the objectives of the study.

5.2 Selection of Data

It was decided to use secondary data of companies that featured in the Standard and Poor's (S&P) CNX NIFTY Index at the end of the years 2005-06, 2006-07 and 2007-08. Companies featuring in the Index represented diverse industries and sectors. However, while most of the companies selected for study are from the manufacturing sector, some of them are from service and allied sectors. The Nifty Index comprises equity shares of fifty companies. Twelve companies presently featuring, were not listed at the National Stock Exchange in all the three years as mentioned above. These companies were excluded from the sample in order to provide a comparable basis for the study and also to discern trends in Corporate Governance (CG). Further, claims made by Satyam Computers Services Ltd. about its CG practices raised suspicion in the light of subsequent revelations, so it too was not considered. Out of the remaining thirty-seven companies, publically disclosed information was not available in the case of three companies, viz., National Aluminium Company Limited, Punjab National Bank and State Bank of India (SBI). In the wake of non-availability of data, it was further decided to send a registered letter to these above-mentioned three companies requesting their annual reports. Till July 15, 2011, no response was received from these companies except SBI. SBI stated that it has complied with provisions of Clause 49 of the Listing Agreement except where provisions are not in conformity with SBI Act, 1955 and the directives issued by Reserve Bank of India (RBI) or Government of India. It is further stated that mandatory requirements of Clause 49 such as composition of Board, composition of Audit Committee and compensation of Non-Executive Directors are not binding on the bank as separate provisions of the SBI Act, 1955, SBI general regulations and RBI guidelines deal with the same. So, on these grounds SBI was not considered. Eventually, the sample for the study comprised thirty-four companies.

5.3. Objectives of the Study

1. To ascertain the extent of compliance with mandatory provisions of Clause 49 of Listing Agreement.
2. To examine the status of non-mandatory and exemplary CG practices.
3. To ascertain barriers to CG reforms in India.

5.4 Definitions

5.4.1 CG

CG means a set of practices that safeguards the interest of the set of stakeholders, in particular, shareholders.

5.4.2 CG PROVISIONS

The reference is to mandatory as well as non-mandatory CG provisions as per Clause 49 of the Listing Agreement.

5.4.3 CG PRACTICES

Compliance with mandatory as well as non-mandatory CG provisions as per Clause 49 of the Listing Agreement and exemplary CG practices followed by listed companies for compliance, transparency, value creation and excellence.

5.4.4 COMPLIANCE

It warrants full conformance with mandatory and non-mandatory CG provisions contained in Clause 49 of the Listing Agreement.

5.4.5 CLAUSE 49

One of the stipulations in the Listing Agreement required by stock exchanges that contains provisions of CG.

5.4.6 LISTING AGREEMENT

A regulation mandated by the Securities and Exchange Board of India to be complied with by companies vis-a-vis stock exchanges in order to get their equity shares listed on stock exchange(s) in India.

5.4.7 LISTED COMPANIES

Companies that featured in the S&P CNX NIFTY Index as at 31st March 2006, 2007 and 2008.

5.4.8 EXEMPLARY CG PRACTICES

Voluntary CG practices that go beyond mandatory and non-mandatory provisions of Clause 49 of the Listing Agreement.

5.4.9 BARRIERS TO CG

Practices that hinder CG compliance.

5.4.10 CG REFORMS

Effecting gradual improvements in the existing CG regulations in the interests of stakeholders and the country at large.

5.5 Sample

The following is a list of sample companies for the study.

EXHIBIT 5.1

SAMPLE COMPANIES THAT FEATURED IN S&P CNX NIFTY INDEX AT 31ST MARCH

Sr. No.	As at 31.3.2006	As at 31.3.2007	As at 31.3.2008
1.	ABB Limited, India	ABB Limited, India	ABB Limited, India
2.	Associated Cement Companies Limited	ACC Limited	ACC Limited
3.	Guj Ambuja Cements	Guj Ambuja Cements*	Ambuja Cements Ltd.
4.	Bharti Tele V*	Bharti Airtel Limited	Bharti Airtel Limited
5.	Bharat Heavy Electricals Limited**	Bharat Heavy Electricals Limited**	Bharat Heavy Electricals Limited**
6.	Bharat Petroleum Corporation Limited**	Bharat Petroleum Corporation Limited**	Bharat Petroleum Corporation Limited**
7.	Cipla Limited	Cipla Limited	Cipla Limited
8.	Dr. Reddy's Laboratories Limited	Dr. Reddy's Laboratories Limited	Dr. Reddy's Laboratories Limited
9.	GAIL (India) Limited**	GAIL (India) Limited**	GAIL (India) Limited**
10.	Grasim Industries Limited	Grasim Industries Limited	Grasim Industries Limited
11.	HCL Technologies Ltd.	HCL Technologies Ltd.	HCL Technologies Limited
12.	Housing Development Finance Corporation Limited	Housing Development Finance Corporation Limited	Housing Development Finance Corporation Limited
13.	HDFC Bank Limited	HDFC Bank Limited	HDFC Bank Limited
14.	Hero Honda Motors Limited	Hero Honda Motors Limited	Hero Honda Motors Limited
15.	Hindalco Industries Limited	Hindalco Industries Limited	Hindalco Industries Limited
16.	Hindustan Lever Limited*	Hindustan Unilever Limited	Hindustan Unilever Limited
17.	ICICI Bank Limited	ICICI Bank Limited	ICICI Bank Limited
18.	Infosys Technologies Limited	Infosys Technologies Limited	Infosys Technologies Limited
19.	ITC Limited	ITC Limited	ITC Limited
20.	Larsen & Toubro Limited	Larsen & Toubro Limited	Larsen & Toubro Limited
21.	Mahindra & Mahindra Limited	Mahindra & Mahindra Limited	Mahindra & Mahindra Limited
22.	Maruti Udyog Limited	Maruti Udyog Limited*	Maruti Suzuki India Limited
23.	Oil and Natural Gas Corporation Limited**	Oil and Natural Gas Corporation Limited**	Oil and Natural Gas Corporation Limited**
24.	Ranbaxy Laboratories Limited	Ranbaxy Laboratories Limited	Ranbaxy Laboratories Limited
25.	Reliance Energy Limited	Reliance Energy Limited*	Reliance Infrastructure Limited
26.	Reliance Industries Limited	Reliance Industries Limited	Reliance Industries Limited
27.	Steel Authority of India Limited**	Steel Authority of India Limited**	Steel Authority of India Limited**
28.	Sun Pharmaceutical Industries Ltd.	Sun Pharmaceutical Industries Ltd.	Sun Pharmaceutical Industries Ltd.
29.	Tata Motors Limited	Tata Motors Limited	Tata Motors Limited
30.	The Tata Power Company Limited	The Tata Power Company Limited	The Tata Power Company Limited
31.	Tata Steel Limited	Tata Steel Limited	Tata Steel Limited
32.	Tata Consultancy Services Limited	Tata Consultancy Services Limited	Tata Consultancy Services Limited
33.	Wipro Limited	Wipro Limited	Wipro Limited
34.	Zee Telefilms Limited*	Zee Entertainment Enterprises Limited	Zee Entertainment Enterprises Limited

* Indicates those companies that have changed their names in the year, so a new name features in the following year's Nifty Index.
** Government companies.
Sources: (i) *The Economic Times*, Ahmedabad, 31st March 2006, 2007 and 1st April 2008.
(ii) www.nseindia.com
(iii) Annual Reports of sample companies.

EXHIBIT 5.2

SECTOR-WISE CLASSIFICATION OF SAMPLE COMPANIES

Sr. No.	Company	Sector
1.	ABB Limited, India	Capital Goods
2.	ACC Limited	Housing Related
3.	Ambuja Cements Ltd.	Housing Related
4.	Bharti Airtel Limited	Telecom
5.	Bharat Heavy Electricals Limited	Capital Goods
6.	Bharat Petroleum Corporation Limited	Oil and Gas
7.	Cipla Limited	Healthcare
8.	Dr. Reddy's Laboratories Limited	Healthcare
9.	GAIL (India) Limited	Oil and Gas
10.	Grasim Industries Limited	Diversified
11.	HCL Technologies Limited	Information Technology
12.	Housing Development Finance Corporation Limited	Finance
13.	HDFC Bank Limited	Finance
14.	Hero Honda Motors Limited	Transport Equipments
15.	Hindalco Industries Limited	Metal and Mining
16.	Hindustan Unilever Limited	Fast Moving Consumer Goods (FMCG)
17.	ICICI Bank Limited	Finance
18.	Infosys Technologies Limited	Information Technology
19.	ITC Limited	FMCG
20.	Larsen & Toubro Limited	Capital Goods
21.	Mahindra & Mahindra Limited	Transport Equipments
22.	Maruti Suzuki India Limited	Transport Equipments
23.	Oil and Natural Gas Corporation Limited	Oil and Gas
24.	Ranbaxy Laboratories Limited	Healthcare
25.	Reliance Infrastructure Limited	Power
26.	Reliance Industries Limited	Oil and Gas
27.	Steel Authority of India Limited	Metal and Mining
28.	Sun Pharmaceutical Industries Ltd.	Healthcare
29.	Tata Motors Limited	Transport Equipments
30.	The Tata Power Company Limited	Power
31.	Tata Steel Limited	Metal and Mining
32.	Tata Consultancy Services Limited	Information Technology
33.	Wipro Limited	Information Technology
34.	Zee Entertainment Enterprises Limited	Entertainment

Sources: (i) Das, Subhash Chandra, *Corporate Governance in India: An Evaluation*, Prentice-Hall of India Private Limited, New Delhi, 2008, pp. 139-140.
(ii) www.bseindia.com, website accessed on 12th May, 2008.

TABLE 5.1

SECTOR-WISE WEIGHTINGS OF COMPANIES IN THE SAMPLE

Sector	No. of Companies	Weightings (%)
Capital Goods	3	8.82
Housing Related	2	5.88
Telecom	1	2.94
Oil and Gas	4	11.77*
Healthcare	4	11.77
Diversified	1	2.94
Information Technology	4	11.77
Finance	3	8.82
Transport Equipments	4	11.77
Metal and Mining	3	8.82
FMCG	2	5.88
Power	2	5.88
Entertainment	1	2.94
Total	34	100.00

*Fractions are adjusted in order to obtain total as 100%.
Source: Gleaned from Annual Reports.

TABLE 5.2

CLASSIFICATION OF GOVERNMENT AND PRIVATE SECTOR COMPANIES

BY OWNERSHIP

Ownership	Government Owned Companies	Private Sector Owned Companies	Total
No. of Companies	5	29	34
% Ownership	14.71	85.29	100

Source: Gleaned from Annual Reports.

EXHIBIT 5.3

EXPLANATION OF OTHER VARIABLES PERTAINING TO CG

Sr. No.	Variable	Description
1.	Majority	More than 50%
2.	Appropriate Size of Board	Six to nine directors on the Board of any company at the end of a particular year
3.	Government Company	More than 50% equity shares held by Government of India
4.	Non-Executive Independent Director	Definition as per Clause 49 of the Listing Agreement (Annexure 1)
5.	CG Norms/CG Matters	Provisions of Clause 49 related to CG
6.	Formal Training to Directors	Participation in Seminars, Workshops and Programmes in CG
7.	CG Approach	Focus of companies on CG Matters
8.	Companies	Sample Companies
9.	Primacy of Equity Shareholders	Considering overriding preference for pursuing interests of equity shareholders over other stakeholders in CG Matters
10.	Executive Directors	Whole Time Directors, Promoter Executive Directors
11.	Non-Executive Directors	Non-Executive Non-Independent Directors
12.	Independent Directors	Non-Executive Independent Directors, Lead Independent Director, Nominee Directors (except in Government companies), and Representative Directors

5.6 Findings

As the study covers three years i.e., 2005-06, 2006-07 and 2007-08, findings are presented accordingly. With a few exceptions, the data represent the status as at the end of March, for the years mentioned.

TABLE 5.3
COMPLIANCE WITH MANDATORY PROVISIONS OF CG AS PER CLAUSE 49

Provisions	**Clause of Listing Agreement**	**Number of Companies**					
		2005-06		**2006-07**		**2007-08**	
I. Board of Directors	**49(I)**	**Full Compliance**	**Non-Compliance[a]**	**Full Compliance**	**Non-Compliance[a]**	**Full Compliance**	**Non-Compliance[a]**
(A) Composition of Board	49 (IA)	29	5	30	4	29	5
(B) Non-Executive Directors' Compensation and Disclosures	49 (IB)	34	0	34	0	34	0
(C) Other Provisions as to Board and Committees	49 (IC)	34	0	34	0	33	1
(D) Code of Conduct	49 (ID)	33	1	34	0	34	0
Mean of Number of Companies not complying and corresponding percentage		32.5 (95.59%), i.e., 33	1.5 (4.41%), i.e., 2	33 and 97.06%	1 and 2.94%	32.5 (95.59%), i.e., 33	1.5 (4.41%), i.e., 2
II. Audit Committee	**49 (II)**						
(A) Qualified and Independent Audit Committee	49 (IIA)	33	1	34	0	34	0
(B) Meeting of Audit Committee	49 (IIB)	31	3	34	0	33	1
(C) Powers of Audit Committee	49 (IIC)	34	0	34	0	34	0
(D) Role of Audit Committee	49 (IID)	34	0	34	0	34	0
(E) Review of Information by Audit Committee	49 (IIE)	34	0	34	0	34	0
Mean of Number of Companies not complying and corresponding percentage		33.2 (97.65%), i.e., 33	0.8 (2.35%), i.e., 1	34 and 100%	0 and 0%	33.8 (99.41%), i.e., 34	0.2 (0.59%), i.e., 0
III. Subsidiary Companies	**49 (III)***	1	33[b]	1	33[c]	2	32[d]
IV. Disclosures	**49 (IV)**						
(A) Basis of Related Party Transactions	49 (IVA)	34	0	34	0	34	0
(B) Disclosures of Accounting Treatment	49 (IVB)	34	0	34	0	34	0
(C) Board Disclosures (Including Risk Management)	49 (IVC)	32	2	32	2	33	1
(D) Proceeds from Public Issues, Rights Issues, Preferential Issues	49 (IVD)*	5	29[e]	5	29[e]	5	29[e]
(E) Remuneration of Directors	49 (IVE)	34	0	34	0	34	0
(F) Management Discussion	49 (IVF)	34	0	34	0	34	0
(G) Information to Shareholders	49 (IVG)	34	0	34	0	34	0
Mean of Number of Companies not complying and corresponding percentage*		33.666 (99.03%), i.e., 34	0.33 (0.97%), i.e., 0	33.666 (99.03%), i.e., 34	0.33 (0.97%), i.e., 0	33.833 (99.50%), i.e., 34	0.17 (0.50%), i.e., 0
V. Chief Executive Officer (CEO)/Chief Financial Officer (CFO) Certification	**49 (V)**	23 (67.65%)	11 (32.35%)	27 (79.41%)	7 (20.59%)	29 (85.29%)	5 (14.71%)
VI. Report on Corporate Governance	**49 (VI)**	34 (100%)	0 (0%)	34(100%)	0 (0%)	34 (100%)	0 (0%)
VII. Compliance (As Certified)	**49 (VII)**	34 (100%)	0 (0%)	34 (100%)	0 (0%)	34 (100%)	0 (0%)

[a] Non-Compliance includes less than full compliance. [b] Includes not applicable 14, no information 18 and partial compliance by 1 company. [c] Includes not applicable 15 and no information by 18 companies. [d] Includes not applicable 14, no information 17 and partial compliance by 1 company. [e] Includes not applicable 28 and no information by 1 company. * Clause 49 (III) and 49 (IVD) are excluded from computation of the mean percentages for testing as these clauses are not applicable or no information has been provided by many companies in this regard.

Source: Gleaned from Annual Reports.

TABLE 5.4

COMPLIANCE WITH NON-MANDATORY PROVISIONS OF CG

AS PER CLAUSE 49

Provisions	Clause 49 of Listing Agreement	Number of Companies					
		2005-06		2006-07		2007-08	
		Full Compliance	Non-Compliance*	Full Compliance	Non-Compliance*	Full Compliance	Non-Compliance*
1. The Board	Annexure I D	2 (5.88%)	32	1 (2.94%)	33	1 (2.94%)	33
2. Remuneration Committee	Annexure I D	21 (61.76%)	13	21 (61.76%)	13	21 (61.76%)	13
3. Shareholder Rights	Annexure I D	9 (26.47%)	25	8 (23.53%)	26	9 (26.47%)	25
4. Audit Qualifications	Annexure I D	14 (41.18%)	20	15 (44.12%)	19	16 (47.06%)	18
5. Training of Board Members	Annexure I D	7 (20.59%)	27	6 (17.65%)	28	6 (17.65%)	28
6. Evaluation of Non-Executive Directors	Annexure I D	8 (23.53%)	26	8 (23.53%)	26	7 (20.59%)	27
7. Whistle-Blower Policy	Annexure I D	23 (67.65%)	11	24 (70.59%)	10	23 (67.65%)	11

*Non-Compliance includes less than full compliance.
Source: Gleaned from Annual Reports.

