Chapter-1

Introduction: Corporate Governance - Genesis and Key Variables

Corporate India is a blend of small, large, family-owned and professionally owned companies with investors from both domestic and international realms. Investors provide financial support to these organisations, and in exchange, they expect corporations to offer a good return on their investments. However, to grow in today's competitive world, an organisation needs to gain a competitive advantage over others. Thus, it is important for an organisation to have innovative ideas, strategic planning, and compliance with laws, optimum and cordial relations among directors, shareholders, employees and customers. It is a fact that the corporate sector facilitates faster economic growth and development of a country.

Lately, Corporate Governance (CG) has been gaining importance. This is to secure a company's efficient and effective functioning and assure stakeholders that the organisation is working towards securing their interests. Corporate governance revolves around "fair and equitable treatment", for various stakeholders, as per their expectations. Thus, corporate governance (with sound principles) is fundamental to promoting economic growth and nation-building. Therefore, to achieve sustainability, while being competitive, in the present scenario, good corporate governance is emerging as a robust instrument. Further, good corporate governance helps organisation to sustain and grow in

international and domestic markets efficiently and transparently as it leads to innovative vision and strategies that deliver value to stakeholders.

The policies and procedures that govern an organisation play the most crucial role in corporate governance, as failure may lead to risk and uncertainty. It should be noted that poor CG is stated to weaken an organization's growth potential. It can even lead to financial difficulties for the Company and also enhance the scope of frauds, among others, to happen. Literature also states that that well-governed company usually outperform companies that have poor corporate governance and are even favoured by investors.

The framework of CG essentially defines "the role and responsibilities" of the BoD, various committees constituted and the management. It enables them to promote a structure for the board's policies. It provides tools such as annual meetings, committee charters, etc., to ensure that all the critical issues are dealt with. Thus, corporate governance fundamentally monitors the board's behaviour in making management decisions that align with stakeholders' interests. The board of management must involve employees of all levels while formulating strategies to maintain their acceptability and flexibility while preparing the organisation against future growth.

Corporate governance has existed since the evolution of corporate entities in various forms. During the Vedic era, kings used to have their council of ministers, tested on their good governance skills, including ethics, values, principles, and knowledge. The success and popularity of a kingdom were directly proportional to good governance practices executed by its ministers.

Before 1991, India was viewed as a closed economy, emphasising broad corporate aims and strategies. However, today, India being a democratic country has laws and

constitution to govern itself; these laws and corporate practices, including corporate governance, help organisations sustain growth. Companies like Infosys, TCS, and Reliance are examples of Indian origin giants who have succeeded and are known for their good corporate governance practices.

With the increasing interdependence and free trade among countries and citizens worldwide, stakeholders worldwide have accepted the paramount importance this concept, specifically for companies that wants to set themselves apart.

Major financial frauds that have happened during the recent past in the corporate sector, including Enron (2001), WorldCom (2002), Satyam (2009), Kingfisher (2016), and Punjab National Bank (2018), Yes Bank (2020), etc., further portray the need for good governance. Companies now need to realise that they are an "integral part" of the society, and the legitimacy of their "existence" will be determined by their acts for the common good and not by activities just for themselves, its shareholders, employees and managers alone **(Sharma et. al. 2009)**

Organisations involved in illegal tactics concerning industrial licensing, import licenses, illegal holding of money aboard, bribery and several other unethical practices given way to scams. Since India is now fully integrated with the international practices and the society is growing impatient towards such issues, good CG has taken center stage for the corporates. Hence, it is need of the hour for the corporations to adopt professionalism and transparency, in functioning. With this background, it becomes crucial to examine the "impact of CG on firm's performance in India" in the current context.

This chapter has been divided into eight subsections covering concept and genesis, major developments, principles, theories, models of CG, significance of good CG, issues and challenges of CG, CG reforms in India and CG key variables.

