ISSN (Online): 2230-7893
www.IJCEM.org

Legal Framework and Corporate Governance: An Indian Perspective

APARNA SHARMA

Assistant Professor, University School of Management
Kurukshetra University Kurukshetra
aparna4hr@yahoo.com

Abstract:
Corporate Governance has been gaining momentum across the world due to miserable corporate failures, unethical business practices and insufficient disclosure etc. Effective Corporate Governance depends upon two factors. Transparency in the business operations and the second are the legal and administrative framework created by the Government. There is a gap between percept and practice of Corporate Governance. In this paper attempt has been made to elaborate the Corporate Governance mechanisms in the context of the legal framework in India, specifically how Clause 49 of Listing Agreement act as an opportunity for public listed companies to achieve IT Governance; though the amendment to Clause 49 of the Listing Agreement has been the topic of elaborate discussion in the Indian corporate scene. This study seeks to gain insights into the major regulatory changes impacted corporate governance practices in India.

Keywords: Corporate Governance, Reforms, Clause 49 and IT Governance.

1. Introduction:

Corporate governance is to a large extent, a set of mechanisms through which outsider investors protect themselves from expropriation by insiders (La Porta et al 2000). The topic of Corporate Governance has gained attention since the 1980's and more so after the code of corporate governance issued by the Cadbury committee. In line with the Cadbury committee, the Kumaramangalam Birla Committee has also issued a code of corporate governance for companies in India. According to the Kumaramangalam Birla Committee
"Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting."

The governance structure of a country protects the investors from expropriation by managers and large shareholders. In different jurisdictions, rules protecting investors come from different sources, including company, security, bankruptcy, takeover, and competition laws, and also from stock exchange regulations and accounting standards (La Porta et al 2000).

2. Legal Framework in Corporate Governance:

The companies in India have to comply with the provisions of the Companies Act, 1956, the SEBI guidelines, the Kumaramangalam Birla report on corporate governance, the Accounting Standards issued by the ICAI and the listing agreements with the stock exchanges in which they are listed. The Companies Act, 1956 is the relevant statute in India that governs the incorporation, functioning and winding up of the companies. The ordinary business activities like declaration of dividends, appointment of directors, acceptance of the financial statements and appointment of auditors requires the consent of 51% of the shareholders, whereas all other business activities (other than routine business activities) requires the approval of 75% of the shareholders. If a company wants to start a new business it requires the approval of 75% shareholders, which means that the board of a widely held company should be able to persuade the shareholders about their strategy to pass the special resolution. Whereas the board of a closely held company will not find it difficult to pass such a resolution because the shareholders are usually the managers in such cases
Looking at the structure of the board prescribed by the Act we find that the Act is silent about the composition of the directors or the minimum qualification required (other than qualification shares) to become a director. However the Kumaramangalam Birla report (KMB report) requires that in case of appointment/

reappointment of directors, shareholders should be provided a resume, information regarding functional expertise and number of directorships held in other companies. KMB report mentions that the board shall consist of atleast 50% of non-executive directors. And if the chairman is an executive director then atleast half of the board of directors shall be independent and in other case atleast one-third of the total directors shall be independent. The Act mentions that there should be a minimum of 3 directors and the maximum in no case should be beyond 12 unless the approval of the Central Government is obtained. It further states that no person can be a director for more than 20 companies. The KMB report has taken a more stringent view that the directors shall not be members of more than 10 committees or chairman of more than 5 committees across all companies. The remuneration payable to managerial personnel under the Act, if there is only one such person, shall not exceed 5% of its net profit and in case of more than one managerial personnel it shall not exceed 10% of its net profit except with prior permission of the Central Government. In case of companies, which incurred a loss in the current financial year the limits on the salaries and perquisites to be paid to the Managing personnel, is mentioned in Schedule XIII of the Act.

The minority shareholders are protected under section 398 and 399 of the act. According to this section the members holding atleast 10% of the share capital can make an application to the Company Law Board (CLB) for relief in the cases of oppression and mismanagement by the board. The minority shareholders have a provision to appoint representative director on the board. There is no special provision under the companies to protect the creditors. If the company makes default then the creditors have to move the civil court for realisation of dues, which demands more time and money to be spent around the courts. The latest Securatisation bill which was passed in June, 2002 by the Parliament of India will soon enable the creditors to realise their long standing dues form the company within a normal period of time.