TABLE 5.5

COMPLIANCE WITH EXEMPLARY CG PRACTICES

No.	Exemplary Practices	Number of Companies					
		2005-06		2006-07		2007-08	
		Compliance	Non-Compliance	Compliance	Non-Compliance	Compliance	Non-Compliance
1.	CG Ratings	3	31	3	31	4	30
2.	Shareholders Satisfaction Survey	1	33	2	32	2	32
3.	Compliance Committee	0	34	0	34	2	32
4.	Ethics and Compliance Committee	4	30	4	30	4	30
5.	Nomination Committee	6	28	10	24	9	25
6.	Value Added Statement/Market Value Added	4	30	2	32	3	31
7.	Health, Safety and Environment	7	27	7	27	8	26
8.	Secretarial Standards on CG by Institute of Company Secretaries of India	1	33	1	33	3	31
9.	Fraud Monitoring Committee	2	32	2	32	2	32
10.	Compliance with Recommendations of CG by Committee(s) (e.g. Kumar Mangalam Birla, Naresh Chandra and Narayan Murthy Committee)	2	32	2	32	2	32
11.	United Nations Global Compact Programme	2	32	2	32	3	31
12	Value Reporting	1	33	1	33	1	33
13.	Economic Value Added Analysis	5	29	4	30	4	30
14.	Euro Shareholders CG Guidelines, 2000	1	33	1	33	1	33
15.	30 Organisation for Economic Cooperation and Development's Principles of CG	1	33	1	33	1	33
16.	Findings and Recommendations of The Conference Board Commission on Public Trust and Private Enterprises in the United States, 2002 and 2003	1	33	1	33	1	33
17.	Early Compliance of International Financial Reporting System	1	33	1	33	1	33
18.	Sustainability/Environment and Sustainability Reporting	5	29	6	28	7	27
19.	Risk Monitoring Committee	1	33	1	33	1	33
20.	Environment Report /Policy/Environment Management	5	29	5	29	5	29
21.	Frequently Asked Questions in Annual Report	2	32	2	32	2	32
22.	Secretarial Compliance Certificate by Company Secretary	5	29	5	29	5	29
23.	CG Guidelines for Public Sector Enterprises, 2007	0	34	0	34	1	33
24.	CG Monitoring and Review Process/Compliance	0	34	2	32	1	33
	Mean of Number of Companies complying and corresponding percentage	2.5 (7.35%), i.e., 3	----------	2.71 (7.97%), i.e., 3	----------	3.04 (8.94%), i.e., 3	----------

Source: Gleaned from Annual Reports.

TABLE 5.6

BARRIERS TO CG

Barriers	Number of Companies					
	2005-06		2006-07		2007-08	
	Yes	No	Yes	No	Yes	No
1. Appropriate Size of Board (Six to Nine Directors)	8 (23.53%)*	26	10 (29.41%)*	24	6 (17.65%)*	28
2. Formal Training to Board Members on CG Matters	7 (20.59%)	27	6 (17.65%)	28	6 (17.65%)	28
3. Non-Executive Directors Evaluation	8 (23.53%)	26	8 (23.53%)	26	7 (20.59%)	27
4. Whistle-Blower Policy	23 (67.65%)	11	24 (70.59%)	10	23 (67.65%)	11
5. CG Approach emphasizes the Primacy of Equity Shareholders	7 (20.59%)	27	7 (20.59%)	27	8 (23.53%)	26
6. Representation of Non-Executive Independent Directors in 5 Government Companies	0	5	1	4	0	5

*Approximate percentages.
Source: Gleaned from Annual Reports.

5.7 Presentation of Data on Compliance

Year-wise data are pooled and summarized as frequency distributions and the related percentages are computed. Moreover, graphic presentations are also used to depict trends in CG practices. Statistical testing is also used to examine hypotheses.

5.8 Trends in Compliance with Mandatory Provisions of CG i.e. Clause 49:

Trends in compliance with mandatory provisions of CG as reported in Table 5.3 are shown in the following graphs.

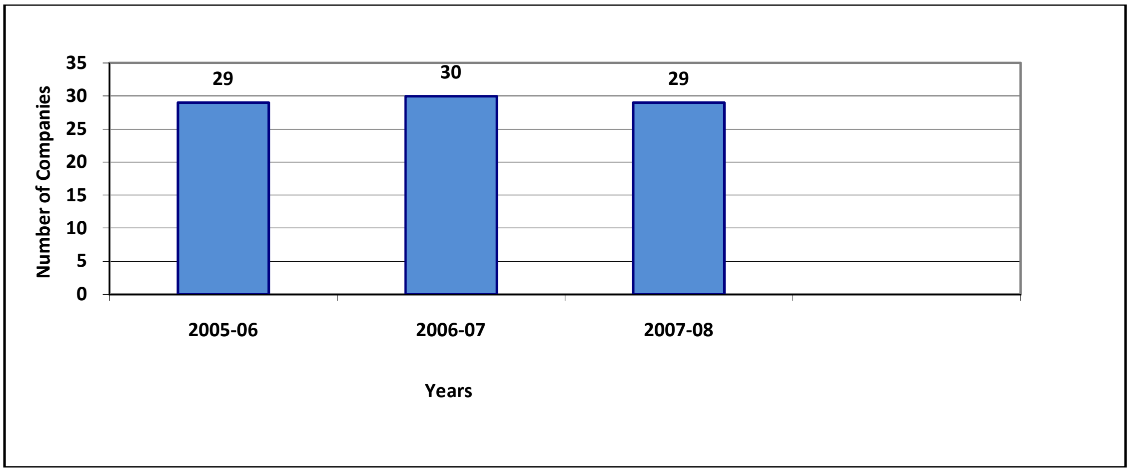

FIGURE 5.1

Number of companies that complied with the provision regarding the Composition of the Board of Directors

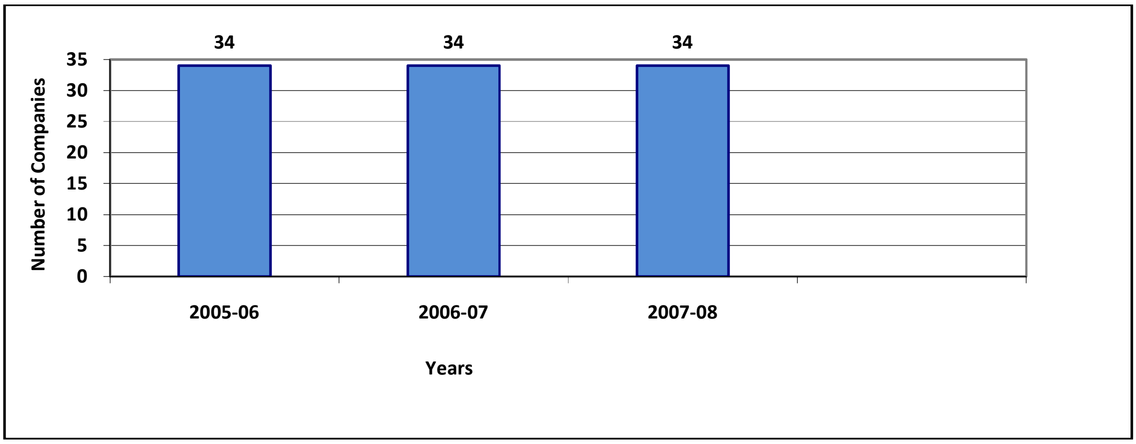

FIGURE 5.2

Number of companies that complied with the provision regarding the Non-Executive Directors' Compensation and Disclosures

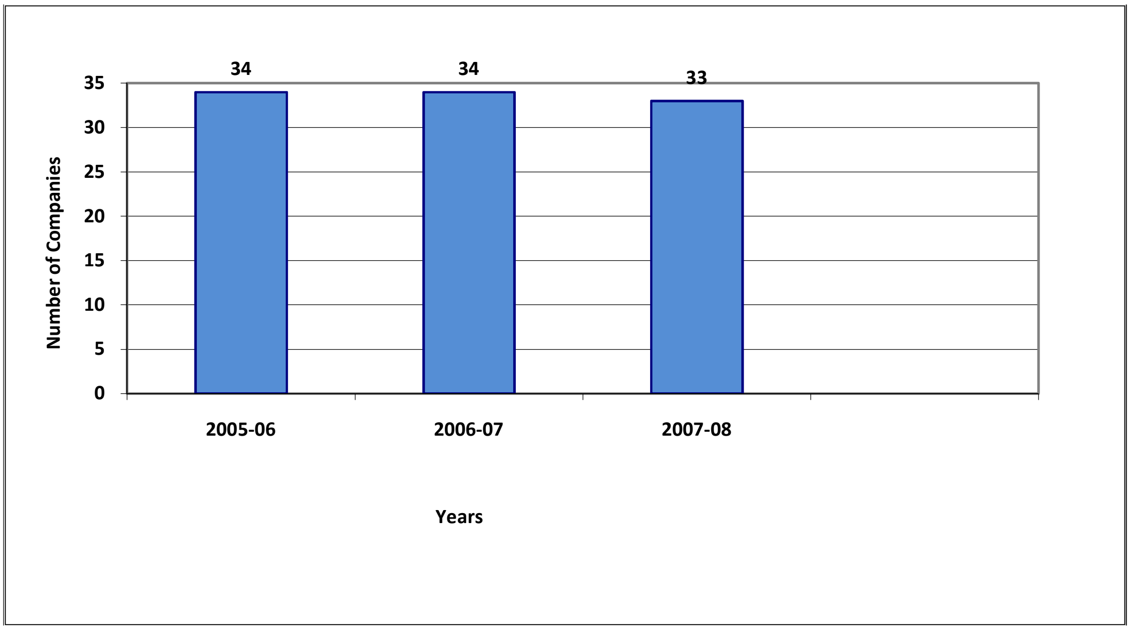

FIGURE 5.3

Number of companies that complied with the other provisions as to Board Meetings and Board Committee Membership

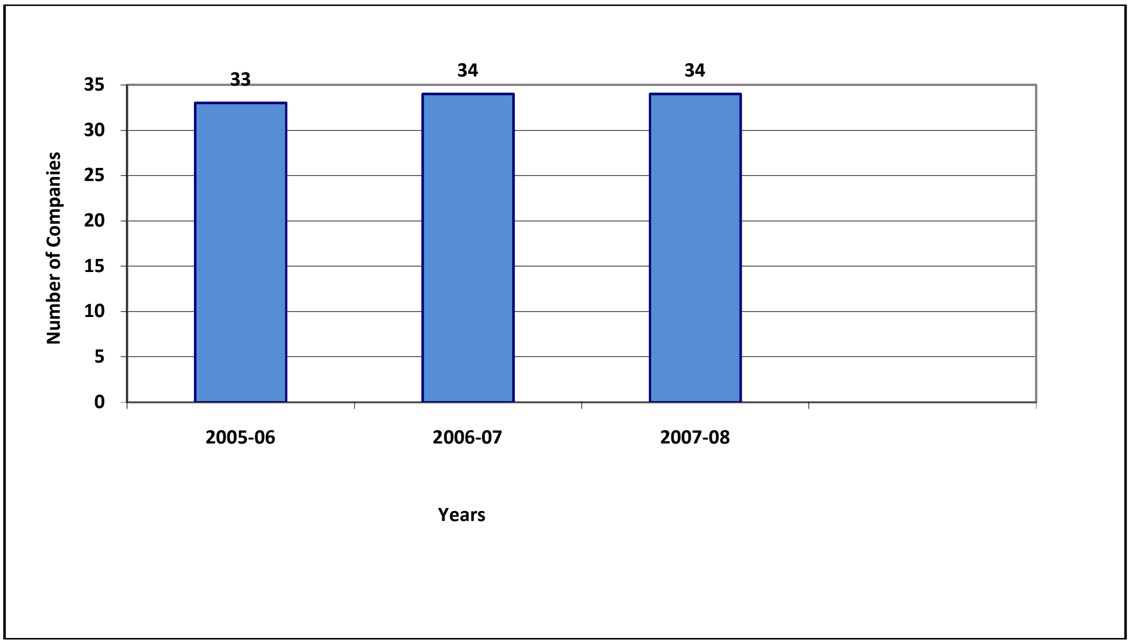

FIGURE 5.4

Number of companies that complied with the provision of Code of Conduct

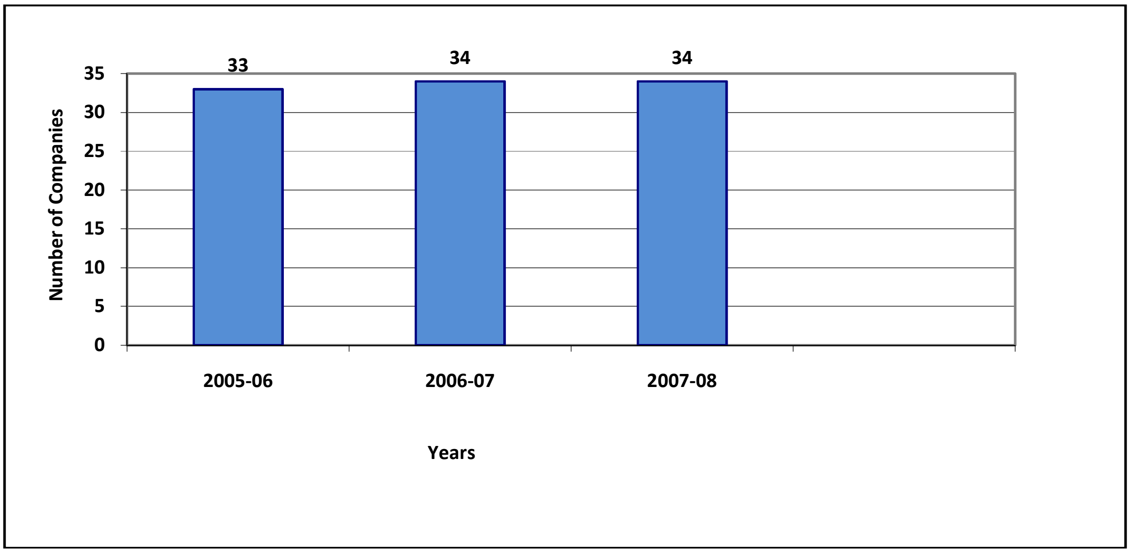

FIGURE 5.5

Number of companies that complied with the provision regarding Qualified and Independent Audit Committee

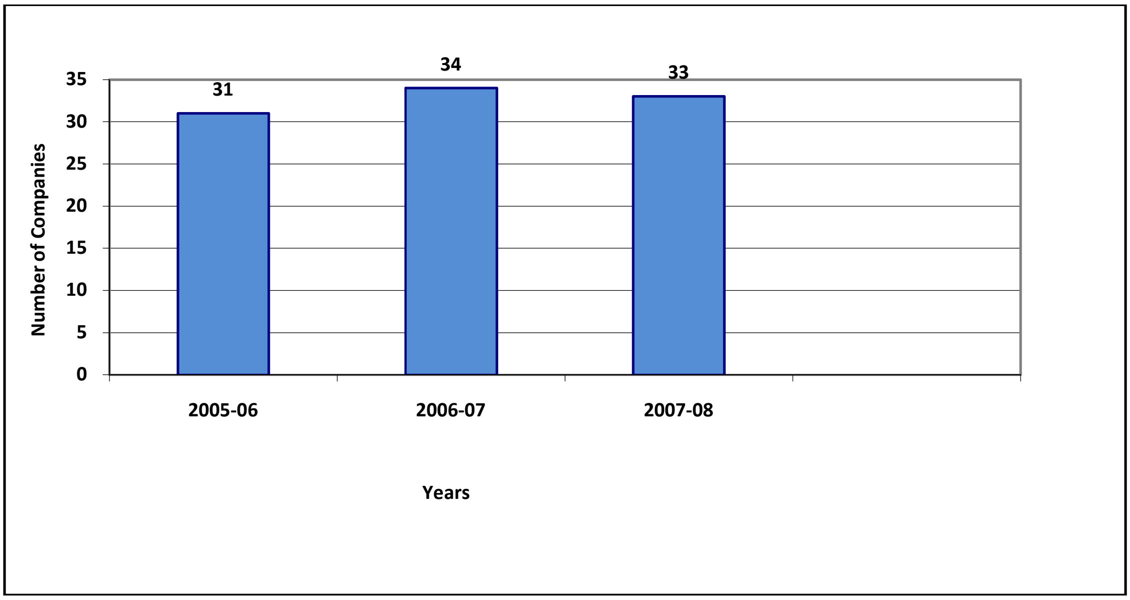

FIGURE 5.6

Number of companies that complied with the provision regarding Meetings of Audit Committee

