Corporate Goverance

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1.1 Corporate Governance: An Introduction

Corporate governance is a 'new buzzing word' in corporate jargon. It gives importance on transparency of the management in business and industry. In simple terms "corporate governance is a system by which the companies are directed and controlled". It includes the set of policies and procedures used by a company for achieving its objectives. It is also a system which put checks and balances between the shareholders, directors, auditors and the management. Corporate governance describes codes of corporate conduct in relation to the stakeholders both external as well as internal. Therefore corporate governance is a system hereby the companies can be controlled and administered. In corporate governance transparency is a system which keeps a check and control over the corporate dealings, and fix responsibility of these companies with those directly involved.

1.2 Concept of Corporate Governance

A huge literature is available on the concepts of corporate governance. To get a fair view it would be practical to give a narrow as well as a broad concept of corporate governance. **In a narrow sense,** corporate governance involves a set of relationship amongst the company's management, its board of directors, shareholders and other stakeholders. These relationships, which involve various rules and incentives, provide the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Thus, the key aspects of good corporate governance include transparency of corporate structures and operations; the accountability of managers and the boards to shareholders; and corporate responsibility towards employees, creditors, suppliers and local communities where the corporation operates.

In a broader sense, however, good corporate governance- the extents to which companies are run in an open and honest manner- is important for overall market confidence, the

efficiency of international capital allocation, the renewal of countries' industrial bases, and ultimately the nations' overall wealth and welfare.

It is important to note that in both the narrow as well as in the broad definitions, the concepts of disclosure and transparency occupy centre-stage. In the first instance, these concepts create trust at the firm level among the suppliers of finance. In the second instance, they create overall confidence at the aggregate economy level. In both cases, they result in efficient allocation of capital.

1.3 Legal Provisions of Corporate Governance in Indian context

Historically, In India, the family owned business houses followed corporate governance practices which are suitable to them. The stakeholders considered them lack of competence and trust. In India up to 70s corporate picture was the small holding of the families in their company's capital, non-transparency at various levels on various matters and no public disclosure did not bring any reaction from the stakeholders, in a protected economy. Non-separation of ownership from the management generated corruption in business and resulted in problem of the value to the stakeholders.

In order to improve the corporate performance, a number of government and industry have been taken initiatives to prepare the necessary laws, bodies and guidelines for corporate governance. The most famous are the voluntary Code of Corporate Governance of the CII, the Kumar Mangalam Birla Committee Report, the Naresh Chandra Committee Report, and the Narayana Murthy Committee Report. The Kumar Mangalam Birla Committee Report led the introduction of clause 49 in the standard listing agreement for implementation by all stock exchanges for all listed companies, within a time frame of three years commencing from the financial year 2000-2001. The Committee's recommendations related to the composition of the board, constitution of audit committee in certain sized companies, remuneration of directors, director's report to include management discussion & analysis report, better disclosure norms to the shareholders through annual report, etc.

Based on these reports, the Companies Act was amended, first in 2000 and then in 2002. Based on the recommendations of the Naresh Chandra Committee the Companies

(Amendment) Bill, 2003 was introduced in the Parliament to further amend the Companies Act. The Bill has been since withdrawn under the strong pressure of the industry. Following are the main legal developments in corporate governance with regard to corporate governance.

1.3.1. Supervisory and Management Function: The regulatory and administrative efforts of the government and the industry have very much impact on the corporate governance. Due to these, now in India, the board is a combination of executive and non-executive directors (the outsiders) under the chairman who accepts the duties and responsibilities which requires. The executive directors are involved in the day-to-day management of companies; the non-executive directors bring independence to the decision-making, but make only supervisory function.

1.3.2. Independent director*:* As per clause 49 of the Listing Agreement the independent director has been defined as a non-executive director who does not have any pecuniary relationship or transactions with the company, or its promoters, or its senior management and its holding or subsidiary company. As per clause 49-I (A) of the Listing Agreement the board should be of seven members, out of which four should be independent directors. The independent directors should not be less than 50% of the board.

1.3.3. Protection of Minority Shareholder *:* Greater legal protection for minority shareholders from transactions involving potential conflicts of interest seriously attempt to reform corporate governance in Indian economy. In a recent judgment that will have a favour on the rights of minority shareholders, the Bombay High Court has held that majority shareholders couldn't easily out minority shareholders from the company just by paying off the value of their shares. The minority shareholders should be offered a scheme by the company under sections 391 and 394 of the Companies Act that provide options to minority shareholders.