The Institute of Chartered Accountants of India is the concerned authority to issue Accounting Standards, which are mandatory in most of the cases. As of now we have 28 Standards that provide guidelines for disclosures of financial information to ensure uniformity between companies.

The Securities and Exchange Board of India is the regulatory authority, which issues regulations, rules and guidelines to companies to ensure protection of investors. The companies whose shares are listed on the stock exchanges should comply with additional requirements as mentioned in the listing agreement on a regular basis.

2.1 Pre-liberalization:

During the initial years Indian organizations were bound by colonial rules and most of the rules and regulations catered to the whims and fancies of the British Employers. The companies act was introduced in the year 1866 and was gradually revised in 1882, 1913 and 1932. Indian Partnership act was introduced for the first time in 1932. The various agendas which were on its focus were managing agency model to corporate affair as individuals / business firms entered into legal contract with joint stock companies. It was characterized by abuse / misuse of responsibilities by managing agent due to dispersed ownership. The issues of profit generation and control were dilapidated leading to various conflicts.

The period of 1950s and 1960s was a period of setting up of industrial activities and cost plus regime. The genesis was the demand for very many products for which the Government administered Fair Prices. This was the time when the Tariff Commission and the Bureau of Industrial Costs and Prices were set up by the Govt. 1951 – India's development Regulation Act 1956 – Companies Act came into existence. Development and Banking institutions came into existence. The period between 70's to mid eighties was an era of Cost, Volume and Profit analysis, as an integral part of the Cost Accounting function.

2.2 Post Liberalization:

After liberalization, India has been keenly looked upon by the organizations/ companies worldwide for the purpose of creating new markets. Progressive firms in India have made an attempt to put the systems of good corporate governance in place. There have been number of discussions and events leading to the development of Corporate Governance. The basic minimal code for corporate governance was proposed by the Chamber of Indian Industries (CII), 1998.The guiding definition proposed by CII, "Corporate Governance deals with laws, procedures, practices and implicit rules that determines a company's ability to take managerial decisions vis- a vis its claimants – in particular its shareholders, creditors, customers, the state and the employees."

2.2.1 The First Phase of India's Corporate Governance Reforms: 1996-2008

India's corporate governance reform efforts were initiated by corporate industry groups, many of which were instrumental in advocating for and drafting corporate governance guidelines. Following vigorous advocacy by industry groups, SEBI proceeded to adopt considerable corporate governance reforms. The first phase of India's corporate governance reforms were aimed at "making boards and audit committees more independent, powerful and focused monitors of management" as well as aiding shareholders, including institutional and foreign investors, in monitoring management.9 These reform efforts were channeled through a number of different paths with both SEBI and the MCA playing important roles.

1998 - Confederation of Indian Industry (CII) -
Desirable Corporate Governance – A Code

In 1996, CII took a special initiative on corporate governance – the first institutional initiative in Indian Industry. The objective was to develop and promote a code for companies – be in private sector, public sectors, Banks or financial Institutions, all of which are corporate entities. The initiatives by CII flowed from Public concerns regarding the protection of investor interest, especially the small investor; the promotion of transparency within business and industry ; the need to move towards international standards in terms of disclosure of information by the corporate sector, and through all of this to develop a high level of public confidence in business and industry. The completed final draft of this code came out in April 1998.

1999- Report of the Committee (Kumar Manglam Birla) on Corporate Governance

SEBI, appointed Kumar Manglam Birla – as chairman to give a comprehensive view of the issues related to insider trading to protect the rights of various stakeholders. The heart of the committee's report is the set of recommendations which distinguishes the responsibilities and obligations of the board and the management in instituting the systems for good corporate governance and emphasizes the rights of shareholders in demanding corporate governance. Many of the recommendations are mandatory. These recommendations are expected to be enforced on the listed companies for initial and continuing disclosures in a phased manner within specified dates, through the listing agreement. The companies will also be required to disclose separately in their annual reports, a report on corporate governance delineating the steps they have taken to comply with the recommendations of the committee. These will enable shareholders to know, where the companies, in which they have invested, stand with respect to specific initiatives taken to ensure robust corporate governance.

