

## Corporate Governance & Firm Performance In India: Post - Satyam The Way Ahead : What Needs To Be Done ?

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### **Abstract**

*Corporate governance has been a topic of hot debate in developed countries like U.K. & U.S.A. for the last two decades. With the opening up of economies, it has also been a concern for developing countries like India. This is because opening up of economies has changed the scenario of Indian market i.e. on the one hand, it has made the world market accessible to the Indian corporates and on the other hand, with the advent of the multinational companies it has increased competition in the domestic market. In this changed scenario, the quality of governance has been an important factor not only for survival of the companies but also for influencing the company's ability to raise money from capital market. Again corporate governance is important in Indian context because of the scams that have occurred since liberalisation in 1991, for e.g. the UTI scam, Ketan Parekh scam , Harshad Mehta scam, & the latest Satyam Fraud case.*

*In this paper, we will look into the historical background of corporate governance in India, recent developments in corporate governance in India till date, issues related with corporate governance in India . We will also look into the latest and the biggest scam that has occurred with respect to corporate governance i.e. The Satyam Fraud Case & will try to suggest some solutions so that such frauds do not occur in the near future.*

**Keywords:** Corporate Governance, Satyam Fraud Case, Liberalization, SEBI, CII, NFCG, ICAL, Ramalinga Raju, Narayana Murthy, Rahul Bajaj Committee, Birla Committee, Clause 49.

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### **1.0 Introduction :**

The term 'Corporate Governance' has become a buzzword worldwide. According to Vittal, N., this is because of two reasons. Firsts after the collapse of Soviet Union & the end of cold war in 1990 the concept of government controlling the commanding heights of the economy has gone, instead the concept that market dynamics must prevail in the economic matters has been the conventional wisdom that is accepted worldwide. Second reason is the setting up of World Trade Organisation (WTO) as a means of promoting globalisation. Globalisation involves the movement of four economic parameters namely financial capital in terms of money invested in the capital markets, physical capital in terms of plant and

machinery, financial capital in terms of money invested in the Foreign Direct Investment (FDI) & labour moving across national borders. The pace of movement of the financial capital has grown because of the world has become a global village.

## **2.0 CORPORATE GOVERNANCE IN INDIA : A BRIEF HISTORY [PRE-LIBERALIZATION i.e. PRE-1991] :**

The historical development of Indian corporate laws is marked with many interesting contrasts. For example at independence, India inherited one of the world's poorest economies but it had a factory sector which accounted for a tenth of the national product. India also had four functioning stock markets and a banking system which had well-developed lending norms and recovery procedures [Goswami, O. (2002) ]

Corporate development in India was marked by the managing agency system, which contributed to the birth of dispersed equity ownership and also gave rise to the practice of management enjoying controlling rights disproportionately greater than their stock ownership. [Goswami, O. (2002) ]

The enactment of 1951 Industries (Development & Regulation) Act & the 1956 Industrial Policy Resolution marked the beginning of a regime & culture of protection, licensing & red tape that encouraged corruption & stilted the growth of the Indian corporate sector. Soon, corruption, nepotism and inefficiency became the hallmarks of Indian corporate sector. [Chakrabarty, R., Megginson, W. & Yadav, P. (2007)]

The corporate bankruptcy and reorganisation system was also not free from problems. In this regard, we should consider the SICA or the Sick Industrial Companies Act 1985 & the Board for Industrial & Financial Reconstruction (BIFR) . According to SICA, a company is declared 'sick' only when its entire net worth has been eroded and it has been referred to BIFR. The BIFR usually took over 2 years on an average just to reach a decision with respect to the companies. Only a few companies emerged successfully from the BIFR & the legal process on an average took more than 10 years by which the assets of the company were virtually worthless. Thus, protection of the creditors' rights existed only on paper and the bankruptcy process was featured among the worst in the World Bank survey on business climate. [Goswami, O. (2002)]

Again, although the Companies Act provided clear instruction for maintaining and updating share registers yet in reality, minority shareholders often suffered from irregularities in share transfers and registrations. For example, there were cases where the rights of the minority shareholders were compromised by the management's private deals in case of corporate takeovers. [Chakrabarty, R., Megginson, W. & Yadav, P. (2007) ]

Also, for most of the pre-liberalization era the Indian equity markets were not sophisticated enough to exert effective control over the companies. Listing requirements of exchanges provided some transparency but non-compliance was not rare and was also not punished.