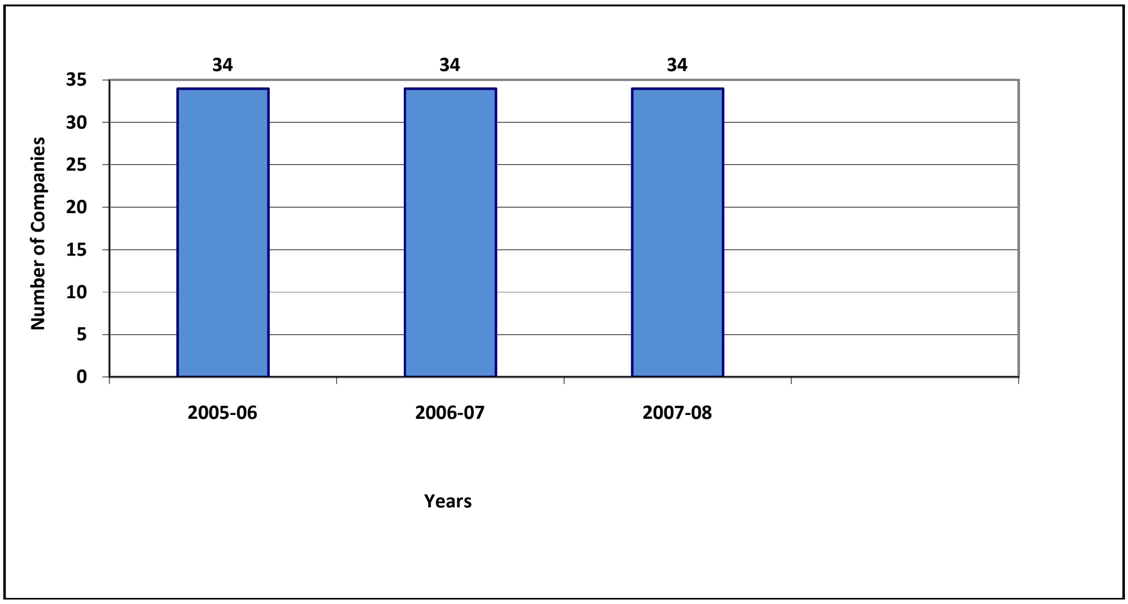

FIGURE 5.7

Number of companies that complied with the provision regarding Powers of Audit Committee

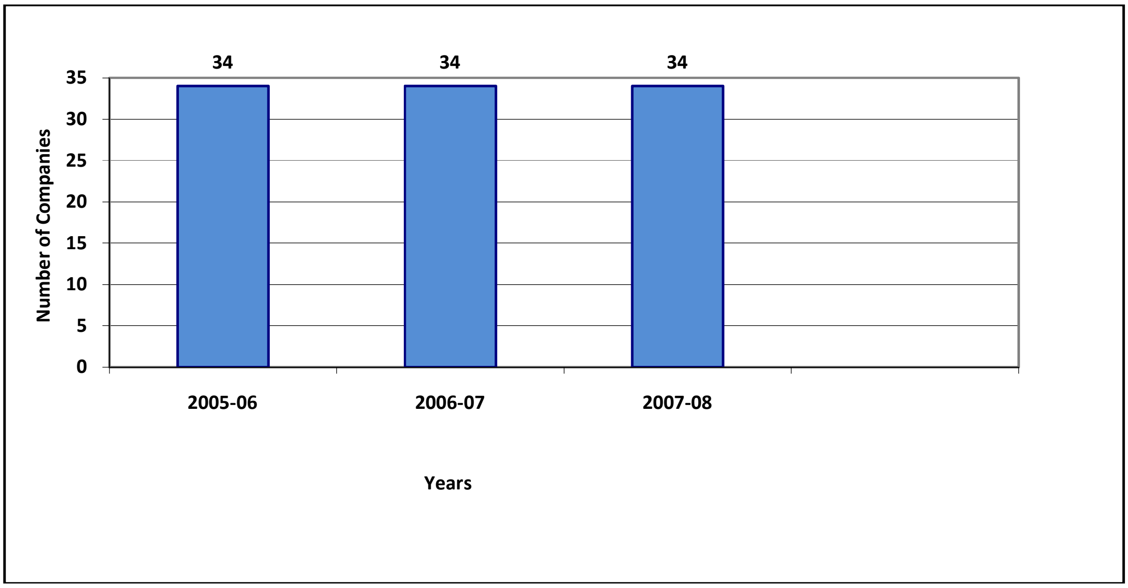

FIGURE 5.8

Number of companies that complied with the provision regarding Role of Audit Committee

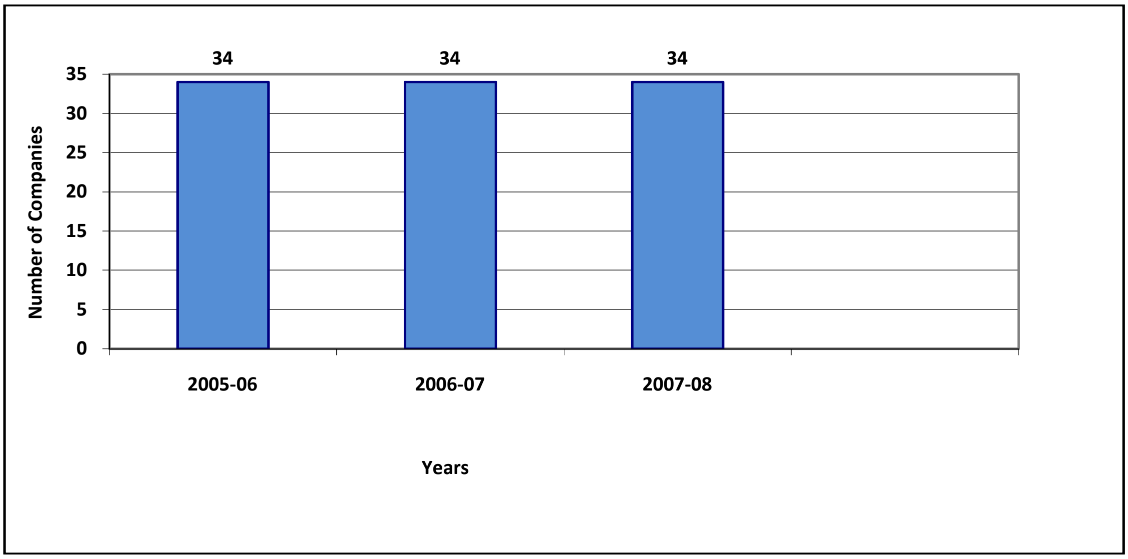

FIGURE 5.9

Number of companies that complied with the provision regarding Review of Information by Audit Committee

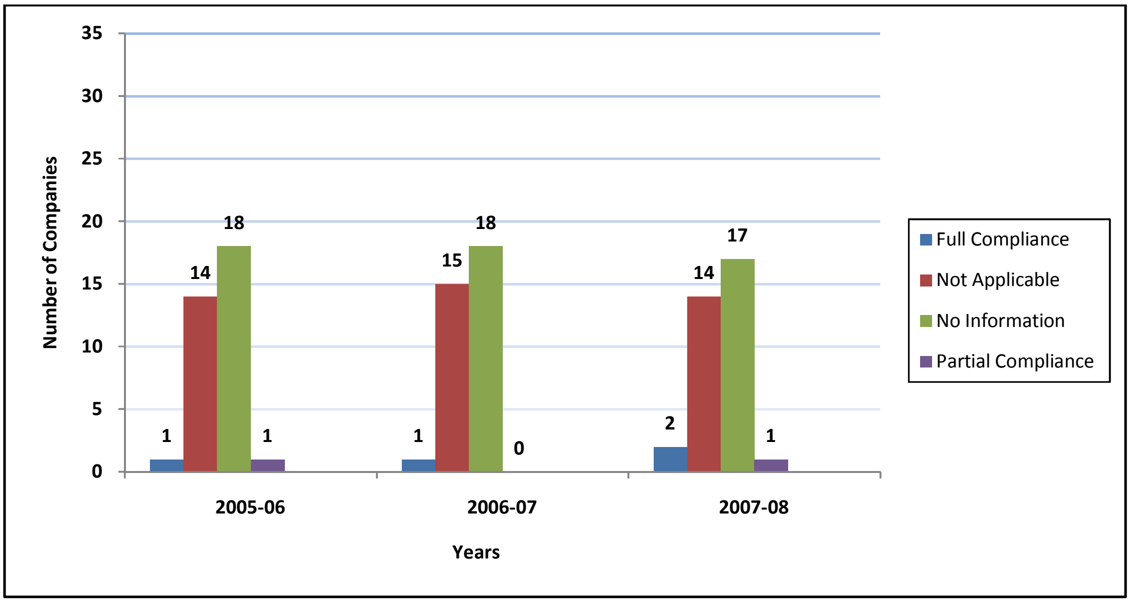

FIGURE 5.10

Number of companies that complied with the stipulation regarding Subsidiary Companies

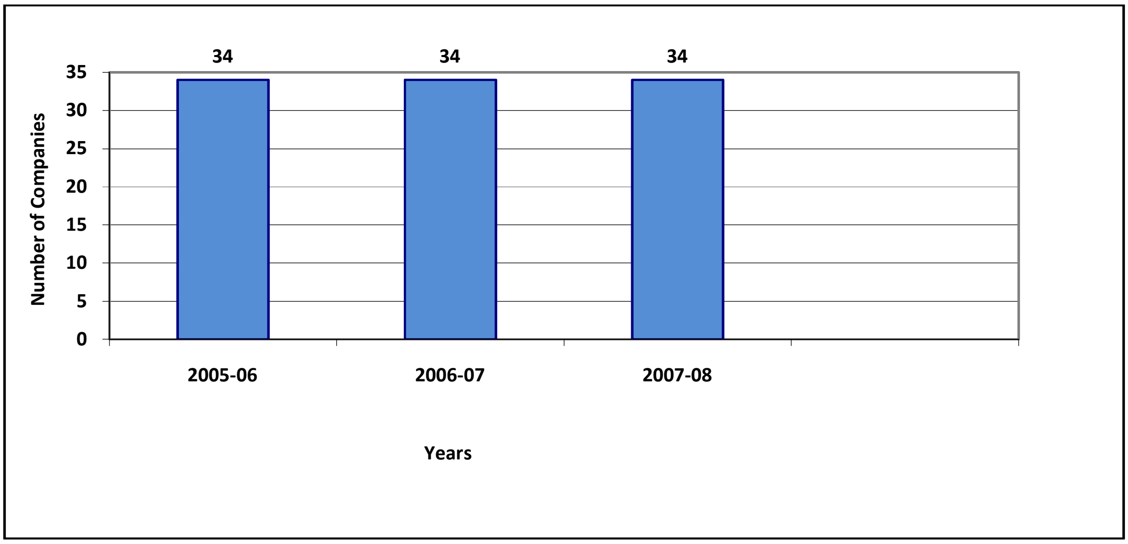

FIGURE 5.11

Number of companies that complied with the provision regarding disclosures of basis of Related Party Transactions

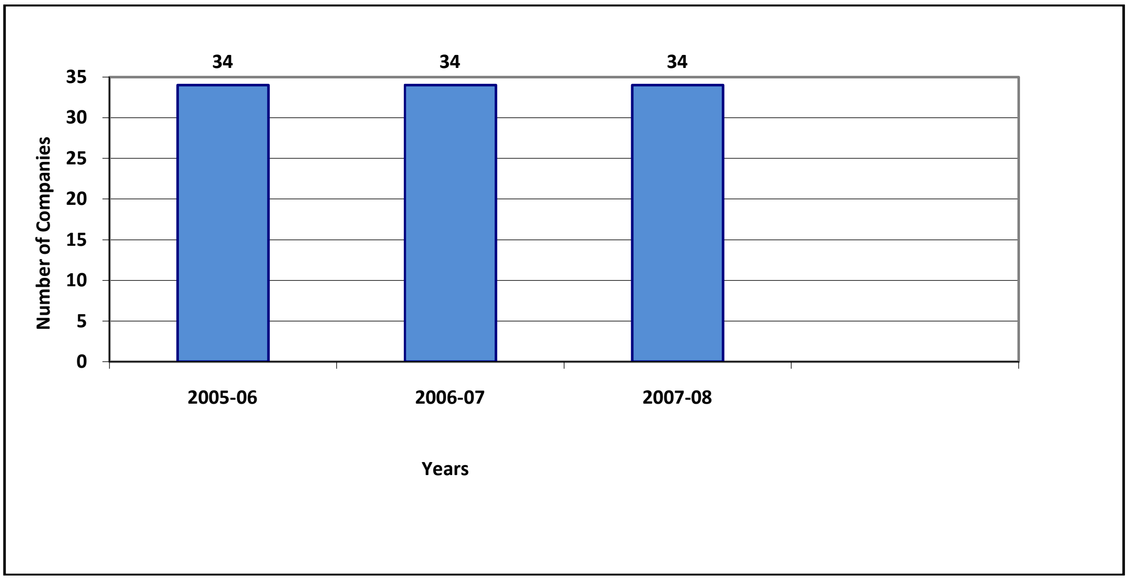

FIGURE 5.12

Number of companies that complied with the provision regarding disclosures of Accounting Treatment

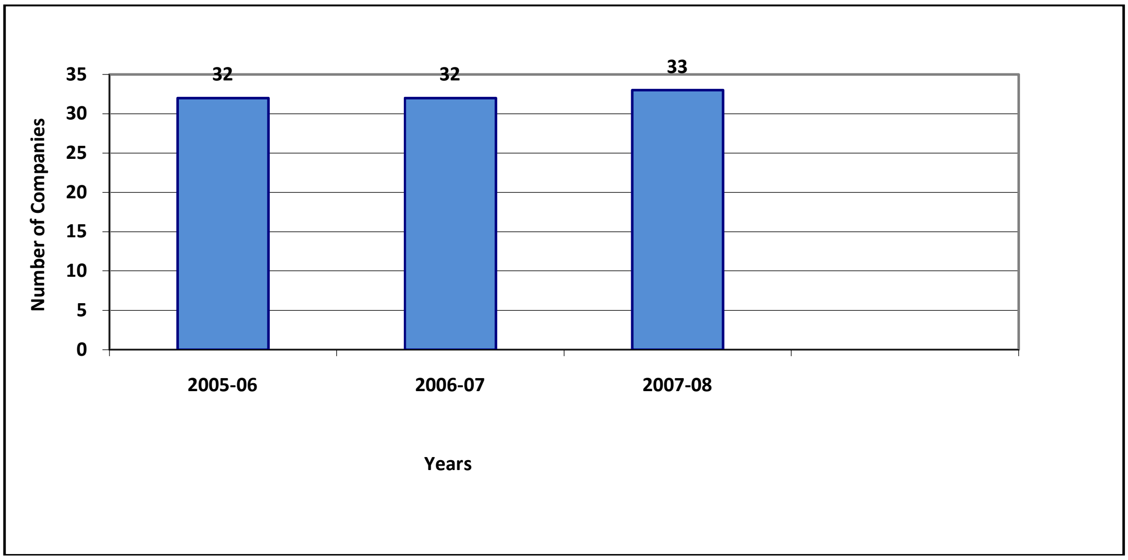

FIGURE 5.13

Number of companies that complied with the provision regarding Board Disclosures including risk management