1.3.4. Audit System: It is also necessary that a half-yearly statement of financial performance including summary of the significant events in the last six months should be sent to each house of shareholders. The company should disclose in the Report on Corporate

Governance whether it has sent to each house of shareholders half-yearly report on financial performance.

Every public company having paid-up capital of rupees 5 crore or more shall constitute a Committee of the Board to be known as Audit Committee.

1.3.5. Authority of Audit Committee: The Audit Committee, constituted in accordance with section 292A of the Companies Act, shall have authority to investigate into any matter in relation to the items specified in the said section 292A or referred to it by the Board. For accomplishing these purposes, the Committee shall have full access to information contained in the records of the company and can seek external professional advice, if necessary. If a default is made in complying with the provisions of section 292A of the Companies Act, 1956, the company and every officer who is in default, shall be punishable with imprisonment for a term which may extend to one year, or with fine which may extend to fifty thousand rupees or with both.

1.3.6. Powers of the Audit Committee*:* As per Clause 49-II(C), the powers of the Audit Committee shall include the following:

a) To investigate any activity within its terms of reference

b) To seek information from any employee

c) To obtain outside legal or other professional advice

d) To secure attendance of outsiders with relevant expertise, if it considers necessary.

The powers of the Audit Committee specified above are illustrative.

1.3.7. Auditor disclosure of contingent liabilities: Management should provide a clear description of each material liability and its risks followed by the auditor's comments on the management view. It should be highlighted in the significant accounting policies and noted on accounts as well as in the auditor's report, if necessary.

1.3.8. Auditor's disclosure of qualifications and consequent action: It is mandatory for Auditor to send a copy of qualified report to the Registrar of Companies, SEBI and the principal stock exchange along with a copy of letter sent to the management.

1.3.9. Chief executive officer (CEO) and Chief finance officer (CFO) Certification of Annual Audited Accounts: Chief executive officer and Chief finance officer have to certify that:

a) they have reviewed the balance sheet and profit and loss account and all its schedules and noted on accounts, the cash flow statement and the Directors' Report;

b) these statements do not contain any material untrue statement or omit any material fact nor do they contain statements that might be misleading;

c) these statements together represent a true and fair view of the financial and operational state of company and are in compliance with the existing accounting standards and/or applicable laws and regulations;

d) they are responsible for establishing and maintaining internal controls which have been designed to ensure that all material information is periodically made known to them, and have evaluated the effectiveness of internal control systems of the company;

e) they have disclosed to the auditors and the audit committee any deficiencies in the design or operation of internal controls; instances of significant fraud involving management or employees; significant changes in internal control and accounting policies during the year; and

f) they will return to the company that part of any bonus or incentive or equity based compensation that was inflated on account of such errors as decided by the audit committee.

g) Three independent Quality Review Boards (QRBs) should be established one each for ICAI, ICSI, ICWAI to periodically examine and review the quality of audit, secretarial and cost accounting firms.

1.3.10. Regulation for Listed Companies: The SEBI and the Stock Exchanges in which the listed companies are registered regulate the listed companies in India. The major Acts are the Securities Contract (Regulation) Act, 1956 and the various guidelines issued by SEBI and enforced through stock exchanges. The listed companies have to follow the Listing Agreement, which has been amended from time to time.

1.4. Evaluation of Legal Reform

The most recent legislative attempt of the Government had been the introduction of the Companies (Amendment) Bill, 2003, which, under industry pressure has since been withdrawn. It was aimed towards providing a growth oriented regulatory framework for companies as well as ensuring discipline and professionalism in the management of the corporate sector. The Bill also sought to ensure greater investor protection, good corporate governance, increased transparency and improved accountability. The Bill was based on the recommendations of the Naresh Chandra Committee, Joint Parliamentary Committee, R D Joshi Committee and the provisions of the Companies Bill, 1997. In addition to above some other related laws on Corporate Governance are as follows:

1.4.1. Implementation of Accounting Standards

During 2003, new international accounting standards, guidance notes, auditing and assurance standards came into play. This has brought Indian Corporate accounting closer to International Accounting Standards (IAS). As on November 2003, there were 30 subjects covered by both Indian accounting and the IAS. The subjects include like earning per share, segment reporting, leases, consolidated financial statements and impairment of assets which are dealt both in India as well as under IAS.

