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The Evolution And Challenges Of Corporate Governance In India

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Abstract

The topic has always been important to finance and economics, even though high-profile corporate governance scandals in wealthy nations have recently drawn public attention to it. Given its importance to financial and economic development, the issue is especially significant for emerging nations. Recent studies have shown that a nation's ability to safeguard investors, both legally and practically, is a major factor in financial success. India possesses some of the greatest corporate governance regulations due to the English legal system's legacy; yet, the pre-reform era's socialistic policies and inadequate implementation have negatively impacted corporate governance. The Indian business environment is characterized by concentrated share ownership, pyramiding, and tunnelling of cash among group companies. Due to the GOI nominated directors' inability or unwillingness to fulfil their oversight responsibilities, boards of directors have frequently been passive participants. However, after liberalization, significant attempts have been made to reform the system, as evidenced by the implementation of the corporate governance-related Clause 49 of Listing Agreements by SEBI. A shift towards more market-based governance is also occurring in the corporate governance of Indian banks.

Key words: Corporate Governance, Issues and Challenges.

Introduction

By using corporate governance, society may be certain that family businesses and major corporations are competent organizations to which lenders and investors can entrust their money. It is true that effectively run corporate governance fosters the core principles of a market economy in a democracy while providing protections against mismanagement and corruption. The fundamental principles of corporate governance are accountability, responsibility, transparency, and fairness. Corporate governance has come to the fore and is now a significant concern for businesses in the increasingly globalized economy in light of the Asian financial crisis, high-profile scandals in Russia and Latin America, and the growing emphasis on governance practices in the Middle East and North Africa. The lesson that basic business and management procedures must be put in place in order to be competitive globally and to draw investment is one that national business communities are constantly learning and repeating. Corporate governance, at its most fundamental, addresses problems that arise from the division of ownership and control. However, corporate governance is more than just putting managers and owners in a responsible and transparent relationship. Robust corporate governance norms

facilitate more financial accessibility, which in turn promotes economic growth. Investors are drawn to organizations with strong corporate governance because it gives them confidence that the business environment is transparent and equitable, that corporations can be held responsible for their actions or inaction, and that contracts can be upheld and investments protected.

After a number of high-profile company failures, the topic of corporate governance shot to prominence in the world of global business. The telecom behemoth WorldCom and the energy giant Enron, both based in Houston, Texas, shocked the business community with the scope and duration of their unethical and illegal operations. Worse, it appeared that they were just the tip of a very dangerous iceberg. Although US companies' corporate practices came under fire, it seemed that the issue was much more pervasive. Prominent and reliable corporations, such as Italy's Parmalat and the multinational newspaper conglomerate Hollinger Inc., have exposed serious and pervasive issues with their corporate governance. Public outcry over excessive compensation forced even the renowned New York Stock Exchange to remove its director, Dick Grasso. Globally, it was evident that there was a problem with corporate governance.

Naturally, corporate governance has been a significant area of research for the finance discipline for many years. The superiority of the German and Japanese bank-based corporate governance models over the Anglo-Saxon market-based model has been discussed. But when compared to the gap between these developed countries' corporate governance norms and practices and those in the developing world, the disparities in these developed countries' corporate governance quality become less significant.

Long before the recent wave of corporate scandals in developed economies made headlines, corporate governance was a major concern in developing nations. Economic development and corporate governance are, in fact, inextricably linked. Strong financial systems, whether primarily bank- or market-based, are fostered by effective corporate governance frameworks, and robust financial systems inevitably contribute to economic growth and the decrease of poverty.

The causality operates through a number of channels. Good corporate governance makes it easier for businesses to obtain outside funding, which encourages more investment as well as faster growth and job creation. In the nations with the highest quartile of creditor right enactment and enforcement, the share of private credit to GDP is more than twice that of the nations with the lowest quartile. Regarding equity financing, the nations in the highest quartile of shareholder right enactment and enforcement have stock market capitalization to GDP ratios that are roughly four times larger than those in the lowest quartile. Inadequate corporate governance impedes the establishment and growth of new businesses.

Additionally, by lowering risk and raising firm valuation, good corporate governance lowers the cost of capital and encourages real investments. The "control premium," which is the difference between the transaction prices of shares in block transfers that indicate control transfers less the ordinary share price, varies by a factor of 8 between the nations that have the highest and lowest levels of protection for equity rights.

Better resource allocation and management are ensured by efficient corporate governance systems, which increase return on capital. The nations with the highest degree of protection for equity rights have roughly twice the return on assets (ROA) compared to those with the lowest level of protection. Effective corporate governance has the potential to drastically lower the likelihood of national financial crises. Currency depreciation and corporate governance quality are strongly correlated in the opposite direction. It is true that lax corporate governance and transparency are regarded as the main causes of the 1997 Asian Crisis. Such financial crises can cause a nation to regress several years on its path to development and have enormous economic and social costs.

Finally, sound corporate governance can eliminate mistrust amongst stakeholders, lower legal expenses, and enhance labor and social relations as well as external economies like environmental preservation.