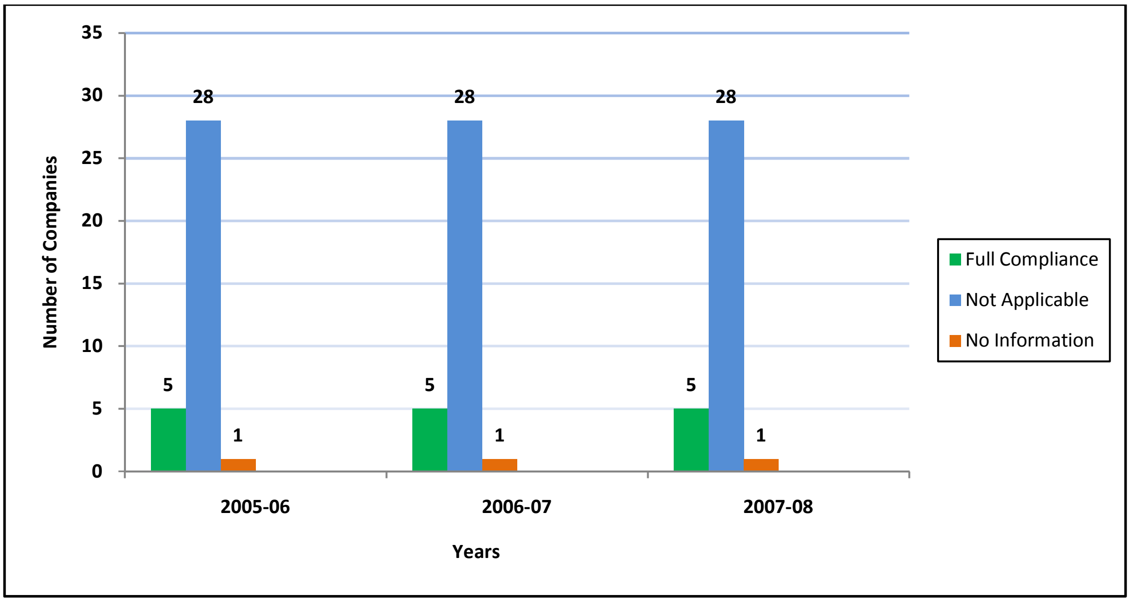

FIGURE 5.14

Number of companies that complied with the provision regarding disclosures of Proceeds from Public Issues, Rights Issues and Preferential Issues

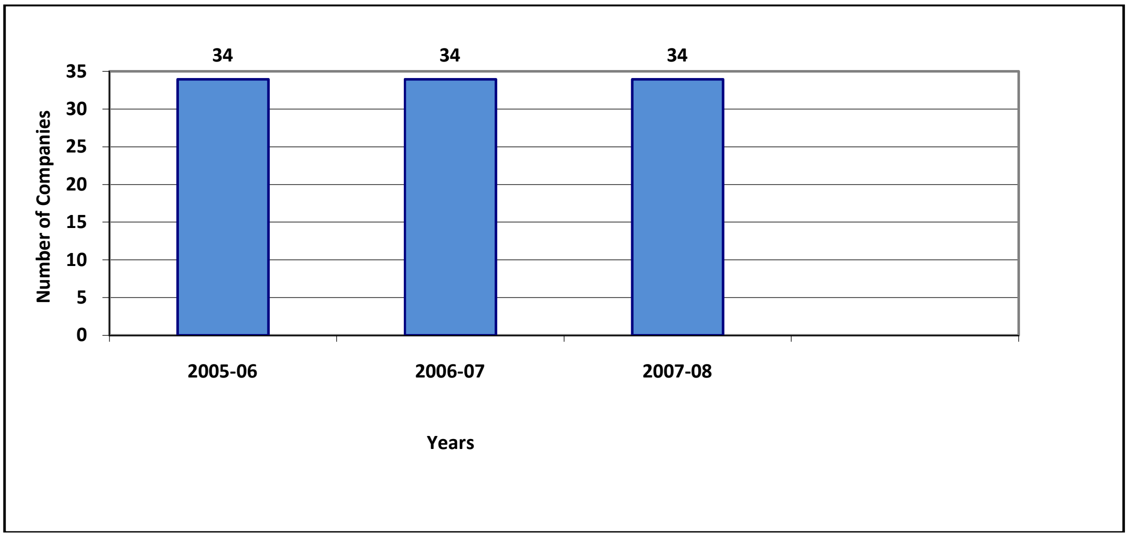

FIGURE 5.15

Number of companies that complied with the provision regarding disclosures of remuneration of Directors

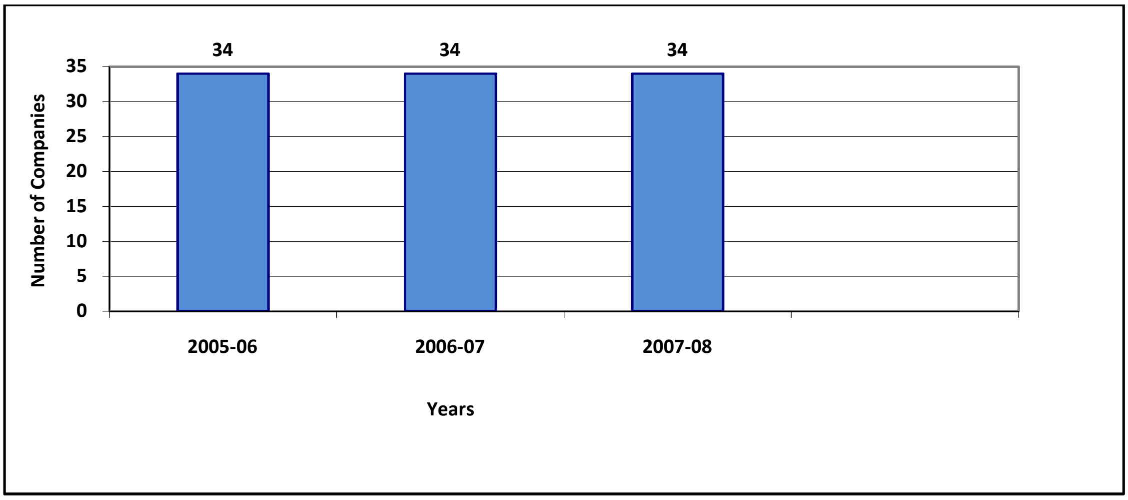

FIGURE 5.16

Number of companies that complied with the provision regarding disclosures of Management Discussion and Analysis and all material transactions

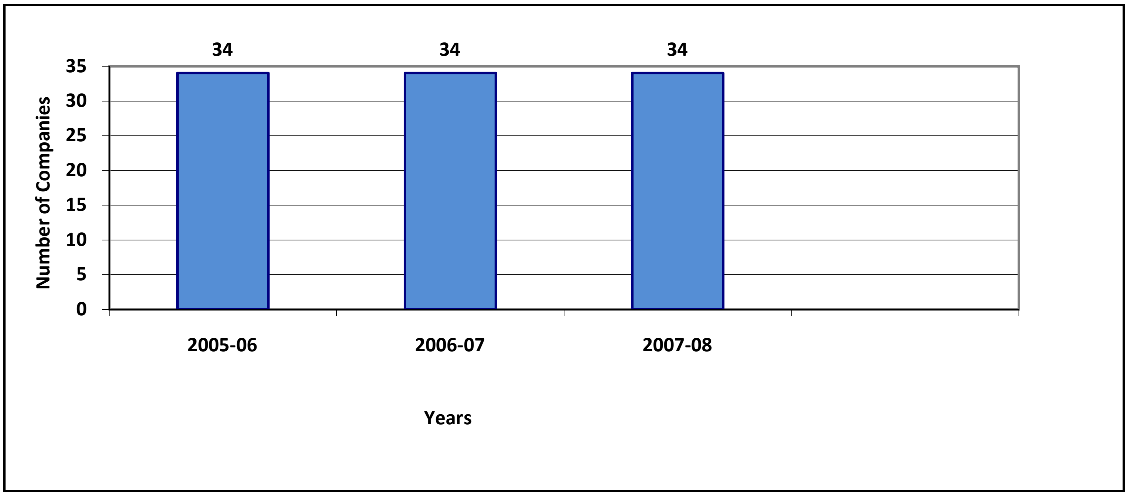

FIGURE 5.17

Number of companies that complied with the provision regarding disclosures of information to the shareholders on appointment or re-appointment of a Director

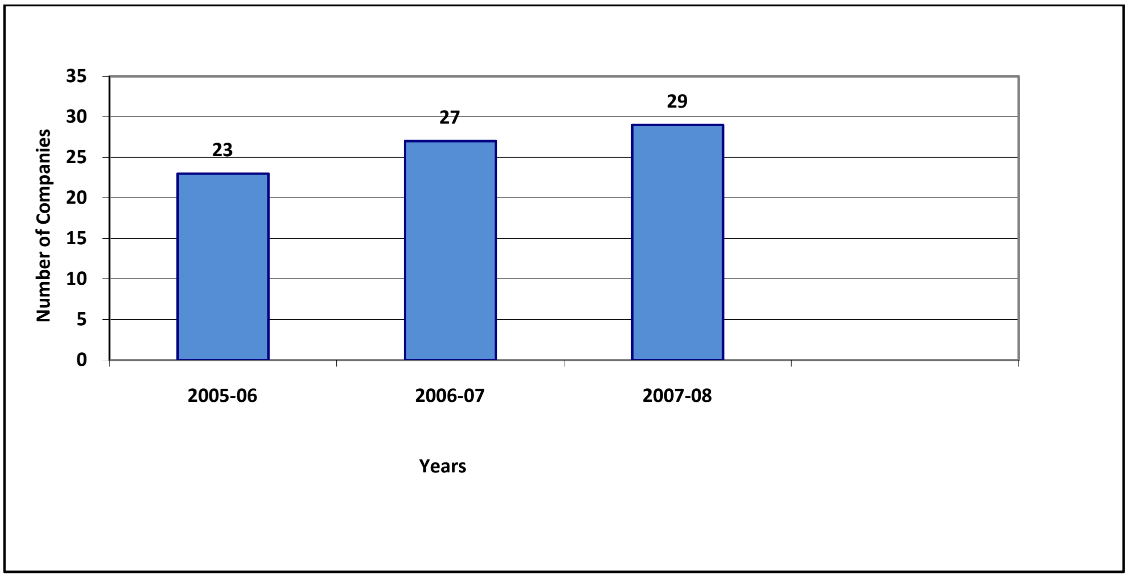

FIGURE 5.18

Number of companies that complied with the provision regarding CEO/CFO Certification of Financial Statements to the Board

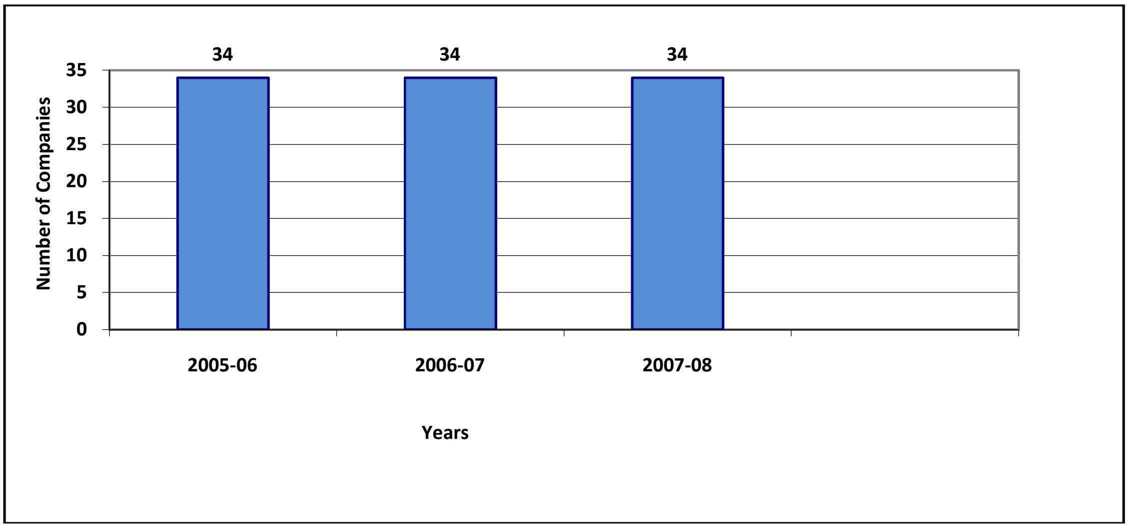

FIGURE 5.19

Number of companies that complied with the provision regarding Report on CG

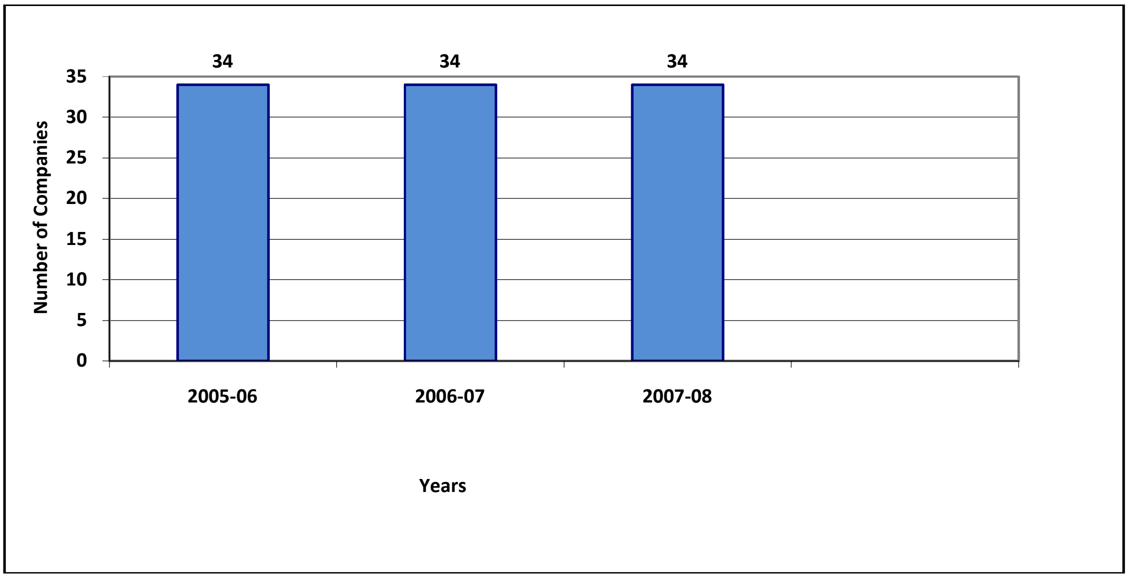

FIGURE 5.20

Number of companies that reported compliance with CG (as certified) in the CG Report

5.8.1 TRENDS IN COMPLIANCE WITH VARIOUS MANDATORY PROVISIONS OF CG BY COMPANIES – A COMPOSITE VIEW

It can be noticed from Figure 5.21 that there is a steadily increasing trend in compliance with almost all mandatory CG provisions. However, in the year 2007-08, compliance with Board of Directors and Audit Committee has reduced marginally i.e., by 1%. This is on account of inadequate representation of independent directors on the Boards of companies, lack of Accounting or Financial Management expertise in Audit Committee and inadequate number of Audit Committee meetings. There is apparently markedly lower compliance with CEO/CFO certification which suggests a deficiency, contrary to the reported full compliance certified in CG reports.

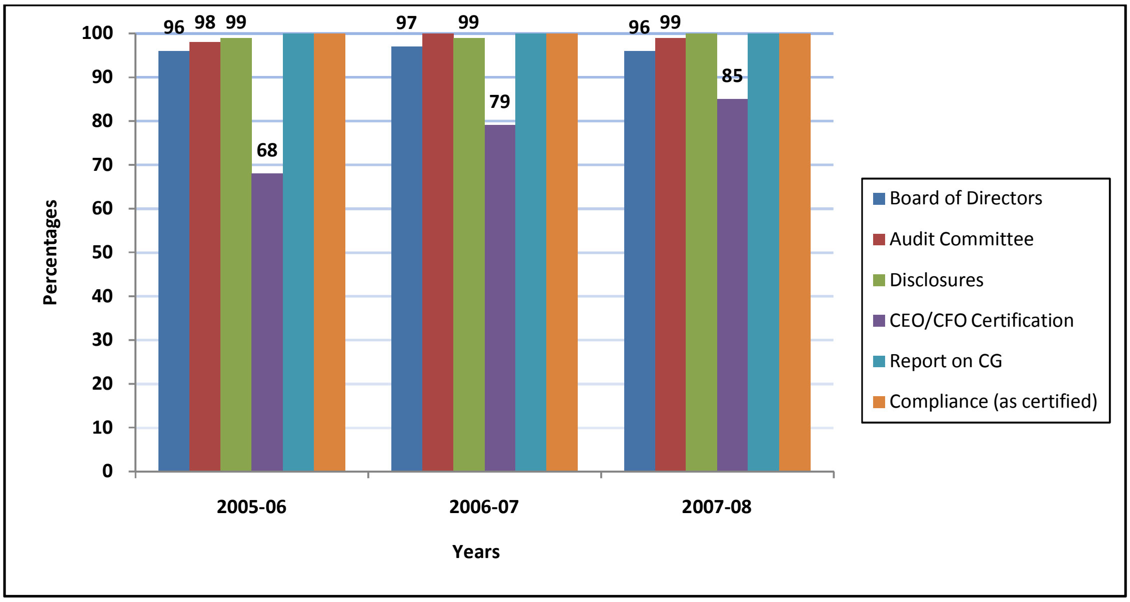

FIGURE 5.21

Mean Compliance Percentages (rounded off) of Mandatory Provisions of CG (except for CEO/CFO Certification, Report on CG and Compliance)

5.9 Trends in Compliance with Non-Mandatory Provisions of CG

Compliance with non-mandatory provisions of CG can prove beneficial for the smooth functioning of companies. For instance, whistle-blowing on unethical tendencies may discourage fraud within the company.