November 2000- Report of the task force on Corporate Excellence through Governance:

Department of company affairs, prepared a report on achieving corporate excellence through governance. Depending upon the size and capabilities of the companies as well the requirements of the market place, the task force recommended phased implementations of the essential measures.

2000 – Enactment of Clause 49

Shortly after introduction of the CII Code, SEBI appointed the Committee on Corporate Governance (the Birla Committee). In 1999, the Birla Committee submitted a report to SEBI "to promote and raise the standard of Corporate Governance" for listed companies.12 The Birla Committee's recommendations were primarily focused on two fundamental goals—improving the function and structure of company boards and increasing disclosure to shareholders. With respect to company boards, the committee made specific recommendations regarding board representation and independence that have persisted to date in Clause 49.The committee also recognized the importance of audit committees and made many specific recommendations regarding the function and constitution of board audit committees. The Birla Committee also made several recommendations regarding disclosure and transparency issues, in particular with respect to information provided to shareholders. Among other recommendations, the Birla Committee stated that a company's annual report to shareholders should contain a Management Discussion and Analysis (MD&A) section, and that companies should transmit certain information, such as quarterly reports and analyst presentations, to shareholders.

SEBI implemented the Birla Committee's proposals less than five months later, in February 2000. At that time, SEBI revised its Listing Agreement to incorporate the recommendations of the country's new code on corporate governance. These rules—contained in Clause 49, a new section of the Listing Agreement—took effect in phases between 2000 and 2003. The reforms applied first to newly listed and large companies, then to smaller companies, and eventually to the vast majority of listed companies.

March 2001 – RBI – Report of the advisory group on Corporate Governance: Standing Committee on International Financial Standards and Code

The governance mechanism differs in each country and is shaped by its political, economic, and social history as also by its legal framework. With keen interest shown by organizations like World Bank, Asian Development Bank etc, OECD developed a set of principles which are internationally recognized to serve as good benchmarks. The advisory group on CG attempted to compare the status of corporate governance in India vis a vis the internationally recognized best standards and suggested to improve corporate governance standards in India.

April 2001 – RBI – Report of the consultative Group of Directors of Banks/Financial Institutions

The Consultative group of directors of banks and financial institutions was set up by reserve bank to review the supervisory role of boards of banks and financial institutions and to obtain feedback on the functioning of the boards vis a vis compliance, transparency, disclosures, audit committees etc and make recommendations for making the role of board of directors more effective with a view to minimizing risks and over exposure. Following the best international practices as recommended by Basel Committee on Banking Supervision, the committee recommended a review of the existing framework governing the constitution of the boards of banks and financial institutions.

December 2002 –Report of the committee (Naresh Chandra) on Corporate Audit and Governance Committee

The department of company affairs (DCA) under the ministry of finance and company affairs appointed a committee under the chairmanship of Naresh Chandra to examine various corporate governance issues. The committee took upon the task to analyze, and recommend changes in diverse areas like: the statuary auditor – company relationship, procedure for appointment of auditors and determination of audit fee, restrictions- if required on non auditory fee, measures to ensure that management and companies put forth a 'true and fair' statement of financial affairs of company. It also reflected on other measures such as certification of accounts, and financial statement by the management and directors. The committee intended to study and build upon its report following the benchmarks set by Sarbanes Oxley Law (SOX).

February 2003 (N. R. Narayan Murthy) – SEBI report on Corporate Governance

The Securities and Exchange Board of India (SEBI), in its effort to improve the governance standards constituted a committee to study the role of independent directors, related parties, risk management, directorship and director compensation, codes of conduct and financial disclosures. The committee based its recommendations on various parameters like fairness, accountability, transparency, ease of implementation, verifiability and enforceability.