## **2.1 RECENT DEVELOPMENTS IN CORPORATE GOVERNANCE IN INDIA TILL DATE [POST- LIBERALIZATION i.e. POST- 1991]:**

Liberalization of the Indian economy began in 1991. Since then, there have been

major changes in both laws and regulations and in the corporate governance landscape.

- (a) The most important development in the field of corporate governance and investor protection has been the establishment of the Securities & Exchange Board of India (SEBI) in 1992. It has played a crucial role in establishing the basic minimum ground rules of corporate conduct in India. [Chakrabarty, R., Megginson, W. & Yadav, P. (2007) ]
- (b) The next significant event was the Confederation of Indian Industry (CII) Code for Desirable Corporate Governance developed by a committee chaired by Rahul Bajaj . The committee was formed in 1996 & it submitted its recommendations on April 1998. [Chakrabarty, R., Megginson, W. & Yadav, P. (2007)]
- (c) Later two more committees were constituted by SEBI, one chaired by Kumar Mangalam Birla & the other by Narayana Murthy. The Birla committee submitted its report in early 2000 and the second committee submitted its report in 2003. The recommendations of these two committees had been instrumental in bringing major changes in the corporate governance through the formulation of Clause 49 of the Listing Agreement. [ Chakrabarty, R., Megginson, W. & Yadav, P. (2007)]
- (d) Along with SEBI, the Department of Company Affairs and The Ministry of Finance , Government of India, also took some initiatives for improving corporate governance in India. For example, the establishment of a study group to operationalize the Birla Committee recommendations in 2000, the Naresh Chandra Committee on Corporate Audit and Governance in 2002 & the Expert Committee on Corporate Law (J.J. Irani Committee) in late 2004. [ Goswami, O. (2002) ]
- (e) SEBI implemented the recommendations of the Birla Committee through the enactment of Clause 49 of the Listing agreement. Clause 49, can be referred to as a milestone with respect to the changes in corporate governance in India. It is similar to Sarbanes - Oxley Act (SOX) in U.S. [Chakrabarty, R., Megginson, W. & Yadav, P. (2007)]  
 Clause 49 looks into the following matters :
  - (i) Composition of the Board of Directors.
  - (ii) Composition & Functioning of the Audit Committee.
  - (iii) Governance & disclosures regarding subsidiary companies.
  - (iv) Disclosures by the company.
  - (v) CEO/CFO certification of the financial results.
  - (vi) Reporting on corporate governance as part of the annual report.
  - (vii) Certification of compliance of a company with the provisions of Clause 49.
- (f) The National Foundation for Corporate Governance (NFCG) was formed by the Ministry of Corporate Affairs, Govt of India, in partnership with Confederation of Indian Industry (CII), Institute of Chartered Accountants of India (ICAI) & Institute of Company Secretaries of India (ICSI) with the goal of promoting better corporate governance practices in India.  
 [http://www.nfcgindia.org/aboutus.htm]

(g) Corporate Governance Voluntary Guidelines (2009) were developed by NFCG to help the companies in achieving the highest standard of corporate governance in India.

[[http://www.nfcgindia.org/pdf/CG\\_Voluntary\\_Guidelines\\_2009\\_Final.pdf](http://www.nfcgindia.org/pdf/CG_Voluntary_Guidelines_2009_Final.pdf)]

### 3.0 ISSUES IN CORPORATE GOVERNANCE IN INDIA:

Corporate governance has been a topic of hot debate in developed countries like U.K. & U.S.A. for the last two decades. With the opening up of economies, it has also been a concern for developing countries like India. This is because, opening up of economies has changed the scenario of Indian market i.e. on the one hand, it has made the world market accessible to the Indian corporates and on the other hand, it has increased competition in the domestic market with the advent of the multinational companies. In this changed scenario, the quality of governance has been an important factor not only for survival of the companies but also for influencing the company's ability to raise money from capital market.