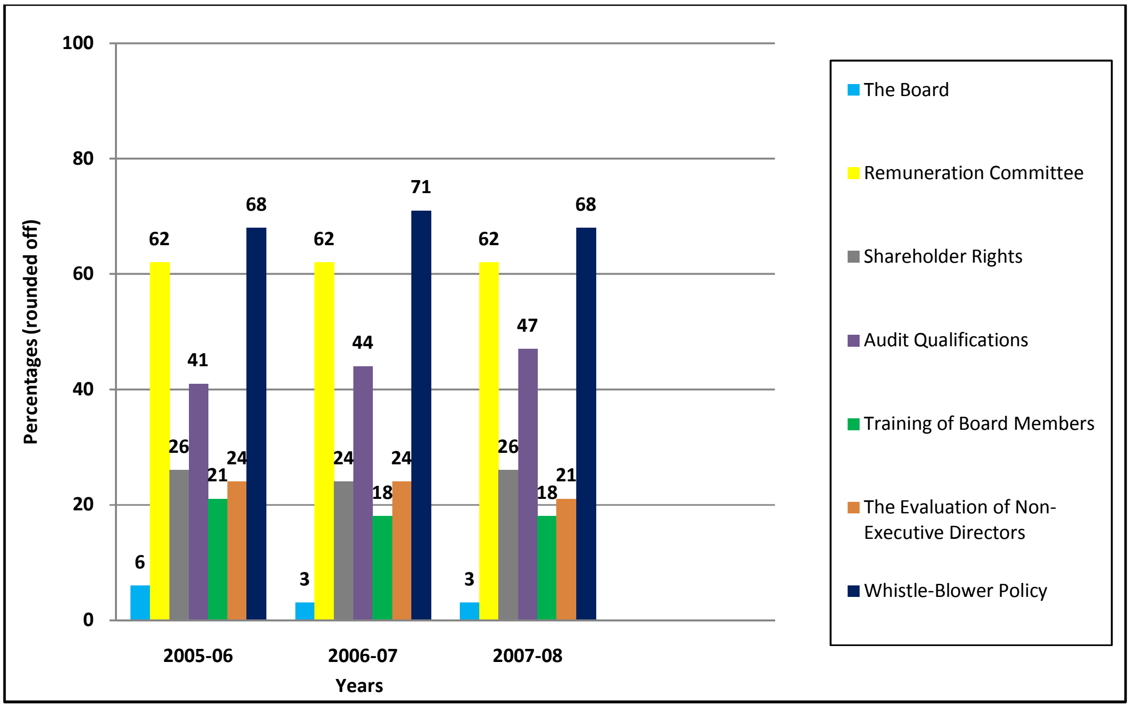

FIGURE 5.22

Trends in compliance with Non-Mandatory Provisions of CG

An inconsistent pattern emerges with regard to adherence to non-mandatory provisions of CG as presented in Figure 5.22. Instances of the oddity can be seen across the three years in the evaluation of Non-Executive Directors and the whistle-blower policy.

5.9.1 MAJORITY COMPLIANCE WITH NON-MANDATORY PROVISIONS OF CG

Only in two non-mandatory provisions of CG out of seven i.e., Remuneration Committee and whistle-blower policy, has a majority of companies shown compliance as presented in Figure 5.23.

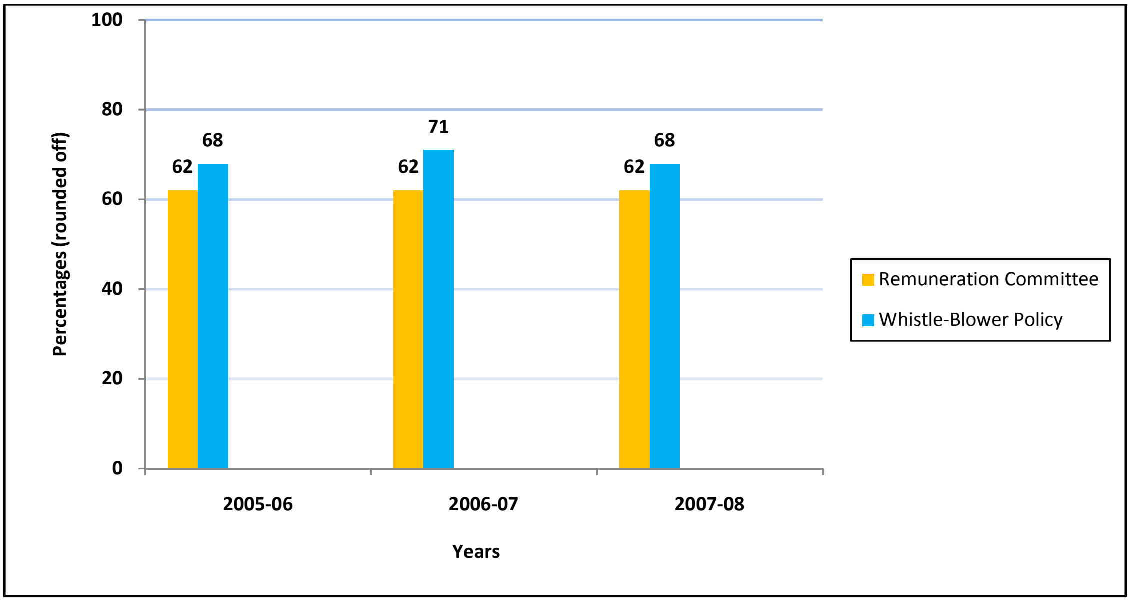

FIGURE 5.23

Compliance with Non-Mandatory Provisions of CG

5.10 Statistical Tests

Seeing the nature of data collected from sample companies, it was decided to adopt Single-Sample Tests involving proportions. For suitability of statistical tests and applications, data were classified into two categories. The first set included those that demonstrated full compliance while the other comprised those whose compliance was either partial or nil.

As a part of computation of the Test Statistic, Z scores were calculated using the following formula.[1]

$$Z = \frac{p_s - p_u}{\sqrt{p_u q_u / N}}$$

Where p_s = Percentage of actual number of companies demonstrating full compliance

p_u = Percentage of standard / null hypotheses, i.e., a majority as meaning greater than 50 per cent, hence 0.501.

q_u = 1- p_u

N = Sample size

Significance Level and Critical Region: The significance level of 0.2 and a one-tailed test are selected.

5.11 Hypotheses Testing

5.11.1 COMPLIANCE WITH MANDATORY PROVISIONS OF CLAUSE 49 OF THE LISTING AGREEMENT

Companies listed at stock exchanges are expected to comply with mandated CG provisions. Compliance warrants adherence to CG regulations. Such compliance aids business in many instances of which one such is risk mitigation and risk management. Moreover, properly designed mandatory CG reforms are likely to result in higher share prices (for e.g., large firms gain 4.5% on average compared to small firms) in an emerging market such as India.[2]

The following null hypotheses are considered for testing in pursuance of the objectives of the study for all the three consecutive years as discussed above.

H_1 : There exists no compliance with mandatory provisions of CG with respect to composition of Board of Directors in a majority of the companies.

Computation of Test Statistic of H_1 for 2005-2006:

$$Z = \frac{0.0441 - 0.501}{\sqrt{[(0.501)(0.499)]/34}} = -0.4569 \div 0.0857 = -5.33$$

The Z scores for the subsequent two years were computed in the same way (Annexure 2).

TABLE 5.7

Z SCORES FOR H_1

Provision	Years		
	2005-06	2006-07	2007-08
Composition of Board of Directors	-5.33	-5.50	-5.33

For the year 2005-06, 2006-07 and 2007-08 a normal distribution table will show that the chances of Z scores of -5.33 and -5.50 are almost nil if the assumptions were true and since this is less than the significance level of 2 per cent, the null hypothesis is rejected. On the basis of the evidence at hand it can be established that there exists compliance with mandatory provisions of CG with respect to the composition of Board of Directors in a majority of the companies.

H_2 : There exists no compliance with mandatory provisions of CG with respect to Audit Committee in a majority of the companies.

TABLE 5.8

Z SCORES FOR H_2

Provision	Years		
	2005-06	2006-07	2007-08
Audit Committee	-5.57	-5.85	-5.78

For the year 2005-06, 2006-07 and 2007-08 a normal distribution table will show that the probabilities of Z scores of -5.57, -5.85 and -5.78 are almost nil if the assumptions were true and since it is less than the significance level of 2 per cent considered, the null hypothesis is rejected.

H_3 : There exists no compliance with mandatory provisions of CG with respect to disclosures in a majority of the companies.

TABLE 5.9

Z SCORES FOR H_3

Provision	Years		
	2005-06	2006-07	2007-08
Disclosures	-5.73	-5.73	-5.79

For the year 2005-06, 2006-07 and 2007-08 a normal distribution table will show that the probabilities of Z scores of -5.73 and -5.79 are almost nil if the assumptions were true and as it is less than the significance level of 2 per cent, the null hypothesis is rejected.

H_4 : There exists no compliance with mandatory provisions of CG with respect to CEO/CFO Certification in a majority of the companies.

TABLE 5.10

Z SCORES FOR H_4

Provision	Years		
	2005-06	2006-07	2007-08
CEO/CFO Certification	-2.07	-3.44	-4.13

For the year 2005-06, a normal distribution table will show that a Z score of -2.07 would occur approximately 1.92 percentage of the time by chance if the assumptions were true and as it is less than the significance level of 2 per cent, we reject the null hypothesis.

For the years 2006-07 and 2007-08 a normal distribution table will show that the probabilities of Z scores of -3.44 and -4.13 are almost nil if the assumptions were true and as they are less than the significance level of 2 per cent, the null hypothesis is rejected.

H_5 : There exists no compliance with mandatory provisions of Report on CG in a majority of the companies.

TABLE 5.11

Z SCORES FOR H_5

Provision	Years		
	2005-06	2006-07	2007-08
Report on CG	-5.85	-5.85	-5.85

For the year 2005-06, 2006-07 and 2007-08 a normal distribution table will show that the probability of a Z score of -5.85 is almost nil if the assumptions were true and since it is less than the significance level of 2 per cent, the null hypothesis is rejected.

H_6 : There exists no adherence to mandatory provisions of CG with respect to Compliance (as certified) in a majority of the companies.

TABLE 5.12

Z SCORES FOR H_6

Provision	Years		
	2005-06	2006-07	2007-08
Compliance (as certified)	-5.85	-5.85	-5.85

For the year 2005-06, 2006-07 and 2007-08 a normal distribution table will show that the probability of a Z score of -5.85 is almost nil if the assumptions were true and as it is less than the significance level of 2 per cent, the null hypothesis is rejected.

5.12 Status of Non-Mandatory and Exemplary CG Practices

5.12.1 STATUS OF COMPLIANCE WITH NON-MANDATORY PROVISIONS OF CG

Compliance with non-mandatory provisions of CG is voluntary. However, it is deemed desirable in the general interest.

H_7 : A majority of companies adheres to non-mandatory provisions of CG with respect to the Board.

TABLE 5.13

Z SCORES FOR H_7

Provision	Years		
	2005-06	2006-07	2007-08
Non-mandatory provisions of CG with respect to the Board	-5.16	-5.50	-5.50

For the year 2005-06, 2006-07 and 2007-08 a normal distribution table will show that the probabilities of Z scores of -5.16 and -5.50 are almost nil if the assumptions were true and as it is less than the significance level of 2 per cent, the null hypothesis is rejected.

H_8 : A majority of companies adheres to non-mandatory provisions of CG with respect to Remuneration Committee.

TABLE 5.14

Z SCORES FOR H_8

Provision	Years		
	2005-06	2006-07	2007-08
Remuneration Committee	1.36	1.36	1.36

For the year 2005-06, 2006-07 and 2007-08 a normal distribution table will show that a Z score of 1.36 would occur approximately 8.69 percentage of the time by chance if the assumptions were true and since it is more than the significance level of 2 per cent, we fail to reject the null hypothesis.

H_9 : A majority of companies adheres to non-mandatory provisions of CG with respect to shareholders rights.

TABLE 5.15

Z SCORES FOR H_9

Provision	Years		
	2005-06	2006-07	2007-08
Shareholders rights	-2.76	-3.10	-2.76

For the year 2005-06, 2006-07 and 2007-08 a normal distribution table will show that Z scores of -2.76 and -3.10 would occur approximately 0.29 and 0.09 percentages of the time respectively by chance if the assumptions were true and as they are less than the significance level of 2 per cent considered, the null hypothesis is rejected.

H_{10} : A majority of companies adheres to non-mandatory provisions of CG with respect to Audit qualifications.

TABLE 5.16

Z SCORES FOR H_{10}

Provision	Years		
	2005-06	2006-07	2007-08
Audit qualifications	-1.04	-0.70	-0.35

For the year 2005-06, 2006-07 and 2007-08 a normal distribution table will show that Z scores of -1.04, -0.70 and -0.35 would occur approximately 14.92, 24.02 and 36.32 percentages of the time respectively by chance if the assumptions were true and as they are more than the significance level of 2 per cent, we fail to reject the null hypothesis.

H_{11} : A majority of companies adheres to non-mandatory provisions of CG with respect to training of Board Members.

TABLE 5.17

Z SCORES FOR H_{11}

Provision	Years		
	2005-06	2006-07	2007-08
Training of Board Members	-3.44	-3.79	-3.79

For the year 2005-06, 2006-07 and 2007-08 a normal distribution table will show that probabilities of Z scores of -3.44 and -3.79 are almost nil if the assumptions were true and as they are less than the significance level of 2 per cent, the null hypothesis is rejected.

H_{12} : A majority of companies adheres to the non-mandatory provision of CG with respect to the evaluation of Non-Executive Directors.

TABLE 5.18

Z SCORES FOR H_{12}

Provision	Years		
	2005-06	2006-07	2007-08
Evaluation of Non-Executive Directors	-3.10	-3.10	-3.44

For the year 2005-06, 2006-07 and 2007-08 a normal distribution table will show that probabilities of Z scores of -3.10 and -3.44 are 0.10 and nil percentages if the assumptions were true and since they are less than the significance level of 2 per cent, the null hypothesis is rejected.

H_{13} : A majority of companies adheres to non-mandatory provisions of CG with respect to whistle-blower policy.

TABLE 5.19

Z SCORES FOR H_{13}

Provision	Years		
	2005-06	2006-07	2007-08
Whistle-blower policy	2.05	2.39	2.05

For the year 2005-06 and 2007-08 a normal distribution table will show that a Z score of 2.05 would occur approximately 2.02 percentage of the time by chance if the assumptions were true and as it is more than the significance level of 2 per cent, we fail to reject the null hypothesis.

However, for the year 2006-07 a normal distribution table will show that a Z score of 2.39 would occur approximately 0.84 percentage of the time by chance if the assumptions were true and since it is less than the significance level of 2 per cent, the null hypothesis is rejected.

In the years 2005-06 and 2007-08, the failure to reject the null hypothesis implies that evidence is not strong enough to reject unlike the year 2006-07. It may be on account of inconsistency in reporting with respect to the whistle-blower policy.

5.12.2 STATUS OF EXEMPLARY CG PRACTICES

Some companies have introduced exemplary CG practices. These practices go beyond mandated CG compliance. Such practices can further promote value creation and improved transparency.

H_{14} : A majority of companies follows exemplary CG practices.