July, 2003 (Naresh Chandra Committee II) Report of the committee on regulation of private companies and partnerships

The companies act, 1956 had its base in environment encompassing the license and permit raj in India. The act has undergone amendments more than two dozen occasions, keeping in view the various changes in the business environment. As large number of private sector companies was coming into picture there was a need to revisit the law again. In order to build upon this framework, government constituted a committee in January,2003 , to ensure a scientific and rational regulatory environment. The main focus of this report was on

a) The Companies Act; 1956

b) The Indian Partnership Act, 1932.

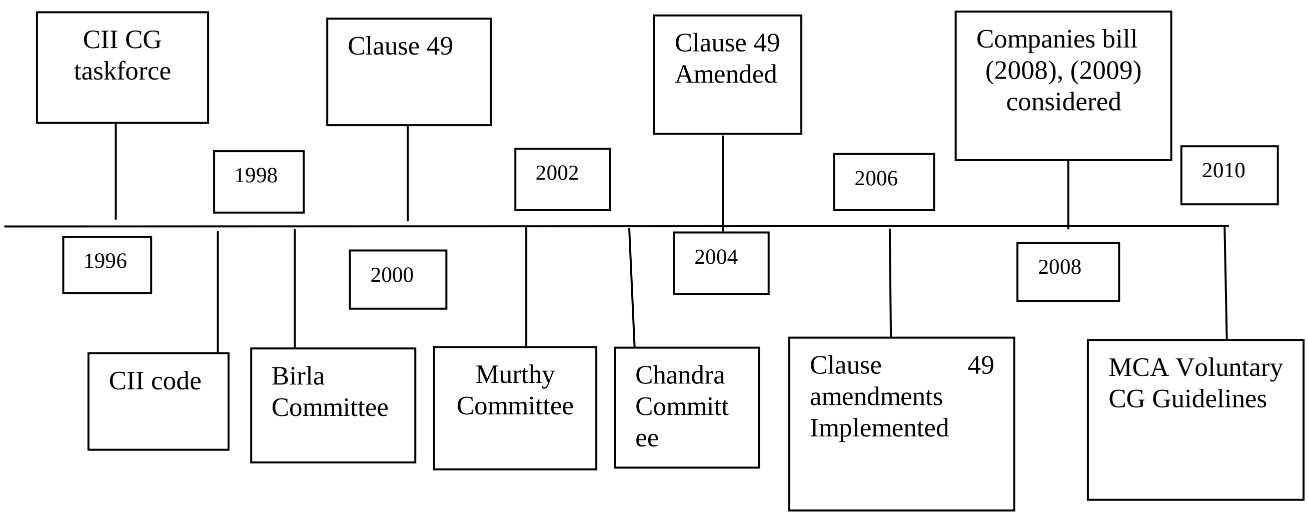
The final report was submitted in July 23, 2003.

Clause 49 Amnedments:

The Murthy Committee paid particular attention to the role and responsibilities of audit committees. It recommended that audit committees be composed of "financially literate" members, provided a greater role for the audit committee, and stated that whistleblowers should have access to the audit committee without first having to inform their supervisors. Further, the committee required that companies should annually affirm that they have not denied access to the audit committee or unfairly treated whistleblowers generally.

In 2004, SEBI further amended Clause 49 in response to the Murthy Committee's recommendations. However, implementation of these changes was delayed until January 1, 2006 due primarily to industry resistance and lack of preparedness to accept such wide-ranging reforms. While there were many changes to Clause 49 as a result of the Murthy Report, governance requirements with respect to corporate boards, audit committees, shareholder disclosure, and CEO/CFO certification of internal controls constituted the largest transformation of the governance and disclosure standards of Indian companies.

Figure: Corporate Governance major developments in India.



Clause 49, as currently in effect, includes the following key requirements:

• Board Independence Boards of directors of listed companies must have a minimum number of independent directors. Where the Chairman is an executive or a promoter or related to a promoter or a senior official, then at least one-half the board should comprise independent directors; in other cases, independent directors should constitute at least one-third of the board size.

• Audit Committees Listed companies must have audit committees of the board with a minimum of three directors, two-thirds of whom must be independent; in addition, the roles and responsibilities of the audit committee are specified in detail.

• Disclosure Listed companies must periodically make various disclosures regarding financial and other matters to ensure transparency.