1.1 Corporate Governance - Concept and Genesis

This section discusses the concept of CG and its genesis highlighting the reforms in India, international developments and OECD Principles.

1.1.1 The Concept

The major issues concerning the governance of corporate entities revolve around the concept of "Agency Theory" of Management. Owners provide capital and are interested in profit maximisation. They hold the position of the principal and hire agents to manage a business. These agents (executives) are more interested in increased pay and a better working environment. Corporate governance gains prominence to deal with these conflicting interests as it deals with all the issues that arises due to the "separation of ownership from management".

CG relates to achieving corporate objectives to have interaction and involvement of the BoD, the managers, and owners to bring more transparency and protect stakeholders' interest.

Different definitions available on corporate governance are reproduced as hereunder:

The "Cadbury Committee" defined CG as "the system by which companies are directed and controlled".

The *OECD* Principles of Corporate Governance states that "Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the company's objectives are set, and the means of attaining those objectives and monitoring performance are determined."

World Bank states that "corporate governance is about maximising value subject to meeting the company's financial, legal and contractual obligation from the corporate angle. And from the public point of view, it is about nurturing an enterprise while ensuring accountability in the firm's exercise of power and patronage."

Institute of Company Secretaries of India (ICSI) states that "Corporate Governance is the application of best management practices, compliance of laws in true letter and spirit and adherence to ethical standards for effective management and distribution of wealth and discharge of social responsibility for sustainable development of all stakeholders."

Standard and Poor (S&P) defined Corporate Governance as "the way a company is organised and managed to ensure that all financial stakeholders receive a fair share of the company's earnings and assets."

*U.S. Business Round Table "*Paper on CG, September 1997", defined "Corporate governance is not an abstract goal, but exists to serve corporate purposes by providing a structure within which stockholders, directors and management can pursue most effectively the objectives of the corporation." –

Corporate Governance, Forum of Japan, 1997, states that “by definition, corporate governance rests with the conduct of the board of directors, who are chosen on behalf of the shareholders.”

Thus, from the above definitions, it may be stated that CG relates to the system, practices, and processes to control the organisation based on pillars of accountability, transparency, and fairness, focusing on serving every stakeholder. Further, the analysis of these definitions reveals that corporate governance is both a structure and a well-defined system of relationship that gives directions that could lead to corporate excellence. At the top of the corporate governance lies the BoD, which acts as a connector between the stakeholders’ expectations and the governance system.

1.1.2 The Genesis

Post-liberalisation, in 1998, the CII introduced Corporate Governance (and had set up a task force, bestowing corporate governance guidelines). These guidelines were influenced by OECD and Cadbury Committee codes. Codes were finalised as “Desirable Corporate Governance: A Code”. Following this initiative, intending to protect investors’ interest, the SEBI constituted **Kumar Mangalam Birla (K M B) Committee** in 1999**.** This Committee suggested “Clause 49 of the listing agreement”. Further, in 2002, the Department of Company Affairs appointed **N C Committee** to “investigate various corporate governance issues”. The Committee’s report on “Corporate Audit and Governance” acknowledged the suggestions of the K M B Committee. Moreover, SEBI wanted to take forward on the K M B committee’s report, since it concluded that there is still a need to establish a robust Corporate Governance Structure because governance

standards are yet evolving. Thus, to serve the twin purpose, they formulated a committee under **Narayan Murthy in 2003,** primarily focused on investors and shareholders. Further, in December 2004, **JJ Irani Committee** was constituted to address changes and bring international best practices. Further, in 2017, SEBI appointed another committee under **Uday Kotak,** aiming to improve the standards of CG of "listed companies in India".

As a result of these committees and recommendations, on the 8th of August 2013, the new Companies Act was passed in Rajya Sabha, replacing the 57-year-old Companies Act 1956. Besides the Companies Act, 2013, listed companies must comply with the guidelines laid down by SEBI (LODR). In light of the above, the growth and development of the present framework can majorly be categorised into three phases.