Corporate governance is also important in Indian context because of the scams that have occurred since liberalisation in 1991, for e.g. the UTI scam, Ketan Parekh scam, Harshad Mehta scam and the latest and the biggest of them all the Satyam Fraud scam.

Another reason is that in an emerging market like India when investments take place the investors want to verify not only that the capital markets or the companies in which they have invested run competently but also have good corporate governance.

Another reason is that it is believed that poor transparency and corporate governance norms were one of the main reasons for the Asian crisis in 1997. And also because such crisis has huge impact on the economy which can set a country several years back on its path to development. [Vittal, N.]

Another reason, is that the legal and administrative environment in India provide excellent scope for corrupt practices in business. [Vittal, N.]

According to Goswami, (2000), the research on corporate governance has remained in its infancy in India because of opaque disclosure practices followed by Indian corporate sector.

However, it should be noted that the corporate governance problem in India is different from that in U.S. or U.K. The governance issue in U.S. or U.K. is that of disciplining the management while the problem in the Indian corporate sector is that of disciplining the dominant shareholder and protecting the minority shareholders. [Varma, J. (1997)]

### 4.0 THE SATYAM FRAUD CASE :

In one of the biggest frauds in India's corporate history, B. Ramalinga Raju, founder & CEO of Satyam Computers, India's fourth largest IT services firm announced on January 7<sup>th</sup>, 2009 that his company had been falsifying accounts for years, overstating revenues and inflating profits by \$ 1 billion. The Satyam scam had been referred to as 'India's Enron' by the experts.

[<http://knowledge.wharton.upenn.edu/india/article.cfm?articleid=4344>]

The admission of committing fraud and resignation by Raju showed that the company had been feeding investors, shareholders, clients and employees a steady diet of untruth with respect to its financial performance. Raju said in a letter addressed to the board, the stock exchanges & SEBI that Satyam's profit was inflated over several years to unmanageable proportions & that it was forced to carry more assets & resources than its real operations. According to Raju, 'It was like riding a tiger not knowing how to get off without being eaten'

[<http://knowledge.wharton.upenn.edu/india/article.cfm?articleid=4344>]

Raju's departure was followed by resignation of the company's CEO and appointment of an interim CEO. Meanwhile, a team of auditors from SEBI began investigation into the fraud. Also, since Satyam's stocks were registered on the New York Stock Exchange along with the Bombay Stock Exchange international regulators swung into action. Two US law firms filed class- action law suits against Satyam. Satyam's share price fell to Rs.11.50 on January 2009 compared to a high of Rs. 554 in 2008. In New York Stock Exchange also Satyam's shares were trading at \$1.80 in March 2009 as compared to \$29.10 in 2008.

[<http://knowledge.wharton.upenn.edu/india/article.cfm?articleid=4344>]

Satyam fraud case had laid bare the complete lack of accountability in the company and prompted questions about corporate governance practices of the company.

#### **(A) ROLE OF THE BOARD:**

Among the many shortcomings of the Satyam episode, the most significant one has been the role of the independent directors who were supposed to safeguard the interests of all stakeholders. While the three committees had explicitly mentioned the role, independence, remuneration & responsibilities of independent directors the same did not translate into action but remained only on paper.

[<http://www.rediff.com/money/2009/jan/19satyam-what-india-must-do.htm>. ]

According to Andrew Holland, CEO, equities Ambit capital, independent directors should also be held accountable for board decisions and audit-related compliance practices.

[<http://www.rediff.com/money/2009/jan/19satyam-what-india-must-do.htm>].

#### **(B) ROLE OF THE AUDITORS :**

Although maximum focus in the Satyam episode was on the role of the independent directors, experts believe the role of the auditors in this case Pricewaterhouse Coopers should also be taken into account.

According to a fund manager, there should be a system similar to one adopted in case of Public Sector Unit (PSU) banks where auditors are changed every three years.

[<http://www.rediff.com/money/2009/jan/19satyam-what-india-must-do.htm>.]