• CEO/CFO certification of internal controls The CEO and CFO of listed companies must (a) certify that the financial statements are fair and (b) accept responsibility for internal controls.

• Annual Reports Annual reports of listed companies must carry status reports about compliance with corporate governance norms.

2.2.2 The Second Phase of Reform: Corporate Governance After Satyam

India's corporate community experienced a significant shock in January 2009 with damaging revelations about board failure and colossal fraud in the financials of Satyam. The Satyam scandal also served as a catalyst for the Indian government to rethink the corporate governance, disclosure, accountability and enforcement mechanisms in place. As described below, Indian regulators and industry groups have advocated for a number of corporate governance reforms to address some of the concerns raised by the Satyam scandal. Industry response shortly after news of the scandal broke, the CII began examining the corporate governance issues arising out of the Satyam scandal. Other industry groups also formed corporate governance and ethics committees to study the impact and lessons of the scandal. In late 2009, a CII task force put forth corporate governance reform recommendations. In its report the CII emphasized the unique nature of the Satyam scandal, noting that "Satyam is a one-off incident . . . The overwhelming majority of corporate India is well run, well regulated and does business in a sound and legal manner."

In addition to the CII, the National Association of Software and Services Companies (NASSCOM, self-described as "the premier trade body and the chamber of commerce of the IT-BPO industries in India") also formed a Corporate Governance and Ethics Committee, chaired by N. R. Narayana Murthy, one of the founders of Infosys and a leading figure in Indian corporate governance reforms. The Committee issued its recommendations in mid-2010, focusing on stakeholders in the company. The report emphasizes recommendations related to the audit committee and a whistleblower policy. The report also addresses improving shareholder rights. The Institute of Company Secretaries of India (ICSI) has also put forth a series of corporate governance recommendations. Government response Satyam prompted quick action by both SEBI and the MCA.

SEBI actions

In September 2009 the SEBI Committee on Disclosure and Accounting Standards issued a discussion paper that considered proposals for:

• appointment of the chief financial officer (CFO) by the audit committee after assessing the qualifications, experience and background of the candidate;

• rotation of audit partners every five years;

• voluntary adoption of International Financial Reporting Standards (IFRS);

• interim disclosure of balance sheets (audited figures of major heads) on a half-yearly basis; and

• streamlining of timelines for submission of various financial statements by listed entities as required under the Listing Agreement

In early 2010, SEBI amended the Listing Agreement to add provisions related to the appointment of the CFO by the audit committee and other matters related to financial disclosures. However, other proposals such as rotation of audit partners were not included in the amendment of the Listing Agreement.

MCA actions

Inspired by industry recommendations, including the influential CII recommendations, in late 2009 the MCA released a set of voluntary guidelines for corporate governance. The Voluntary Guidelines address a myriad of corporate governance matters including:

independence of the boards of directors;

responsibilities of the board, the audit committee, auditors, secretarial audits; and

mechanisms to encourage and protect whistleblowing.

Important provisions include:

Issuance of a formal appointment letter to directors.

Separation of the office of chairman and the CEO.

Institution of a nomination committee for selection of directors.

Limiting the number of companies in which an individual can become a director.

Tenure and remuneration of directors.

Training of directors.

Performance evaluation of directors.

Additional provisions for statutory auditors.

In discussing the voluntary nature of the guidelines, Corporate Affairs Secretary, R. Bandyopadhyay, stated that the MCA did not want to enact a rigid, mandatory law. However, the MCA also indicated that the guidelines are a first step and that the option remains open to perhaps move to something more mandatory.53 In fact, certain voluntary aspects of the guidelines, such as the separation of the office of chairman and CEO, have now been recommended for enactment in amendments to the Companies Bill pending in Parliament.