The main concerns in corporate governance are ensuring that the managers truly represent the company's owners, the stockholders, and distribute the profits to them. The joint-stock company form of organization's primary characteristics, limited liability and distributed ownership, ultimately result in a decentralized and ineffective management oversight by the company's real owners.

Despite having actual control over the company, managers might not always act in the best interests of the shareholders. These possible corporate governance issues are widespread. The Indian financial sector is also characterized by a history of managing agency systems, a relatively simple equity market that is susceptible to manipulation, a high degree of corruption overall, the dominance of family businesses, and rudimentary analyst activity. In India, corporate governance is a particularly significant issue because of all these characteristics.

An overview of Indian corporate governance's past

India was among the world's poorest nations economically when it gained independence in 1947. It had a well-designed economic system with lots of planning and regulations for future development because planners and economists worked methodically. India has a robust five-year planning system for development in addition to a wide range of laws governing commerce, industry, society, and the market. The founding of financial institutions and the Companies Development and Regulation Act of 1956 are significant moments in Indian history. The majority of the long-term financial needs of India's industries are currently being financed by the three main development financial institutions: IFCI, IDBI, and ICICI. The entire industrial development of the nation was made possible by all of these advancements. It also has a sound financial system and well-designed corporate laws to support a strong industrial base. The managing agency system was a defining feature of Indian corporate development in the early years. It significantly cleared the path for disproportionate ownership controls within the company and equity ownership. Due to widespread wrongdoing, corporate ethics gradually began to deteriorate over time.

Corporate governance became increasingly important and influential in India following the release of the groundbreaking Cadbury Report and the country's economic liberalization. Leading the conversation and advocating for its implementation were the Department of Company Affairs, the Institute of Company

Secretaries, trade associations like the CII and FICCI, capital market regulator SEBI, and businesses like ICICI. All listed companies had embraced the SEBI code of corporate governance by April 2003. The Confederation of Indian Industry (CII) developed a voluntary code that marked the beginning of the corporate governance movement in India in 1997. About thirty sizable listed companies, or more than 25% of India's market capitalization, voluntarily adopted the CII code over the course of the following three years. International standards of corporate governance for listed companies were mandated by the Securities and Exchange Board of India (SEBI), India's capital market regulator, by 1999. To address this issue, a committee led by Kumar Mangalam Birla was established. Around 140 listed companies, representing nearly 80% of market capitalization, began adhering to a mandatory code that was in line with some of the best international practices on April 1, 2001. Every listed company had joined the SEBI code by April 2003.

The managing agency system, which gave rise to distributed equity ownership and the practice of management enjoying control rights disproportionately greater than their stock ownership, was a significant factor in the early development of corporate developments in India. The 1951 Industries (Development and Regulation) Act and the 1956 Industrial Policy Resolution signalled the country's shift towards socialism in the decades that followed independence. These laws established a system of licensing, protection, and pervasive red tape that encouraged corruption and slowed the expansion of the corporate sector.

Central issues in Corporate Governance

In theory, the joint-stock company form of business has the following basic power structure. The real proprietors of the company are the numerous shareholders who provide capital. They choose a Board of Directors to oversee the company's operations on their behalf. In response, the Board names a group of managers who are in charge of running the business on a daily basis and who submit reports to the Board on a regular basis. Managers, then, act as the representatives of their shareholders and work to maximize their wealth.

In the event that this power structure held true, the Board would still have difficulty keeping an effective eye on management. The nature of the agreement between managers and shareholder representatives instructing the latter on what to do with the money contributed by the former is the main point of contention. The primary obstacle stems from the inherent "incompleteness" of these contracts. The Board cannot possibly advise management on the best course of action in every scenario that could arise in the course of business. There is an endless number of scenarios that could occur. Therefore, it is not possible to write a contract between the management and shareholders that outlines the proper course of action in every scenario. If the management does something different under the circumstances, it could be held liable for violating Shleifer and Vishny's (1997) contract. Due to the "incomplete contracts" scenario, the management or the financiers must have some "residual powers" over the company's finances. These remaining powers must go to management because it is obvious that the former lacks the knowledge and motivation to oversee the company in the circumstances not covered by the contract. The efficient limits to these powers constitute much of the subject of corporate governance.

The actual situation is even more convoluted and management-biased. In real life, common shareholders have very little control over how their money is spent by joint stock companies, and managers hold a great deal of power. In businesses where ownership is widely distributed, the manager—the CEO in the United States and the Managing Director in organizations with a British bent—has very little accountability. The majority of shareholders frequently give their "proxies" to the management and do not enjoy attending general meetings to elect or replace the board of directors. Since only management has the authority to suggest a slate of directors for voting, even those who attend the meeting find it difficult to participate in the process of choosing the directors. The CEO, for his part, usually appoints friends and allies who rarely disagree with him to the board. The CEO frequently doubles as the board of directors' chairman. As a result, the Board's oversight function is frequently seriously undermined, and management—who essentially holds the keys to the company—may utilize corporate resources to further their personal goals at the expense of shareholders' interests.