A major reason for the fallout of the Satyam case was the issue related to the delay in implementation of Indian corporate laws. According to N.K. Jain, Secretary & CEO of the Institute of Company Secretaries of India, the need of the hour is to enforce corporate laws in transparent, swift and uniform fashion.

[<http://www.rediff.com/money/2009/jan/19satyam-what-india-must-do.htm>].

**(B) MINORITY SHAREHOLDERS :**

According to experts, institutional investors have the tools, bandwidth and clout to extract information and play an activist role in ensuring that the management doesn't go off track as it did in the case of Satyam. If institutional investors act collectively they can demand the required change in the companies they have invested in.

[<http://www.rediff.com/money/2009/jan/19satyam-what-india-must-do.htm>]

According to Anup Bagchi, Executive Director, Industrial Credit & Investment Corporation of India (ICICI) Securities, although independent directors play an important role in ensuring better risk management, it is the demand for good governance by institutional shareholders which is the best driver towards higher governance standards. [<http://www.rediff.com/money/2009/jan/19satyam-what-india-must-do.htm>]

**(C) IMPACT ON BRAND INDIA:**

The Satyam Fraud Scam had raised concerns about the potential damage to India's appeal to foreign investors and the IT services industry in particular.

According to Michael Useem, Wharton Management Professor, one or two more accounting scandals similar to Satyam will make the foreign investors wary about investing in India.

[<http://knowledge.wharton.upenn.edu/india/article.cfm?articleid=4344>]

On the other hand, corporate India had tried to control the damage. For example, Rajeev Chandrasekhar, President of the Federation of Indian Chambers of Commerce & Industry (FICCI), called upon regulators to move quickly to demonstrate that the Satyam was an exceptional case among corporations & investors need not worry about Indian corporate governance & accounting standards.

[<http://knowledge.wharton.upenn.edu/india/article.cfm?articleid=4344> ]

Even though, Raju was widely blamed for unleashing India's Enron, a major difference between Enron & Satyam is that in Enron the CEO stonewalled, while whistleblowers came out with the truth but in Satyam there were no whistle-blowers the CEO blew the whistle on himself.

[<http://knowledge.wharton.upenn.edu/india/article.cfm?articleid=4344>]

**5.0 RECOMMENDATIONS:**

1. SEBI should develop adequate expertise for analysing financial statements so that it is able to detect fraud in the financial statements in the future.
2. The Institute of Chartered Accountants of India (ICAI) or the Government should encourage the development of a whistle-blowing committee so that anybody who finds anything doubtful or fishy about a company should report against the same immediately to the committee .
3. SEBI should reconsider its financial disclosure norms. A few years back SEBI suspended sending of printed copy of audited balance sheets to the shareholders as a cost cutting measure. In today's world , it can be done easily by uploading the same in the internet.

Bankers and Rating Agencies can also then analyse the financial statements for detecting fraud.

4. The ICAI should implement a rule, indicating that audit firms should be allowed to work as auditors of large companies for a period of two years on a rotation basis in order to avoid undue influence committed by the audit firms.
5. The Benami Transaction Prevention Act and The Prevention of Money Laundering Act, should be encouraged in order to prevent fraudulent activities and also to ensure that corrupt practices are effectively punished. [Vittal, N.]

#### 6.0 CONCLUSION :

Thus, in this paper we have tried to see the historical background of corporate governance in India, the developments in this field till date, the issues of corporate governance in India, the Satyam Fraud case and also made recommendations so that a similar fraud does not happen in the near future.

Thus, it can be concluded that while corporate governance framework in the country is seen at par with the developed countries the same has to be implemented in letter as well as in spirit.

[<http://www.rediff.com/money/2009/jan/19satyam-what-india-must-do.htm>]

Also, shareholders should ensure that the composition of the board of directors is a balanced mix of independent directors & management appointees as this would help to keep a check on the internal process of a company.

[<http://www.rediff.com/money/2009/jan/19satyam-what-india-must-do.htm>]

Finally, we should approach corporate governance issues in India not merely from the point of view of the Companies Act or the guidelines issued by Birla committee, Murthy Committee, but look at the entire network of various rules and regulations impinging on business so that an integrated wholistic system is created to ensure that transparency and good corporate governance prevail.

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