TABLE 5.20

Z SCORES FOR H_{14}

Feature	Years		
	2005-06	2006-07	2007-08
Exemplary CG practices	-4.99	-4.92	-4.80

For the year 2005-06, 2006-07 and 2007-08 a normal distribution table will show that probabilities of Z scores of -4.99, -4.92 and -4.80 are almost nil if the assumptions were true and as it is less than the significance level of 2 per cent, the null hypothesis is rejected. On the basis of the evidence at hand it can be established that a majority of companies do not follow exemplary CG practices.

5.13 Barriers to Reforming CG Practices

To ascertain whether there exist barriers to reforming CG practices, a few more hypotheses were tested. These are as follows.

H_{15} : In a majority of companies the size of the Board is appropriate.

Board composition is one of the important CG requirements. However, the size of the Board is equally important. Smaller Boards can be more efficient than the larger ones which tend to be dysfunctional. When Boards are compact, the members can have frank discussions, whereas in the case of large Boards, the Directors may unwittingly get divided into frictional sub-groups which is undesirable from the company's perspective.[3] Lipton and Lorsch suggested limiting the Board size to eight to nine members.[4] Jensen recommends the Board size at between six and eight.[5] Garg recommends limiting the Board size to six members.[6] In consonance with the above studies, the appropriate size of the Board in this study is reckoned at between from six and nine members. By testing this hypothesis an attempt is made to know whether a majority of companies has adhered to the appropriate size of the Board.

TABLE 5.21

Z SCORES FOR H_{15}

Feature	Years		
	2005-06	2006-07	2007-08
Size of the Board	-3.10	-2.41	-3.79

For the year 2005-06, 2006-07 and 2007-08 a normal distribution table will show that Z scores of -3.10, -2.41 and -3.79 would occur approximately 0.10, 0.80 and almost nil percentages of the time respectively by chance if the assumptions were true and as they are less than the significance level of 2 per cent, the null hypothesis is rejected. On the basis of the evidence at hand it can be established that in a majority of instances the size of the Board is not appropriate. So it is a barrier to better CG practices.

H_{16} : In a majority of companies the directors undergo formal training in CG matters.

Training facilitates better execution of corporate responsibilities. To be more precise, Board members i.e., directors undergo formal training in companies to execute fiduciary duties mainly through the CG framework.

This hypothesis is already tested to ascertain compliance with non-mandatory provisions of CG with respect to training of Board members (see H_{11}). As the hypothesis is rejected, it can be inferred that in a majority of cases the directors do not undergo formal training in CG matters which hinders CG reforms.

H_{17} : Evaluation for Non-Executive Directors is conducted in a majority of companies.

The presence of an adequate number of directors is one of the requirements of Clause 49. Moreover, they need to contribute effectively to the Board. Their active involvement in Board proceedings is of prime importance. Evaluation of Non-Executive Directors is an important tool and the basis for companies to re-appoint Board members and to ensure that their role is aligned to protection of interests of stakeholders, in particular, equity shareholders. Hence, this hypothesis is considered to ascertain whether a majority of companies has conducted evaluation for Non-Executive Directors.

This hypothesis is already tested to ascertain compliance with a non-mandatory provision of CG with respect to evaluation of Non-Executive Directors (see H_{12}). As the hypothesis is rejected, on the basis of the evidence at hand it can be established that evaluation of Non-Executive Directors is not conducted in a majority of cases and thus a barrier to CG reforms.

H_{18} : A majority of companies has instituted a whistle-blower policy.

Blowing the whistle in case of wrong-doing is one of the mechanisms through which frauds are exposed, as was the case with Enron. Whistle-blowing will not prove its worth unless it is done at the right time so that loss to stakeholders can be minimized. A cautious and caring approach is required for protecting whistle-blowers, especially job security. An environment of frankness among employees, clarity about their rights and duties and freedom to speak without fear will embolden them to blow the whistle, if the need arises. So this hypothesis is considered to ascertain whether a majority of companies has instituted a whistle-blower policy.

This hypothesis is already tested to ascertain compliance with a non-mandatory provisions of CG with respect to whistle-blower policy (see H_{13}). For the years 2005-06 and 2007-08 we failed to reject the null hypothesis. However, it stands rejected for the year 2006-07, an outcome that is probably due to inconsistency in reporting with regard to whistle-blower policy.

H_{19} : The CG approach emphasizes the primacy of equity shareholders in a majority of companies.

CG regulations emphasize that interests of stakeholders, particularly shareholders, be protected. An issue here is the pre-eminence of the interests of the owners, i.e., shareholders, over other stakeholders. An argument is that all stakeholders other than equity shareholders are protected and have legal rights about adequate returns in respect of capital investment in a firm but shareholders, who assume the highest risk, cannot sue firms for not paying dividend. The practices in the said context vary from country to country based on historical models of conduct of business i.e., CG models. CG in India apparently draws on the Anglo-Saxon Model. The point here is that there is no most commonly acceptable definition of CG among countries. Different countries, agencies and committees have defined CG in their own ways. Accordingly, Anglo-Saxon countries i.e., the United States and United Kingdom equate CG with the pursuit of shareholders' interests whereas in countries like Japan, Germany and France, CG is concerned with the interests of a wider set of stakeholders including employees, customers and shareholders.[7] In short, arriving at an objective definition of CG is itself an important issue. The hypothesis is tested to know whether a majority of companies have adhered to the shareholders' emphasis goal of CG.

TABLE 5.22

Z SCORES FOR H_{19}

Feature	Years		
	2005-06	2006-07	2007-08
Primacy of Equity Shareholders	-3.44	-3.44	-3.10

For the year 2005-06, 2006-07 and 2007-08, a normal distribution table will show that probabilities of Z scores of -3.44 and -3.10 are almost nil and 0.10 percentages of the time respectively by chance if the assumptions were true and as they are less than the significance level of 2 per cent, the null hypothesis is rejected. On the basis of the evidence at hand it can be established that the CG approach does not emphasize the primacy of equity shareholders in a majority of companies. So interests of shareholders may be somewhat compromised. In this context, it is a barrier to CG reforms because companies apparently betray a confusion of priorities about the interests of shareholders vis-a-vis other stakeholders.

5.13.1 THE NUMBER OF NON-EXECUTIVE INDEPENDENT DIRECTORS IN GOVERNMENT COMPANIES

As far as CG provisions are concerned, Clause 49 is applicable to government companies as well. Over and above this clause, these companies may voluntarily follow CG Guidelines for Public Sector Enterprises, 2007.[8] To bring transparency and independency in Board matters, the involvement of an adequate number of Non-Executive Independent Directors is important.

TABLE 5.23

REPRESENTATION OF NON-EXECUTIVE INDEPENDENT DIRECTORS IN GOVERNMENT COMPANIES

Feature	2005-06		2006-07		2007-08	
	Yes	No	Yes	No	Yes	No
Representation of Non-Executive Independent Directors as per CG Norms in Five Government Companies	0	5 (100%)*	1	4 (80%)*	0	5 (100%)*

*Percentages.
Source: Gleaned from Annual Reports.

In all the 3 years, representation of Non-Executive Independent Directors as per CG norms in the 4 Government companies is not adequate and hence a barrier. Only one company has adhered to this requirement in the year 2006-07 as presented in Figure 5.24.

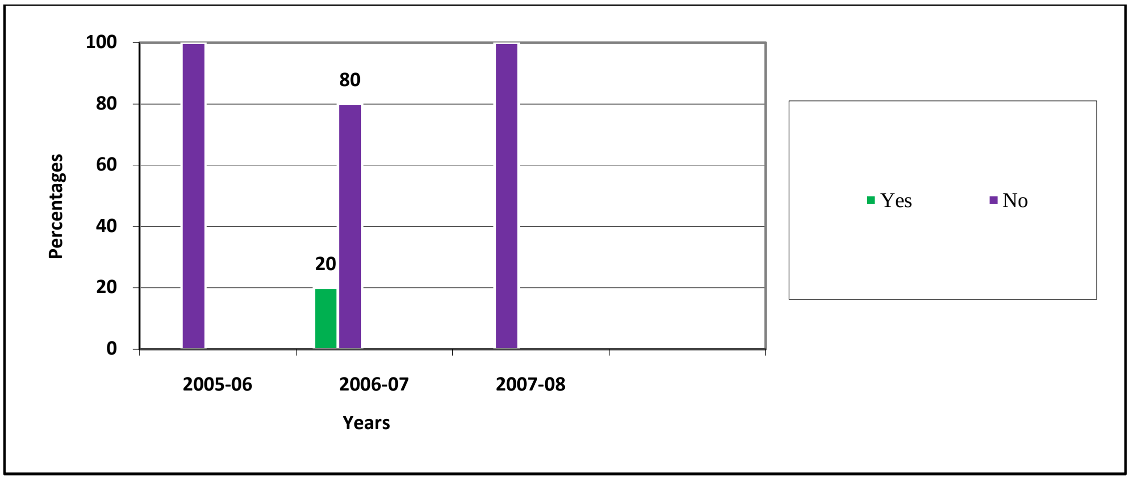

FIGURE 5.24

Percentage Representation of Non-Executive Independent Directors in Five Government Companies

5.14 Summary of Statistical Analysis

The summary of hypotheses tested above are presented in Table 5.24 with the results.

TABLE 5.24

SUMMARY OF HYPOTHESES

Hypotheses	Z Scores and Results			
	2005-06	2006-07	2007-08	Results
Mandatory Provisions				
H_1 There exists no compliance with mandatory provisions of CG with respect to composition of Board of Directors in a majority of the companies.	-5.33	-5.50	-5.33	Rejected
H_2 There exists no compliance with mandatory provisions of CG with respect to Audit Committee in a majority of the companies.	-5.57	-5.85	-5.78	Rejected
H_3 There exists no compliance with mandatory provisions of CG with respect to disclosures in a majority of the companies.	-5.73	-5.73	-5.79	Rejected
H_4 There exists no compliance with mandatory provisions of CG with respect to CEO/CFO Certification in a majority of the companies.	-2.07	-3.44	-4.13	Rejected
H_5 There exists no compliance with mandatory provisions of Report on CG in a majority of the companies.	-5.85	-5.85	-5.85	Rejected
H_6 There exists no adherence to mandatory provisions of CG with respect to Compliance (as certified) in a majority of the companies.	-5.85	-5.85	-5.85	Rejected
Non-Mandatory Provisions				
H_7 A majority of companies adheres to non-mandatory provisions of CG with respect to the Board.	-5.16	-5.50	-5.50	Rejected
H_8 A majority of companies adheres to non-mandatory provisions of CG with respect to Remuneration Committee.	1.36	1.36	1.36	Fail to reject

H_9 A majority of companies adheres to non-mandatory provisions of CG with respect to shareholders rights.	-2.76	-3.10	-2.76	Rejected
H_{10} A majority of companies adheres to non-mandatory provisions of CG with respect to Audit qualifications.	-1.04	-0.70	-0.35	Fail to reject
H_{11} A majority of companies adheres to non-mandatory provisions of CG with respect to training of Board Members.	-3.44	-3.79	-3.79	Rejected
H_{12} A majority of companies adheres to the non-mandatory provision of CG with respect to the evaluation of Non-Executive Directors.	-3.10	-3.10	-3.44	Rejected
H_{13} A majority of companies adheres to non-mandatory provisions of CG with respect to whistle-blower policy.	2.05 Fail to reject	2.39 Rejected	2.05 Fail to reject	———
Exemplary CG Practices				
H_{14} A majority of companies follows exemplary CG practices.	-4.99	-4.92	-4.80	Rejected
Barriers to Reforming CG Practices				
H_{15} In a majority of companies the size of the Board is appropriate.	-3.10	-2.41	-3.79	Rejected
H_{16} Same as H_{11} above.	-3.44	-3.79	-3.79	Rejected
H_{17} Same as H_{12} above.	-3.10	-3.10	-3.44	Rejected
H_{18} Same as H_{13} above.	2.05 Fail to reject	2.39 Rejected	2.05 Fail to reject	———
H_{19} The CG approach emphasizes the primacy of equity shareholders in a majority of companies.	-3.44	-3.44	-3.10	Rejected

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CHAPTER 6

CONCLUSIONS, IMPLICATIONS AND DIRECTIONS FOR FUTURE RESEARCH

6.1 Summary of Findings

The findings and statistical analyses were presented in the preceding chapter. A summary of the key findings is recapitulated as follows.

1. As regards mandatory Corporate Governance (CG) provisions, approximately on average 96 per cent, 97 per cent and 96 per cent of the companies studied complied with the requirement relating to the composition of Board of Directors in the years 2005-06, 2006-07 and 2007-08 respectively.

2. With respect to mandatory CG provisions, approximately on average 98 per cent, 100 per cent and 99 per cent companies complied with the Audit Committee requirement in the years 2005-06, 2006-07 and 2007-08 respectively.

3. With reference to mandatory CG provisions, approximately on average 99 per cent, 99 per cent and 100 per cent companies complied with disclosure requirements in the years 2005-06, 2006-07 and 2007-08 respectively.

4. As regards mandatory CG provisions, approximately 68 per cent, 79 per cent and 85 per cent of the companies complied with the requirement of certification of financial statements by Chief Executive Officer (CEO) or Chief Financial Officer (CFO) in the years 2005-06, 2006-07 and 2007-08 respectively.

5. As for mandatory CG provisions, almost 100 per cent of the companies complied with the Report on CG and Compliance with CG (as certified) requirements in the three years as mentioned previously.

6. Approximately 62 per cent of the companies complied with the non-mandatory provision of having a remuneration committee in the three years studied.

7. Approximately 68 per cent, 71 per cent and 68 per cent of the companies complied with the non-mandatory provision of adherence to whistle-blower policy for the years 2005-06, 2006-07 and 2007-08 respectively.

8. Other non-mandatory provisions were followed but not by a majority of the companies.

9. Approximately 21 per cent of the companies followed the exemplary practice of promoting Health, Safety and Environment in the years 2005-06, 2006-07 and 24 per cent in the year 2007-08.

10. About 18 per cent, 29 per cent and 26 per cent of the companies followed the exemplary practice of establishing of a Nomination Committee (for appointment of Directors) in the years 2005-06, 2006-07 and 2007-08 respectively.

11. Another exemplary practice followed is Sustainability Reporting by 15 per cent, 18 per cent and 21 per cent of the companies in the years 2005-06, 2006-07 and 2007-08 respectively.

12. The practices of Environment Policy and Secretarial Compliance certification by the Company Secretary were followed by 15 per cent of the companies in all the three years mentioned previously.

13. Mean compliance percentages for all exemplary practices are approximately 7 per cent, 8 per cent and 9 per cent for the years 2005-06, 2006-07 and 2007-08 respectively.

14. As a majority of companies has not adhered to all non-mandatory provisions of CG and if this pattern continues then non-mandatory provisions may be viewed as unmet standards or barriers to reforming CG practices. From that perspective, some barriers in a majority of companies which were possible to test are: inappropriate size of the Board, lack of formal training to directors in CG matters, lack of evaluation for Non-Executive Directors and a failure to articulate priorities about protection of interests of shareholders vis-à-vis other stakeholders.

15. There was 100 per cent non-compliance by 5 government companies (including Central Public Sector Enterprises) in the year 2005-06, 80 per cent in the year 2006-07 and 100 per cent in the year 2007-08. These enterprises have failed to fully comply with the requirement of the composition of Board of Directors, particularly Independent Directors.

The statistical significance, or otherwise, of the results were presented in the previous chapter.

6.2 Conclusions

A majority of the companies has adhered to most of mandatory provisions of CG as per requirements of Clause 49. However, though a majority of companies complied with the mandatory requirement of certification of financial statements by CEO/CFO, the level of compliance is comparatively lower vis-à-vis other mandatory requirements. Encouragingly, since the year 2005-06, compliance with the certification requirement shows an improving trend. The results further suggest that a majority of the companies has not adhered to all non-mandatory provisions of CG prescribed by the aforesaid clause. The majority of companies has adhered to the non-mandatory provisions of CG with respect to the remuneration committee in all the years studied. However, in case of the whistle-blower policy, the results do not uphold compliance in the year 2006-07 though there is adherence to this requirement in the years 2005-06 and 2007-08. Further, companies follow exemplary CG practices but they do not constitute a majority. However, adherence to such exemplary CG practices over the three years shows an increasing trend, which is heartening.

The picture that emerges is a mixed one as results strongly support a view that there exists compliance with mandatory CG provisions but not so with all non-mandatory provisions and exemplary CG practices.

A fallout of the findings is that regulatory attention and if need be, action, are warranted to ensure full compliance with mandatory provisions of Clause 49. Further, regulatory persuasion and self-regulatory impetus are desirable with regard to adherence to non-mandatory provisions of CG, in the larger public interest.