The **first phase** started in1999 with the recommendations of the Birla committee. Even though SEBI, which appointed the Birla committee, was established in 1992, it was only in 1999 when SEBI decided to enhance the corporate governance. Subsequently, SEBI revised its listing agreement (clause 49) and formed the Narayana Murthy Committee (after the Enron scandal in the U.S.) that suggested various reforms, including independent directors and audit committee qualifications. Along with SEBI, this phase also saw a number of initiatives from the MCA that formed the Naresh Chandra Committee, which the J.J. Irani committee followed, to bring in reforms covering all types of companies (unlike SEBI, whose scope is limited to listed entities).

The **second phase** started from the year 2009 and was triggered by the unfolding of the Satyam Scandal. In January 2009, Satyam (awarded the "Golden Peakcock Award") disclosed a huge corporate scandal. The effects of the collapse of the Satyam group were even observed in the IL&FS crises in 2019. The Satyam scandal had triggered a spate of

measures by various industry representative organisations, including MCA, SEBI, CII and NASSCOM. SEBI once again acted and amended its listing agreement in 2010. This phase further led to various committees that recommended various reforms and led the way for the third phase.

The **third phase** (the current phase) marked its presence with a landmark bill to replace the Companies Act, 1956. With the introduction of the Companies Act, 2013, the Corporate Governance Framework got its legal structure and a new direction to move towards international standards. Companies Act, 2013 also introduced various landmark reforms, including provisions for establishing the financial and audit regulatory body, i.e. NFRA (similar to PCAOB in the U.S.), to further strengthen the financial reporting framework and check the audit community.

Likewise, SEBI also issued a set of comprehensive regulations, including the very famous SEBI (LODR) (Listing Obligations and Disclosure Requirements), 2015, establishing minimum required corporate governance ground rules for all the listed entities. ICAI and the Accounting Standard Board of India also issued the Indian Accounting Standards framework aligning the Indian framework closer to IFRS (International Financial Reporting System).

1.1.3 International Developments

The historical perspective of corporate governance has been examined since the 16th century, with the East India Company (EIC) formation. The EIC remained in existence as a commercial organisation from 1600 to 1833, and from 1833 to 1857; and the first joint-

stock multinational corporation of the world that functioned as an agency its respective government.

During the initial years, EIC raised money from its stockholders for each voyage and returned proportionate profits that it made from that respective voyage. However, from 1613, the company began financing its operations through money raised on an annual basis rather than per voyage. With its stocks being traded and the unique organisational structure, technically made it the first business to separate ownership (stockholders) and control (managers).

EIC was a perfect example of a modern-day organisation, which was managed by the hierarchy of paid managers for stockholders. The company's design made it possible for the effective control of the head office over its managers. However, with this principal-agent relation, EIC also faced many problems associated with it. The most severe principal-agent problem was between the head office in Britain and managers working in the Indian sub-continent.

Thus, EIC became a complicated organisation, with employees focusing on generating wealth through private trade and also waging wars, and the Board of Directors focusing on maximising the earnings, with no interest in financing battles.

With the beginning of the 19th century, many other developments in the organised sector took place wherein besides companies created by the crown, people started engaging themselves in trade through several different ways like a sole proprietor, partnerships and unincorporated organisations. Whenever any such organisation becomes insolvent, i.e., the owner fails to repay debts, as per the law, it was regarded as an offence, thus leading to debtors' imprisonment. After that, the need for shareholders limited liability sprouted. In

1807, French took the initiative and became the first county to setup a corporation with restricted shareholders liability. Concurrently, the threat of bankruptcy also became a cause of concern in the British Parliament; as a result, in 1855, the British Companies Act was introduced that granted limited liability to all the shareholders.

In mid 19th century, the United States, New York, Financial institutions had become prominent share trading actors to build Railways Wall Street. In these corporations, life span and objectives were evidently defined; however, the state altered its existing laws and introduced limited liability clauses to attract additional wealth. Even though the first joint-stock organisation was registered in Britain post world war II, but it was more popularized in the U.S.A.