1.4.2. Chartered Accountants Act, 1949

The Government has moved a bill on 22 December 2003 in Rajya Sabha called *the Chartered Accountants (Amendment) Bill, 2003* to expand the definition of 'professional misconduct'. The bill, when passed, will provide the Department of Company Affairs (DCA) with powers to specify acts and omissions that amount to professional misconduct, in order to keep both the professionals and professional bodies under control. The bill lists 23 acts and omissions that could amount to misconduct for CAs, as against 13 already listed in the Act.

1.4.3. Bankruptcy Law Reform

Bankruptcy rules are an important aspect of corporate governance. These rules help in determining that how a company is to be controlled and managed and whose claims have priority when it faces financial difficulties and especially if it seeks the protection of the bankruptcy courts. On bankruptcy, the Indian law closely follows the principles of English common law. The Industrial Disputes Act, 1947 makes it illegal to close down an industry without the state government permission. The Sick Industrial Companies Act (SICA) was passed to solve the sick company's problem. Under the Act, the Board for Industrial and Financial Reconstruction (BIFR) was set-up.

1.5. Development of Corporate Governance in International Context

During the 1990s, a number of high-profile corporate scandals in the USA (viz., Lehman Brothers, AIG Insurance, Xerox, Arthur Anderson, Enron, WorldCom, Tyco, etc.), and also elsewhere in the world, started an in-depth reflection on the regulatory role of the government in protecting the interests of shareholders. Thus, to redress the problem of corporate misconduct, ensuring 'sound' corporate governance is believed to be essential to maintaining investors' confidence and good performance. In view of the growing number of scandals and the subsequent wide-spread public and media protest, a surplus of governance 'norms,' 'codes,' 'best practices,' and 'standards' have grow around the globe. For instance, the Sarbanes-Oxley legislation in the USA, the Cadbury Committee recommendations for the European Union (EU) companies, and the OECD principles of corporate governance, are perhaps the best-known among these. The Cadbury Committee (1992) advocated, first of all, disclosure as "a mechanism for accountability, emphasising the need to raise reporting standards in order to ward-off the threat of regulation. Improved disclosure results in improved transparency, which is one of the most essential elements of healthy corporate governance practices." Similarly, the Hampel Committee (1998) regulated disclosure as "the most important element of accountability and in introducing a new code and set of principles stated that their objective was not to prescribe corporate behavior in detail but to secure sufficient disclosure so that investors and others can assess companies performance and governance practice and respond in an informed way." In the Millennium Declaration, the

world leaders stated that the development goals could only be achieved through good or democratic governance. Further, they pledged to spare no effort to promote democracy and strengthen the rule of law. These goals constitute the vision of the next decade and India is not lagging behind.

1.6 Corporate Governance Practices towards Stakeholders

It is well-accepted principle now that corporate exist not only for the benefit of shareholders, but also to serve the interests of other stakeholders. A corporate does not exist itself or operates in vacuum-its work is organized and facilitated with the help and co-operation of all constituents of the society in which it functions. Therefore, it is only natural that corporate are expected to return and contribute in a fair measure to the well-being of all stakeholder value. The various types of interest of different stakeholders can be explained as follows:

Stakeholders	Examples of interests
Employees	Rates of pay, Job security, Compensation, Respect, Truthful Communication
Customers	Value, Quality, Customer Care, Ethical products
Suppliers	Providers of products and services used in the end product for the Customer. Equitable Business Opportunities
Creditors	Credit score, New contracts, Liquidity
Community	Jobs, Involvement, Environmental Protection, Shares, Truthful Communication
Government	Taxation, VAT, Legislation, Low unemployment, Truthful Reporting

1.7. Summary

Corporate governance is a system which establishes a check and balance system in the company. Corporate governance is the relationship among various participants [CEO, management, shareholders, and employees] in determining the direction and performance of corporations". Corporate Governance practices are essential for providing direction and control the companies and also mandatory by the law for the listing of the companies in the stock exchange in Indian corporate sector. Beside these legal provisions following better corporate governance practices increase the goodwill not only of companies and also the country. Further a good structure of corporate governance satisfies the needs and interests of different stakeholders in a way that provides for long-term growth in the value of the company and its contribution to society. Thus the government in every country exercises a certain amount of control over operations of the organization and the government could use this to steer the organization towards the path of good corporate governance.

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