Apart from lack of compliance with non-mandatory provisions of CG, inappropriate size of the Board, lack of formal training to directors in CG matters, lack of evaluation for Non-Executive Directors, a failure to articulate priorities about the protection of interests of shareholders vis-à-vis other stakeholders and lack of representation of Independent Directors especially on the Board of Government companies may work as barriers to CG reforms.

6.3 Implications

Despite compliance with Clause 49 of the Listing Agreement by a majority of the companies, there are many implications of current CG practices.

1. The lower percentage compliance with certification of financial statements by CEO/CFO as compared with other mandatory CG requirements shows a lack of accountability on the part of CEO or CFO which in turn could have grave implications, e.g., fraudulent financial statements. However, a possible explanation could be inadequate reporting of such certification in CG reports by the companies. But, all companies have reported that they have achieved 100 per cent compliance with CG provisions, so it implies that either there are inconsistencies in CG reporting or some deficiency in compliance with CG provisions, which is a serious concern.

2. Non-compliance with most of the non-mandatory provisions of Clause 49 may work as barriers to reforming CG practices.

3. The puzzling drop in the number of companies following the exemplary CG practice of forming the Nomination Committee or any other CG practice(s) may be on account of inconsistency in reporting CG matters. Still, it warrants a closer examination.

4. A few Central Public Sector Enterprises have failed to fully comply with the requirement of the composition Board of Directors, particularly Independent Directors which indicates a lack of independency in Board composition; this may work as one of the barriers to reforming CG practices.

5. Barriers to reforming CG practices amount to hindrances in transparency and performance with regard to CG advancements especially for equity shareholders. Therefore, whittling down barriers will serve the cause of equity owners more effectively.

6.3.1 RECOMMENDATIONS

1. Regulators need to be vigilant about the level of compliance especially as regards the certification of financial statements by the CEO or CFO by companies.

2. Only some companies have mentioned about their risk management initiatives in their CG reports. The Audit Committee should focus on risk management as managing risk has become an integral part of business concerns.

3. As regards one of the provisions of the composition of Audit Committee, viz., that one of the members of the committee should have accounting or financial management expertise, the pertinent information needs to be clearly mentioned. Sometimes the profile of directors including their qualification is mentioned but nothing was provided about their area(s) of specialization in the CG reports of sample companies. For instance, a

mention such as “Post Graduate Diploma in Management from Indian Institute of Management, Ahmedabad” does not fulfill the requirement.

4. A few companies have not disclosed information regarding CG practices comprehensively and hence it can impair transparency. For instance, non-disclosure of whether the Company Secretary is Secretary to the Audit Committee, whether the Chairman of the Audit Committee was present in the last Annual General Meeting and whether the head of internal audit is an invitee to the Audit Committee violates convention and the spirit of full disclosure thereby simultaneously diluting effectiveness in compliance with provisions of CG.

5. The regulator(s) should preferably convert, if possible all, else some of the non-mandatory provisions to mandatory such as training of Board members, evaluation of Non-Executive Directors, establishment of remuneration committee and practice of whistle-blower policy. If that is not possible, compliance with these non-mandatory provisions should be commended. Likewise, if illuminating information about exemplary CG practices is made available by the regulator(s), many companies will become aware and will get impetus to emulate the same.

6.4 Directions for Future Research

The areas for further research in CG are: to replicate the research work on wider scale i.e., considering a larger sample size. Further, studies of this kind for listed companies in other groups (Group-A, Group-B) of Stock Exchange can provide a comparative view of levels of CG compliance. Inconsistencies in CG reporting provide scope for further studies on contents of CG reporting. A study on the role of CEO/CFO, especially for certification of financial statements will be useful as there exist inadequate compliance in this regard. Research on Board Composition of Government companies, especially the role of Independent Directors will provide a boost to CG reforms in the government sector as there seems inadequate representation of Independent Directors on the Board. Another area is to explore the relationship between compliance levels of CG provisions with profitability, in order to ascertain whether CG contributes to profitability.

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ANNEXURE 1

CLAUSE 49 OF THE LISTING AGREEMENT

Annexure I

The company agrees to comply with the following provisions:

I. Board of Directors

(A) Composition of Board

(i) The Board of directors of the company shall have an optimum combination of executive and non-executive directors with not less than fifty percent of the board of directors comprising of non-executive directors.

(ii) Where the Chairman of the Board is a non-executive director, at least one-third of the Board should comprise of Independent directors and in case he is an executive director, at least half of the Board should comprise of independent directors.

(iii) For the purpose of the sub-clause (ii), the expression 'independent director' shall mean a non-executive director of the company who:

a. apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect independence of the director;
b. is not related to promoters or persons occupying management positions at the board level or at one level below the board;
c. has not been an executive of the company in the immediately preceding three financial years;
d. is not a partner or an executive or was not partner or an executive during the preceding three years, of any of the following:
    i) the statutory audit firm or the internal audit firm that is associated with the company, and
    ii) the legal firm(s) and consulting firm(s) that have a material association with the company.
e. is not a material supplier, service provider or customer or a lessor or lessee of the company, which may affect independence of the director; and
f. is not a substantial shareholder of the company i.e. owning two percent or more of the block of voting shares.

Explanation

For the purposes of the sub-clause (iii):

a. Associate shall mean a company which is an "associate" as defined in Accounting Standard (AS) 23, "Accounting for Investments in Associates in Consolidated Financial Statements", issued by the Institute of Chartered Accountants of India.

b. "Senior management" shall mean personnel of the company who are members of its core management team excluding Board of Directors. Normally, this would comprise all members of management one level below the executive directors, including all functional heads.
c. "Relative" shall mean "relative" as defined in section 2(41) and section 6 read with Schedule IA of the Companies Act, 1956.

(iv) Nominee directors appointed by an institution which has invested in or lent to the company shall be deemed to be independent directors.

Explanation:
"Institution' for this purpose means a public financial institution as defined in Section 4A of the Companies Act, 1956 or a "corresponding new bank" as defined in section 2(d) of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 or the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 [both Acts]."

(B) Non executive directors' compensation and disclosures
All fees/compensation, if any paid to non-executive directors, including independent directors, shall be fixed by the Board of Directors and shall require previous approval of shareholders in general meeting. The shareholders' resolution shall specify the limits for the maximum number of stock options that can be granted to non-executive directors, including independent directors, in any financial year and in aggregate.

(C) Other provisions as to Board and Committees
(i) The board shall meet at least four times a year, with a maximum time gap of four months between any two meetings. The minimum information to be made available to the board is given in Annexure– I A.

(ii) A director shall not be a member in more than 10 committees or act as Chairman of more than five committees across all companies in which he is a director. Furthermore it should be a mandatory annual requirement for every director to inform the company about the committee positions he occupies in other companies and notify changes as and when they take place.

Explanation:
1. For the purpose of considering the limit of the committees on which a director can serve, all public limited companies, whether listed or not, shall be included and all other companies including private limited companies, foreign companies and companies under Section 25 of the Companies Act shall be excluded.

2. For the purpose of reckoning the limit under this sub-clause, Chairmanship/ membership of the Audit Committee and the Shareholders' Grievance Committee alone shall be considered.

3. The Board shall periodically review compliance reports of all laws applicable to the company, prepared by the company as well as steps taken by the company to rectify

instances of non-compliances.

(D) Code of Conduct

(i) The Board shall lay down a code of conduct for all Board members and senior management of the company. The code of conduct shall be posted on the website of the company.

(ii) All Board members and senior management personnel shall affirm compliance with the code on an annual basis. The Annual Report of the company shall contain a declaration to this effect signed by the CEO.

Explanation: For this purpose, the term "senior management" shall mean personnel of the company who are members of its core management team excluding Board of Directors. Normally, this would comprise all members of management one level below the executive directors, including all functional heads.

II Audit Committee

(A) Qualified and Independent Audit Committee

A qualified and independent audit committee shall be set up, giving the terms of reference subject to the following:

(i) The audit committee shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors.

(ii) All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.

Explanation 1: The term "financially literate" means the ability to read and understand basic financial statements i.e. balance sheet, profit and loss account, and statement of cash flows.

Explanation 2: A member will be considered to have accounting or related financial management expertise if he or she possesses experience in finance or accounting, or requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

(iii) The Chairman of the Audit Committee shall be an independent director;

(iv) The Chairman of the Audit Committee shall be present at Annual General Meeting to answer shareholder queries;

(v) The audit committee may invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of The committee, but on occasions it may also meet without the presence of any executives of the company. The finance director, head of internal audit and a representative of the statutory auditor may be present as invitees for the meetings of the audit committee;

(vi) The Company Secretary shall act as the secretary to the committee.

(B) Meeting of Audit Committee

The audit committee should meet at least four times in a year and not more than four months shall elapse between two meetings. The quorum shall be either two members or one third of the members of the audit committee whichever is greater, but there should be a minimum of two independent members present.

(C) Powers of Audit Committee

The audit committee shall have powers, which should include the following:

1. To investigate any activity within its terms of reference.
2. To seek information from any employee.
3. To obtain outside legal or other professional advice.
4. To secure attendance of outsiders with relevant expertise, if it considers necessary.

(D) Role of Audit Committee

The role of the audit committee shall include the following:

1. Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.
2. Recommending to the Board, the appointment, re-appointment and, if required, the replacement or removal of the statutory auditor and the fixation of audit fees.
3. Approval of payment to statutory auditors for any other services rendered by the statutory auditors.
4. Reviewing, with the management, the annual financial statements before submission to the board for approval, with particular reference to:

    a. Matters required to be included in the Director's Responsibility Statement to be included in the Board's report in terms of clause (2AA) of section 217 of the Companies Act, 1956
    b. Changes, if any, in accounting policies and practices and reasons for the same
    c. Major accounting entries involving estimates based on the exercise of judgment by management
    d. Significant adjustments made in the financial statements arising out of audit findings
    e. Compliance with listing and other legal requirements relating to financial statements
    f. Disclosure of any related party transactions
    g. Qualifications in the draft audit report.

5. Reviewing, with the management, the quarterly financial statements before submission to the board for approval.
6. Reviewing, with the management, performance of statutory and internal auditors, adequacy of the internal control systems.
7. Reviewing the adequacy of internal audit function, if any, including the structure of the internal audit department, staffing and seniority of the official heading the

department, reporting structure coverage and frequency of internal audit.

8. Discussion with internal auditors any significant findings and follow up there on.

9. Reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the board.
10. Discussion with statutory auditors before the audit commences, about the nature and scope of audit as well as post-audit discussion to ascertain any area of concern.
11. To look into the reasons for substantial defaults in the payment to the depositors, debenture holders, shareholders (in case of non payment of declared dividends) and creditors.
12. To review the functioning of the Whistle Blower mechanism, in case the same is existing.
13. Carrying out any other function as is mentioned in the terms of reference of the Audit Committee.

Explanation (i): The term "related party transactions" shall have the same meaning as contained in the Accounting Standard 18, Related Party Transactions, issued by The Institute of Chartered Accountants of India.

Explanation (ii): If the company has set up an audit committee pursuant to provision of the Companies Act, the said audit committee shall have such additional functions / features as is contained in this clause.

(E) Review of information by Audit Committee

The Audit Committee shall mandatorily review the following information:

1. Management discussion and analysis of financial condition and results of operations;
2. Statement of significant related party transactions (as defined by the audit committee), submitted by management;
3. Management letters / letters of internal control weaknesses issued by the statutory auditors;
4. Internal audit reports relating to internal control weaknesses; and
5. The appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee

III. Subsidiary Companies

i. At least one independent director on the Board of Directors of the holding company shall be a director on the Board of Directors of a material non listed Indian subsidiary company.

ii. The Audit Committee of the listed holding company shall also review the financial statements, in particular, the investments made by the unlisted subsidiary company.

iii. The minutes of the Board meetings of the unlisted subsidiary company shall be placed at the Board meeting of the listed holding company. The management should periodically bring to the attention of the Board of Directors of the listed holding company, a statement of all significant transactions and arrangements entered into by the unlisted subsidiary company.

Explanation 1: The term “material non-listed Indian subsidiary” shall mean an unlisted subsidiary, incorporated in India, whose turnover or net worth (i.e. paid up capital and free reserves) exceeds 20% of the consolidated turnover or net worth respectively, of the listed holding company and its subsidiaries in the immediately preceding accounting year.

Explanation 2: The term “significant transaction or arrangement” shall mean any individual transaction or arrangement that exceeds or is likely to exceed 10% of the total revenues or total expenses or total assets or total liabilities, as the case may be, of the material unlisted subsidiary for the immediately preceding accounting year.

Explanation 3: Where a listed holding company has a listed subsidiary which is itself a holding company, the above provisions shall apply to the listed subsidiary insofar as its subsidiaries are concerned.

IV. Disclosures

(A) Basis of related party transactions

(i) A statement in summary form of transactions with related parties in the ordinary course of business shall be placed periodically before the audit committee.
(ii) Details of material individual transactions with related parties which are not in the normal course of business shall be placed before the audit committee.
(iii) Details of material individual transactions with related parties or others, which are not on an arm’s length basis should be placed before the audit committee, together with Management’s justification for the same.

(B) Disclosure of Accounting Treatment

Where in the preparation of financial statements, a treatment different from that prescribed in an Accounting Standard has been followed, the fact shall be disclosed in the financial statements, together with the management’s explanation as to why it believes such alternative treatment is more representative of the true and fair view of the underlying business transaction in the Corporate Governance Report.

(C) Board Disclosures – Risk management

The company shall lay down procedures to inform Board members about the risk assessment and minimization procedures. These procedures shall be periodically reviewed to ensure that executive management controls risk through means of a properly defined framework.

(D) Proceeds from public issues, rights issues, preferential issues etc.

When money is raised through an issue (public issues, rights issues, preferential Issues etc.), it shall disclose to the Audit Committee, the uses / applications of funds by major category (capital expenditure, sales and marketing, working capital, etc), on a quarterly basis as a part of their quarterly declaration of financial results. Further, on an annual basis, the company shall prepare a statement of funds utilized for purposes other than those stated in the offer document/prospectus/notice and place it before the audit committee. Such disclosure shall be made only till such time that the full money raised through the issue has been fully spent. This statement shall be certified by the statutory auditors of the company. The audit committee shall make appropriate recommendations to the Board to take up steps in this matter.

(E) Remuneration of Directors

(i) All pecuniary relationship or transactions of the non-executive directors vis-à-vis the company shall be disclosed in the Annual Report.

(ii) Further the following disclosures on the remuneration of directors shall be made in the section on the corporate governance of the Annual Report:

  (a) All elements of remuneration package of individual directors summarized under major groups, such as salary, benefits, bonuses, stock options, pension etc.

  (b) Details of fixed component and performance linked incentives, along with the performance criteria.

  (c) Service contracts, notice period, severance fees.

  (d) Stock option details, if any – and whether issued at a discount as well as the period over which accrued and over which exercisable.

(iii) The company shall publish its criteria of making payments to non-executive directors in its annual report. Alternatively, this may be put up on the company's website and reference drawn thereto in the annual report.

(iv) The company shall disclose the number of shares and convertible instruments held by non-executive directors in the annual report.

(v) Non-executive directors shall be required to disclose their shareholding (both own or held by / for other persons on a beneficial basis) in the listed company in which they are proposed to be appointed as directors, prior to their appointment. These details should be disclosed in the notice to the general meeting called for appointment of such director

(F) Management

(i) As part of the directors' report or as an addition thereto, a Management Discussion and Analysis report should form part of the Annual Report to the shareholders. This Management Discussion & Analysis should include discussion on the following matters within the limits set by the company's competitive position:

i Industry structure and developments.
ii. Opportunities and Threats.
iii. Segment–wise or product-wise performance.
iv. Outlook
v. Risks and concerns.
vi. Internal control systems and their adequacy.
vii. Discussion on financial performance with respect to operational performance.
viii. Material developments in Human Resources / Industrial Relations front, including number of people employed.

(ii) Senior management shall make disclosures to the board relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large (for e.g. dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives etc.)

Explanation: For this purpose, the term "senior management" shall mean personnel of the company who are members of its core management team excluding the Board of Directors. This would also include all members of management one level below the executive directors including all functional heads.

(G) Shareholders

(i) In case of the appointment of a new director or re-appointment of a director the shareholders must be provided with the following information:

(a) A brief resume of the director;
(b) Nature of his expertise in specific functional areas;
(c) Names of companies in which the person also holds the directorship and the membership of Committees of the Board; and
(d) Shareholding of non-executive directors as stated in Clause 49 (IV) (E) (v) above

(ii) Quarterly results and presentations made by the company to analysts shall be put on company's web-site, or shall be sent in such a form so as to enable the stock exchange on which the company is listed to put it on its own web-site.