In the United States, where shareholders of the bankrupt organisation were trying to get a settlement amount from its management, they also raised questions on accountability. They argued that the board should be held responsible for its stakeholders' decisions. This argument got supported in the United Kingdom also. Consequently, Accounting Standard Steering Committee presented a draft in 1975 that demanded all businesses report publically and admit their accountability towards their stakeholders. Thus, the mid-1970s witnessed three consequential advancements in corporate governance: audit committees, a two-tier model, and corporate responsibility.

In 1985, a couple of high profile business houses collapsed, that disturbed United States. Thus, Tread way Commission was established to trace the main cause, which produced its report in 1987, stating the need for stringent internal control. Based on this report COSO was established.

Meanwhile, the failure of Bank of Credit and Commerce international, Maxwell Mirror Group international, gained the limelight in England, which made U.K. Government realise its inefficiency. After that, London Stock Exchange, FRC, in May 1991, appointed a committee called "**Cadbury Committee**", to "help raise the standards of corporate governance and level of confidence in financial reporting and auditing by setting out clearly what it sees as respective responsibility of those involved and what it believe is expected of them". It submitted its report on the "Code of Best Practices" with nineteen recommendations in Dec1992 that rocked the entire corporate world. These recommendations were related to "Separation of CEO and Chairman", "Independent Audit Committee", "Minimum # of non-executive Directors", "Enhanced role of Institutional Investors", "Remuneration Committee", "Nomination Committee" and "Public Reporting"

However, Cadbury Committee's had flaws regarding director's remuneration, that came into the limelight. After that, **Greenbury Committee** was called in 1995 to strengthen accountability and ascertain remuneration by identifying good practices. Its work was specifically split into four sections, i.e. "Remuneration Committee, Disclosure practices, Remuneration Policy, Service Contracts and Compensation".

Subsequently, in Jan 1998, **Hampel committee,** under Ronnie Hampel, was created that reviewed and enhanced Cadbury report through analysing the role of directors, shareholders and auditors, in corporate governance code. It laid 17 principles that were arranged under four heads – "Directors, Directors Remuneration, Shareholders, Accountability and Audit".

Sarbanes Oxley Act in 2002 was signed by former president of USA Gorge W. Bush, which is commonly known as SOX. Lawmakers established it to protect the "shareholders, employees and the public". It has been arranged under two titles, i.e., Section 302 of the Act is related to corporate responsibility for financial responsibility stating that all financial reports must be reviewed and fairly presented by CEO and CFO. Section 404 is connected to management assessment of internal control. A company must publish details about internal account control and financial reporting in the annual financial report.

Considering diversity in the legal and political system, the CG framework is also varied. The U.S. and U.K. systems, often referred to as the Anglo-Saxon system, rely heavily on solid legal protection to stakeholders, while the German and Japanese designs are focus on ownership. But, the need for strengthening corporate governance is felt everywhere despite variations. Further, it is relevant to mention that the Indian framework is more influenced by U.S. and U.K. frameworks.

The U.K. became the first country to give the first code in 1992, called the Cadbury Code of corporate governance. In many other countries, committee reports were submitted and popular among them: Dey Report in Canada (1992), Bosch Report in Australia (1995), Kings Report in South Africa, and others. At the international level, the WTO, World Bank and OECD have also suggested improving corporate governance.

1.1.4 OECD Principles

In 1999, OECD issued principles on the subject that act as international standards, which were later revised in 2004 and 2015. The six OECD general principles of corporate governance (2004) are:

i. "The regulatory, supervisory and enforcement authorities should establish an effective corporate governance framework so that companies operate transparently and markets remain efficient."
ii. "The corporate governance rules should be able to protect the rights of shareholders and owners."
iii. "The minority, foreign, and all types of shareholders should get equitable treatment and participation in decision making, and their rights should be protected."
iv. "The corporate governance framework should protect the rights of all stakeholders."
v. "The framework should be able to ensure proper disclosure and maintain transparency in financial statement reporting and decision making."
vi. "The companies' board of directors should be held accountable and responsible for effectively delivering and monitoring shareholder-related value."