In the Anglo-Saxon corporate structure, where actual monitoring is supposed to come from financial markets, the ineffectiveness of the Board of Directors in overseeing the actions of management is especially evident. The fundamental idea is that investors who were unhappy with a certain management would just sell their company stock. This would make the company more attractive for acquisition since it would lower the share price. The acquiring company would fire the current management if and when the acquisition actually materializes. Therefore, rather than shareholder action, the fear of a takeover is meant to keep management vigilant and honest.

However, this mechanism requires the presence of a financial and legal system that supports M&A activity, as well as a deep, liquid stock market with significant information efficiency. These characteristics are typically absent from developing nations like India. Another type of corporate governance is offered by bank-based economies such as Germany, where the primary bank (called Hausbank in German) that lends to the company has a significant amount of influence and continuously supervises the management of the company at the project level. The supervisory board is made up of representatives from various stakeholders in the company.

Apart from outright theft, common areas of sub-optimal or contrary to shareholders' interests management action includes: transfer pricing, which is the practice of transacting with privately owned companies at prices below market to siphon off funds; managerial entrenchment, which is the resistance of managers to be replaced by a superior management team; and suboptimal use of free cash flows. The last point relates to how managers have been using the company's retained earnings. These money are often wasted on dubious empire-building investments and acquisitions when their best use would be to be distributed back to the shareholders in the absence of lucrative investment opportunities.

One of the most significant, if not the only, concern in corporate governance is maintaining an expert management team. Corporate governance primarily pertains to the efficient protection of creditors' and investors' rights, which may be jeopardized in a number of different ways. For example, corporate groups and family businesses are prevalent throughout many nations, including India. These include the various family business groups in India, such as the Birlas and Ambanis, as well as the Keiretsus in Japan and the Chaebols

in Korea. It is challenging for outsiders to follow the business realities of individual companies within these goliaths due to the interlocking and "pyramiding" of corporate control within these groups. Furthermore, the majority stake in these businesses is typically held by a small group of people, usually a family, who either retain control directly or indirectly through the assistance of other block holders such as financial institutions. Even in cases where they hold a majority stake, their personal interests do not always align with those of the minority shareholders. This frequently results in the "tunneling" of corporate gains or funds to other corporate entities within the group, which expropriates the value of minority shareholders. Such infringements on the rights of minority shareholders are a significant problem for corporate governance.

Aligning management and shareholder interests is one approach to resolving the corporate governance dilemma. This effort is evident in the recent increase in stock and option-related compensation for top managers in businesses all over the world. The implications of managerial ownership of corporate equity on firm value are intriguing. Firm value is observed to rise for a while (until ownership reaches roughly 5% for Fortune 500 companies), then decline for a while (until ownership is in the 5%–25% range, again for Fortune 500 companies), and finally start to rise again as management ownership (as a percentage of total shares) continues to rise. The intermediate range's decline is explained by the fact that managers have their own enough to guarantee their jobs no matter what, and they can also find ways to increase their income by using company funds in ways that are not optimal for shareholders.

Ownership structures, the legal system, and corporate governance

A nation's legal system is essential to establishing an efficient corporate governance framework and safeguarding creditors' and investors' rights. The two key components of the legal environment are the protection provided by the laws (de jure protection) and the degree of actual law enforcement (de facto protection). The nature of corporate governance in the relevant nation is influenced by both of these factors.

Therefore, the best protection for shareholder rights comes from legal systems of English origin. India, for example, has the highest shareholder rights index in the sample (five), better than all 42 other countries in the study, including France, Germany, Japan, and Switzerland, and on par with the United States, the United Kingdom, Canada, Hong Kong, Pakistan, and South Africa (all countries with English origin law).

Another tale is the Rule of Law Index. Here, the countries of Scandinavian descent have the highest average score of 10, which is followed by those of German, English, and French descent (8.68, 6.46, and 6.05, respectively). On this index, the majority of developed nations have very high scores, while developing nations normally have low scores. India, for example, ranks 41st out of 49 countries studied with a score of 4.17 on this index, ahead of only Nigeria, Pakistan, Sri Lanka, Zimbabwe, Colombia, Indonesia, Peru, and the Philippines. Therefore, it would seem that Indian laws offer excellent protection for shareholders' rights on paper, but their actual application and enforcement are appalling.

The financial and economic development of the various nations have taken entirely different paths because of the disparity in the protection of shareholders' rights.

Conclusions

Numerous corporate governance norms and standards have emerged globally in response to the recent wave of corporate scandals and the ensuing interest in corporate governance. The most well-known of these are probably the OECD's corporate governance principles, the USA's Sarbanes-Oxley law, and the recommendations made by the Cadbury Committee for European businesses. However, developing nations have also not lagged behind.

A significant first step in any serious attempt to enhance corporate governance is the creation of norms and guidelines. The correct application of those regulations at the local level, however, presents a greater challenge in India. Increasingly, it seems that external entities such as analysts and stock markets—especially overseas markets for companies issuing GDRs—have the greatest impact on the decisions made by managers of the nation's top corporations. However, their impact is limited to a select group of leading businesses, despite their size. To guarantee proper corporate governance in the typical Indian company, more has to be done.

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