(iii) A board committee under the chairmanship of a non-executive director shall be formed to specifically look into the redressal of shareholder and investors complaints like transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends etc. This Committee shall be designated as 'Shareholders/Investors Grievance Committee'.

(iv) To expedite the process of share transfers, the Board of the company shall delegate the power of share transfer to an officer or a committee or to the registrar and share transfer agents. The delegated authority shall attend to share transfer formalities at least once in a fortnight.

V. <u>CEO/CFO certification</u>

The CEO, i.e. the Managing Director or Manager appointed in terms of the Companies Act, 1956 and the CFO i.e. the whole-time Finance Director or any other person heading the finance function discharging that function shall certify to the Board that:

(a) They have reviewed financial statements and the cash flow statement for the year and that to the best of their knowledge and belief :

(i) these statements do not contain any materially untrue statement or omit any Material fact or contain statements that might be misleading;
(ii) these statements together present a true and fair view of the company's affairs and are in compliance with existing accounting standards, applicable laws and regulations.

(b) There are, to the best of their knowledge and belief, no transactions entered into by the company during the year which are fraudulent, illegal or violative of the company's code of conduct.

(c) They accept responsibility for establishing and maintaining internal controls for financial reporting and that they have evaluated the effectiveness of the internal control systems of the company pertaining to financial reporting and they have disclosed to the auditors and the Audit Committee, deficiencies in the design or operation of internal controls, if any, of which they are aware and the steps they have taken or propose to take to rectify these deficiencies.

(d) They have indicated to the auditors and the Audit committee
- (i) significant changes in internal control over financial reporting during the year;
- (ii) significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and
- (iii) instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or an employee having a significant role in the company's internal control system over financial reporting.

VI. <u>Report on Corporate Governance</u>

(i) There shall be a separate section on Corporate Governance in the Annual Reports of company, with a detailed compliance report on Corporate Governance. Non-compliance of any mandatory requirement of this clause with reasons thereof and the extent to which the non-mandatory requirements have been adopted should be specifically highlighted. The suggested list of items to be included in this report is given in Annexure- I C and list of non-mandatory requirements is given in Annexure – I D.

(ii) The companies shall submit a quarterly compliance report to the stock exchanges within 15 days from the close of quarter as per the format given in Annexure I B. The report shall be signed either by the Compliance Officer or the Chief Executive Officer of the company.

VII. <u>Compliance</u>

(1) The company shall obtain a certificate from either the auditors or practicing company secretaries regarding compliance of conditions of corporate governance as stipulated in this clause and annex the certificate with the directors' report, which is sent annually to all the shareholders of the company. The same certificate shall also be sent to the Stock Exchanges along with the annual report filed by the company.

(2) The non-mandatory requirements given in Annexure – I D may be implemented as per the discretion of the company. However, the disclosures of the compliance with mandatory requirements and adoption (and compliance) / non-adoption of the non-mandatory requirements shall be made in the section on corporate governance of the Annual Report.

<u>Annexure I A</u>

Information to be placed before Board of Directors

1. Annual operating plans and budgets and any updates.
2. Capital budgets and any updates.
3. Quarterly results for the company and its operating divisions or business segments.
4. Minutes of meetings of audit committee and other committees of the board.
5. The information on recruitment and remuneration of senior officers just below the board level, including appointment or removal of Chief Financial Officer and the Company Secretary.
6. Show cause, demand, prosecution notices and penalty notices which are materially important.
7. Fatal or serious accidents, dangerous occurrences, any material effluent or pollution problems.
8. Any material default in financial obligations to and by the company, or substantial nonpayment for goods sold by the company.
9. Any issue, which involves possible public or product liability claims of substantial nature, including any judgement or order which, may have passed strictures on the conduct of the company or taken an adverse view regarding another enterprise that can have negative implications on the company.
10. Details of any joint venture or collaboration agreement.
11. Transactions that involve substantial payment towards goodwill, brand equity, or intellectual property.
12. Significant labour problems and their proposed solutions. Any significant development in Human Resources/ Industrial Relations front like signing of wage agreement, implementation of Voluntary Retirement Scheme etc.
13. Sale of material nature, of investments, subsidiaries, assets, which is not in normal course of business.
14. Quarterly details of foreign exchange exposures and the steps taken by management to limit the risks of adverse exchange rate movement, if material.
15. Non-compliance of any regulatory, statutory or listing requirements and shareholders service such as non-payment of dividend, delay in share transfer etc.

Annexure I B

Format of Quarterly Compliance Report on Corporate Governance

Name of the Company:
Quarter ending on:

Particulars	**Clause of Listing agreement**	**Compliance Status Yes/No**	**Remarks**
I. Board of Directors	49(I)		
(A) Composition of Board	49 (IA)		
(B) Non-executive Directors' compensation & disclosures	49 (IB)		
(C) Other provisions as to Board and Committees	49 (IC)		
(D) Code of Conduct	49 (ID)		
II. Audit Committee	49 (II)		
(A) Qualified & Independent Audit Committee	49 (IIA)		
(B) Meeting of Audit Committee	49 (IIB)		
(C) Powers of Audit Committee	49 (IIC)		
(D) Role of Audit Committee	49 (IID)		
(E) Review of Information by Audit Committee	49 (IIE)		
III. Subsidiary Companies	49 (III)		
IV. Disclosures	49 (IV)		
(A) Basis of related party transactions	49 (IVA)		
(B) Disclosure of Accounting Treatment	49 (IVB)		
(C) Board Disclosures	49 (IVC)		
(D) Proceeds from public issues, rights issues, preferential issues etc.	49 (IVD)		
(E) Remuneration of Directors	49 (IVE)		
(F) Management	49 (IVF)		
(G) Shareholders	49 (IVG)		
V. CEO/ CFO Certification	49 (V)		
VI. Report on Corporate Governance	49 (VI)		
VII. Compliance	49 (VII)		

Note:

1) The details under each head shall be provided to incorporate all the information required as per the provisions of the Clause 49 of the Listing Agreement.

2) In the column No.3, compliance or non-compliance may be indicated by Yes/No/N.A. For example, if the Board has been composed in accordance with the Clause 49 I of the Listing Agreement, "Yes" may be indicated. Similarly, in case the company has no related party transactions, the words “N.A.” may be indicated against 49 (IV A).

3) In the remarks column, reasons for non-compliance may be indicated, for example, in case of requirement related to circulation of information to the shareholders, which would be done only in the AGM/EGM, it might be indicated in the "Remarks" column as – “will be complied with at the AGM”. Similarly, in respect of matters which can be complied with only where the situation arises, for example, "Report on Corporate Governance" is to be a part of Annual Report only, the words "will be complied in the next Annual Report" may be indicated.

Annexure I C

Suggested List of Items to Be Included In the Report on Corporate Governance in the Annual Report of Companies

1. A brief statement on company’s philosophy on code of governance.

2. Board of Directors:
i. Composition and category of directors, for example, promoter, executive, non-executive, independent non-executive, nominee director, which institution represented as lender or as equity investor.
ii. Attendance of each director at the Board meetings and the last AGM.
iii. Number of other Boards or Board Committees in which he/she is a member or Chairperson
iv. Number of Board meetings held, dates on which held.

3. Audit Committee:
i. Brief description of terms of reference
ii. Composition, name of members and Chairperson
iii. Meetings and attendance during the year

4. Remuneration Committee:
i. Brief description of terms of reference
ii. Composition, name of members and Chairperson
iii. Attendance during the year
iv. Remuneration policy
v. Details of remuneration to all the directors, as per format in main report.

5. Shareholders Committee:
i. Name of non-executive director heading the committee
ii. Name and designation of compliance officer
iii. Number of shareholders' complaints received so far
iv. Number not solved to the satisfaction of shareholders
v. Number of pending complaints.

6 General Body meetings:
i. Location and time, where last three AGMs held.
ii. Whether any special resolutions passed in the previous 3 AGMs
iii. Whether any special resolution passed last year through postal ballot – details of voting pattern
iv. Person who conducted the postal ballot exercise
v. Whether any special resolution is proposed to be conducted through postal ballot
vi. Procedure for postal ballot.

7. Disclosures:
i. Disclosures on materially significant related party transactions that may have potential conflict with the interests of company at large.
ii. Details of non-compliance by the company, penalties, strictures imposed on the company by Stock Exchange or SEBI or any statutory authority, on any matter related to capital markets, during the last three years.
iii. Whistle Blower policy and affirmation that no personnel has been denied access to the audit committee.
iv. Details of compliance with mandatory requirements and adoption of the non mandatory requirements of this clause.

8. Means of communication:
i. Quarterly results
ii. Newspapers wherein results normally published
iii. Any website, where displayed
iv. Whether it also displays official news releases; and
v. The presentations made to institutional investors or to the analysts.

9. General Shareholder information:
i. AGM : Date, time and venue
ii. Financial year
iii. Date of Book closure
iv. Dividend Payment Date
v. Listing on Stock Exchanges
vi. Stock Code
vii. Market Price Data: High., Low during each month in last financial year
viii. Performance in comparison to broad-based indices such as BSE Sensex, CRISIL index etc.
ix. Registrar and Transfer Agents
x. Share Transfer System

xi. Distribution of shareholding
xii. Dematerialization of shares and liquidity
xiii. Outstanding GDRs/ADRs/Warrants or any Convertible instruments, conversion date and likely impact on equity
xiv. Plant Locations
xv. Address for correspondence

<u>Annexure I D</u>

Non-Mandatory Requirements

(1) The Board

A non-executive Chairman may be entitled to maintain a Chairman's office at the company's expense and also allowed reimbursement of expenses incurred in performance of his duties.

Independent Directors may have a tenure not exceeding, in the aggregate, a period of nine years, on the Board of a company.

(2) Remuneration Committee

i. The board may set up a remuneration committee to determine on their behalf and on behalf of the shareholders with agreed terms of reference, the company's policy on specific remuneration packages for executive directors including pension rights and any compensation payment.
ii. To avoid conflicts of interest, the remuneration committee, which would determine the remuneration packages of the executive directors may comprise of at least three directors, all of whom should be non-executive directors, the Chairman of committee being an independent director.
iii. All the members of the remuneration committee could be present at the meeting.
iv. The Chairman of the remuneration committee could be present at the Annual General Meeting, to answer the shareholder queries. However, it would be up to the Chairman to decide who should answer the queries.

(3) Shareholder Rights

A half-yearly declaration of financial performance including summary of the significant events in last six-months, may be sent to each household of shareholders.

(4) Audit qualifications

Company may move towards a regime of unqualified financial statements.

(5) Training of Board Members

A company may train its Board members in the business model of the company as well as the risk profile of the business parameters of the company, their responsibilities as directors, and the best ways to discharge them.

(6) Mechanism for evaluating non-executive Board Members

The performance evaluation of non-executive directors could be done by a peer group comprising the entire Board of Directors, excluding the director being evaluated; and Peer Group evaluation could be the mechanism to determine whether to extend / continue the terms of appointment of non-executive directors.

(7) Whistle Blower Policy

The company may establish a mechanism for employees to report to the management concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics policy. This mechanism could also provide for adequate safeguards against victimization of employees who avail of the mechanism and also provide for direct access to the Chairman of the Audit committee in exceptional cases. Once established, the existence of the mechanism may be appropriately communicated within the organization.

ANNEXURE 2

COMPUTATION OF Z SCORES

No.	Years		
	2005-06	2006-07	2007-08
H_1	$Z = \frac{0.0441 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.4569÷0.0857 = -5.33	$Z = \frac{0.0294 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.4716÷0.0857 = -5.50	$Z = \frac{0.0441 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.4569÷0.0857 = -5.33
H_2	$Z = \frac{0.0235 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.4775÷0.0857 = -5.57	$Z = \frac{0.00 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.501÷0.0857 = -5.85	$Z = \frac{0.0059 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.4951÷0.0857 = -5.78
H_3	$Z = \frac{0.0097 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.4913÷0.0857 = -5.73	$Z = \frac{0.0097 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.4913÷0.0857 = -5.73	$Z = \frac{0.0050 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.4960÷0.0857 = -5.79
H_4	$Z = \frac{0.3235 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.1775÷0.0857 = -2.07	$Z = \frac{0.2059 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.2951÷0.0857 = -3.44	$Z = \frac{0.1471 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.3539÷0.0857 = -4.13
H_5	$Z = \frac{0.00 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.501÷0.0857 = -5.85	$Z = \frac{0.00 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.501÷0.0857 = -5.85	$Z = \frac{0.00 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.501÷0.0857 = -5.85
H_6	$Z = \frac{0.00 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.501÷0.0857 = -5.85	$Z = \frac{0.00 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.501÷0.0857 = -5.85	$Z = \frac{0.00 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.501÷0.0857 = -5.85
H_7	$Z = \frac{0.0588 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.4422÷0.0857 = -5.16	$Z = \frac{0.0294 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.4716÷0.0857 = -5.50	$Z = \frac{0.0294 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.4716÷0.0857 = -5.50
H_8	$Z = \frac{0.6176 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = 0.1166÷0.0857 = 1.36 {0.5-0.4131 = 8.69%}	$Z = \frac{0.6176 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = 0.1166÷0.0857 = 1.36 {0.5-0.4131 = 8.69%}	$Z = \frac{0.6176 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = 0.1166÷0.0857 = 1.36 {0.5-0.4131 = 8.69%}
H_9	$Z = \frac{0.2647 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.2363÷0.0857 = -2.76	$Z = \frac{0.2353 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.2657÷0.0857 = -3.10	$Z = \frac{0.2647 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.2363÷0.0857 = -2.76

H_{10}	$Z = \frac{0.4118 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.0892÷0.0857 = -1.04	$Z = \frac{0.4412 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.0598÷0.0857 = -0.70	$Z = \frac{0.4706 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.0304÷0.0857 = -0.35
H_{11}	$Z = \frac{0.2059 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.2951÷0.0857 = -3.44	$Z = \frac{0.1765 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.3245÷0.0857 = -3.79	$Z = \frac{0.1765 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.3245÷0.0857 = -3.79
H_{12}	$Z = \frac{0.2353 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.2657÷0.0857 = -3.10	$Z = \frac{0.2353 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.2657÷0.0857 = -3.10	$Z = \frac{0.2059 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.2951÷0.0857 = -3.44
H_{13}	$Z = \frac{0.6765 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = 0.1755÷0.0857 = 2.05 {0.5-0.4798 = 2.02%}	$Z = \frac{0.7059 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = 0.2049÷0.0857 = 2.39 {0.5-0.4916 = 0.84%}	$Z = \frac{0.6765 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = 0.1755÷0.0857 = 2.05 {0.5-0.4798 = 2.02%}
H_{14}	$Z = \frac{0.0735 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.4275÷0.0857 = -4.99	$Z = \frac{0.0797 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.4213÷0.0857 = -4.92	$Z = \frac{0.0894 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.4116÷0.0857 = -4.80
H_{15}	$Z = \frac{0.2353 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ =-0.2657÷0.0857 = -3.10	$Z = \frac{0.2941 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.2069÷0.0857 = -2.41	$Z = \frac{0.1765 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.3245÷0.0857 = -3.79
H_{16}	$Z = \frac{0.2059 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.2951÷0.0857 = -3.44	$Z = \frac{0.1765 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.3245÷0.0857 = -3.79	$Z = \frac{0.1765 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.3245÷0.0857 = -3.79
H_{17}	$Z = \frac{0.2353 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.2657÷0.0857 = -3.10	$Z = \frac{0.2353 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.2657÷0.0857 = -3.10	$Z = \frac{0.2059 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.2951÷0.0857 = -3.44
H_{18}	$Z = \frac{0.6765 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = 0.1755÷0.0857 = 2.05 {0.5-0.4798 = 2.02%}	$Z = \frac{0.7059 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = 0.2049÷0.0857 = 2.39 {0.5-0.4916 = 0.84%}	$Z = \frac{0.6765 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = 0.1755÷0.0857 = 2.05 {0.5-0.4798 = 2.02%}
H_{19}	$Z = \frac{0.2059 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.2951÷0.0857 = -3.44	$Z = \frac{0.2059 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.2951÷0.0857 = -3.44	$Z = \frac{0.2353 - 0.501}{\sqrt{[(0.501)(0.499)]/34}}$ = -0.2657÷0.0857 = -3.10