1.2 Corporate Governance - Theories

There are various theories that cover different dimensions of corporate governance. The following six theories have been discussed in detail hereunder.

1.2.1 Agency Theory

In a work environment, all relationships have agency theory in the background. The agent acts as representative of the principal and is expected to deliver the principal's best effort without keeping his self-interest. To support the agency theory, Bengt Holmström and Oliver Hartin 1970s gave insights into contract theory. Bengt Holmström and Oliver Hart were awarded the Nobel Prize in 2016 for their insightful work on Contract theory in the 1970s.

Berle and Means (1932) mentioned agency theory in their study. This was the first mention of this theory. According to them, real decision-making power lies with managers and shareholders, who rarely participate in decision-making processes but do not get involved in everyday management. Further, **Fama and Jensen (1985)** discussed that shareholders invest in a business voluntarily and bear risk, whereas managers who hold only a minority interest in the company take all the significant decisions on behalf of shareholders. Thus, this allows managers to misuse their power and position, maximising the agency cost.

Jensen and Meckling (1976) further added that agency cost majorly depends upon factors including statutory and common law and human ingenuity of contract between shareholders and managers, for which **Daily et al. (2003)** provided the solution and discussed the importance of structured board, compensation contracts to monitor managers actively.

As per the agency theory, corporations are managed by agents, and they must take decisions by considering shareholders' interests. On the other hand, shareholders should

ensure an effective board and define clear compensation contracts for managers to ensure proper authority and accountability.

Agency theory focuses on finding solutions to principal-agent conflict of interest. The corporate governance framework helps provide solutions to many problems in shareholder management conflict of interest.

1.2.2 Stakeholder Theory

Stakeholders are those parties or groups who are associated with organisations' in some form or the other. They may have a variety of stakes and interests in the companies. Stakeholder theory does not state that representatives of all the groups need to sit on governing board, but it simply implies that to create value; one must focus on each stakeholder, as the interest of all groups is towards the same objective. "Stakeholder Theory", according to **Freeman (1984)**, centres around the dilemma of value creation and trade.

Stakeholders can be any group or individual that might affect the organisation's realization of goals. The relationship between stakeholders and the company can be well understood through their expectations. For example, a financial institution who have a stake in the organisation in the form of bonds/loans/financial instruments expect some form of return on their investment in terms of interest payments; employees expect job security, salary and other benefits in return for their services; similarly, customers expect good products and after-sales service, while suppliers expect long term relationship and on-time payments; finally local community that accommodates the firm's expected benefits through taxes, economic and social contribution.

Further, with the rise in globalisation and increased societal awareness about the business impact on society and nation, it has become essential to recognise stakeholders. Based on the stakeholder theory, "business is a set of relationships among various groups that have a stake in the business in creating value". With an economic view, it helps to resolve multiple issues, including ethics, responsibility, sustainability, and answers to questions such as what to teach managers to be successful.

If followed in letter and spirit, these practices will help ensure that organisations' protect the interest of all stakeholders. Adoption of CG will help keep stakeholder's interests in the forefront of the top management.

1.2.3 Stewardship Theory

The term "Steward" defines a person whose responsibility is to manage or supervise the needs of others. Stewardship theory suggests that top management or managers should align their interests with the shareholders' interest of achieving the organisation's objectives so that shareholder's wealth is maximized and they are satisfied with the performance of the business.

Davis et al. (1997) further explain that "stewardship theory has its roots in psychology and sociology". The theory assumes that if a manager chooses between "self-serving" and "pro-organisational behaviour", then "pro-organisational behaviour" will be selected.