3. Impact of Clause 49 on IT Governance

Most Indian corporate entities have witnessed a heavy penetration of IT in the running of business processes. Corporate majors have gone in for massive state-of-the-art enterprise resource planning (ERP) implementations across their geographically dispersed business locations, reaping in the bargain online recording of transactions and availability of information at the click of the mouse. Major ERP vendors have come out with India-specific versions to service their expanding Indian clientele. Adding momentum to this development is the increasing offshore (and often intercontinental) acquisitions of business units by most of the top business houses over the last year, in services and manufacturing verticals. The cumulative impact of all these developments boils down to the fact that the road to corporate governance definitely lies through achieving IT governance. Many of the Indian corporate entities have started recognizing the importance of having a chief information officer (CIO) working independently and reporting directly to the board of directors, in place of the traditional reporting structure of working under and reporting to the CFO. This has lent a sense of urgency to giving the IT function its rightful place in the management scheme of things.

IT in Corporate Governance (IT Governance) ensures right decisions and accountability framework for encouraging desirable behaviour in the use of IT. IT Governance reflects broader corporate governance principles while focusing on management and use of IT to achieve corporate performance goals. Because IT outcomes are often hard to measure, firms must assign responsibility for desired outcomes and assess how well they achieve them. IT Governance should not be considered in isolation because IT is linked to other key enterprise assets (i.e. human, financial, intellectual property, physical and relationships). Thus, IT Governance might share mechanisms with other governance processes, thereby coordinating enterprise-wide decision making processes. When a carefully designed and implemented governance structure is missing there is no harmony and the enterprise is left to chance. (Weill & Ross, 2004). Governance should include an approach to exception handling and continuous improvement.

4. Conclusion

Since the late 1990s, significant efforts have been taken by Indian regulators, as well as by Indian industry representatives and companies, to overhaul Indian corporate governance. Not only have reform measures been put into place prior to discovery of major corporate governance scandals, but both industry groups and government actors have sprung into action following the Satyam scandal. The current corporate governance regime in Indian straddles both voluntary and mandatory requirements. For listed companies, the vast majority of Clause 49 requirements are mandatory. It remains to be seen whether some of the more recent voluntary corporate governance measures will become mandatory for all companies through a comprehensive revision of the Companies Act.

References:

Confederation of Indian Industry, Desirable Corporate Governance: A Code (1998).
CII Sets Up Task Force on Corporate Governance, Business Standard, Jan. 12, 2009.
Institute of Company Secretaries of India, ICSI Recommendations to Strengthen Corporate Governance Framework (Dec. 2009), available at www.mca.gov.in/Ministry/latestnews/ICSI_Recommendations_Book_8dec2009.pdf.
Joshi, V. (2004) Corporate Governance : The Indian Scenario. Foundation Books.
Ministry of Corporate Affairs, Government of India, Corporate Governance Voluntary Guidelines 2009 (December 2009), available at http://www.mca.gov.in/Ministry/latestnews/CG_Voluntary_Guidelines_2009_24dec2009.pdf
National Foundation for Corporate Governance, Corporate Governance in India: Theory and Practice (Sept. 2004).
NASSCOM Announces Formation of Corporate Governance and Ethics Committee, Business Standard, Feb. 11, 2009.
Naresh Chandra, Report of the CII Task Force on Corporate Governance 2 (November 2009), available at www.mca.gov.in/Ministry/latest news/Draft_Report_NareshChandra_CII.pdf
NASSCOM, NASSCOM Governance And Ethics Committee Releases IT's Recommendations For The IT-BPO Industry, April 27, 2010 available at www.nasscom.in/Nasscom/templates/NormalPage.aspx?id=59083.
Omkar Goswami, Aftermath Of Satyam, Businessworld (India), Jan. 23, 2009; Prashant K Sahu, Sapna Dogra & Aditi Phadnis, Satyam Scam Prompts Clause 49 Review, Business Standard, Jan. 14, 2009.
Reports on Corporate Governance, (2004), Economica India Info Services. Academic Foundation.
SEBI Committee on Disclosures and Accounting Standards, Discussion Paper on Proposals Relating to Amendments to the Listing Agreement (Sep. 2009),

available at www.sebi.gov.in/commreport/amendproposal.pdf.
Shri Kumar Mangalam Birla et al., the Securities and Exchange Board of India, Report of the Kumar Mangalam Birla Committee on Corporate Governance (1999), available at http://www.sebi.gov.in/commreport/corpgov.html.