According to the theory, managers behave collectively towards overall organisational objectives, i.e. profit and wealth maximisation. This behaviour of managers will directly help shareholders to prosper. If the interest of shareholders is fulfilled, this will ultimately

satisfy all the other interested stakeholders, as the organisation's wealth have a direct relationship with stakeholders need satisfaction.

Thus, the Stewardship theory propagates that managers make decisions on behalf of shareholders and be good stewards. They will favour the shareholders' interest, i.e. work in the best interest of shareholders, which ultimately help in enhancing stakeholders' interest.

The stewardship theory puts lots of responsibility on the shoulders of top management, and the adoption of corporate governance norms helps them achieve the corporate objectives as stewards of shareholders.

1.2.4 Resource Dependency Theory

This theory emphasizes the role of managers in providing the necessary resources to the company. It emphasized the role of managers in securing essential resources through their links with the external environment. These resources help in improving the organization's operations, business performance and survival.

Thus, top management should function transparently and follow ethical practices so that the organisation's stakeholders' interests are protected and they can have a long-term sustainable relationship with the organization.

1.2.5 Transaction Cost Theory

Ronald Coase (1937) gave transaction cost theory. The difference between agency theories is that it focuses on cost due to individual agents, whereas transaction cost theory relates to individual transactions. It looks at identifying how directors opportunistically

arrange transactions. Transaction cost theory focuses on the effective and efficient achievement of transactions through corporate governance norms.

1.2.6 Political Theory

This theory states that an organization must develop voting support and not purchase such votes from shareholders. It draws inferences from the functioning of political parties and how decisions are taken by the Government and ensuring power, profit, and privileges are delivered for all stakeholders.

Thus, all the above theories understand how corporate governance needs to be exercised in the current context. Of these theories, stakeholders' theory seems to be more relevant and exhaustive in the present context of the global business environment.

1.3 Models of Corporate Governance

Since all countries have different regulations for corporate governance, these have been defined as models used in various countries. These are classified as under:

1.3.1 Anglo Saxon Model

Aka the Anglo-American Model of CG, the model is characterised by outside ownership, i.e. shareholders other than promoters, well defined legal framework and a comparatively straightforward procedure for communication between shareholders and organisation. The model focuses on a single-tier board with particular emphasis on shareholders' interest and assumes separation of ownership. Under this model, owners have power to elect board and direct them altogether. Other essential characteristics of this model are:

- The model revolves around three primary players, i.e. management, shareholder and BoD.
- The BoD includes "executive and non-executive directors" and no CEO duality.
- Strong regulatory environment with federal agencies governing the entire capital market.
- Comprehensive disclosure environment.
- Equity financing is the most common method of raising funds under this model.
- Shareholder approval for majority of corporate actions.
- Strong communication by the players with availability of proxy voting rights.

1.3.2 Japanese Model

Being a multi-faceted model, it majorly revolves around banks and the financial network termed as *Keiretsu*. The organisation is managed by a bank, keiretsu (affiliating company) and management. Under this model, the board of directors are jointly appointed by the bank and Keiretsu. There is low level of input from outside shareholders. Following are the other characteristics of this model:

- Banks being the shareholders are deeply involved in the matters of corporation.
- The top governance layer is majorly comprised of insiders, i.e. executive members/heads of major divisions. However, the main bank and Keiretsu members can remove directors and appoint their candidates.
- Strong regulatory framework through government ministries and regulatory bodies including Securities Bureau of Ministry of Finance, Securities exchange Surveillance Ministry.

- Stringent disclosure requirements on semi annual basis.
- Appointment of directors and dividend decision is taken for shareholder approval in annual meetings.

1.3.3 German Model

Also known as European Model, the model is two-tier, as the company is managed through two boards, i.e. “Management Board” and the “Supervisory Board". The “Management Board” comprises insiders and is represented by the employees and labour. The “Supervisory Board” is defined by the Government and cannot be changed at the shareholders level.

It becomes essential to note that the German model is similar to the Japanese model as wealthy families and foreign investors usually finance business houses. However, the feature of restrictive voting distinguishes the two. The German model against the Japanese model, irrespective of shareholding held by the individual/institution, enables restrictions over the voting rights held by an individual/institution for decision making.

1.3.4 Indian Model of Governance

The sociocultural and economic milieu of India is critical in the development of an Indian corporate governance model. Since India is the oldest and richest heritage globally and has contributed significantly in terms of art, culture, scientific knowledge, spiritualism, yoga, etc., Indian traditions, philosophy of life, governance systems are unique and need to be incorporated into the corporate governance system.

Ethics have always been an essential part of Indian traditional knowledge. It does not merely help determine what actions need to be performed but also serves as a vital tool to resolve business dilemmas. Based on Indian ethics, an ethical organisation will permanently save the interest of society and flourish based on its fairness and integrity towards the benefits of stakeholders. Ethics incorporate a personal sense of value and social value of a business which help in preventing harm to the society and improve brand image.

Further, in India, the quality of corporate governance is identified by the decisions of top management, for example how the management hands out financial resources between themselves and stakeholders. The stakeholders' expects that such decisions are taken with integrity, honesty and transparency. Moreover, to succeed in this competitive world, the board of directors of an organisation must have efficient leadership traits and run the organisation with ethical values and principles.

The concept of CG is not new even in India. Its essence can be observed through ancient books. Karma Yoga advocates performing your duties without expecting the fruits of your actions. Sama Shatro cha Mitre Cho talks about equality. Kautilya's Arthasasthra supported economic advancements through good governance, presented few thoughts regarding board size, and reduced corruption and penalties for fraud. Upnishads also contributed by outlining leadership traits as Vasudhaiva Kutumbakam enlightens that healthy and fair competition can be maintained by following ethics and morality. It must be noted here that ancient Indian scriptures did not just mention the concept of corporate governance theme but also incorporated political, economic and ethical views and the theories that modern management is now being adopted.

Similarly, in the 19th century, Mahatma Gandhi encouraged Ramrajya through his trusteeship theory. He believed that wealthy people are the trustees, and they should look after the welfare of society. Further, Nehru's Satatic model thought that Indian culture was rich but static at the same time as the crowd's attitude is complex. He believed that present resources were not being utilised to the fullest. Hence, he contributed towards human development and economic development by shaping Indian policies.

In 1913, Company Act was incorporated in India, thereby introducing the concept of the Board of Directors. However, initial moves did not yield satisfactory results/outcomes. In 1956 amendments were made in the Companies Act to deal with managing agencies operating in India.

Finally, in the late 20th century, India witnessed liberalisation. To optimally reap the benefits of LPG policy and attract FIIs, it became necessary to introduce corporate governance. Thus CII, in 1998, introduced this reform as a voluntary measure.

Indian corporate governance framework, consisting mainly of the Companies Act, 2013, which draws provisions to facilitate good corporate governance, SEBI-LODR, MCA, the ICAI, ICSI and the recently formed NFRA to meet international standards.

1.4 Significance of Good Corporate Governance (CG)

Companies now adopt CG practices as a matter of compulsion, but the following good governance norms highlights its significance to the business. These are discussed hereunder:

- **Inculcating Participative Attitude**- Top Management should create clear lines of communication within the organisation. They should be responsive and inculcate participation in the organisation.
- **Reducing the k0 -** The implementation of good governance practices can reduce a company's cost of capital. Companies can generate funds at a low cost.
- **Better decision-making –** Good governance ensures that decision making is more transparent, democratic, has open communication and decisions are acceptable to all. This will help improve the performance and long term sustainability of organisations.
- **Better internal controls –** Implementing internal and external controls become more effective with good governance practices in place. The chances of frauds reduce and accountability improves.
- **Effective strategic planning-** Better communication, access to full information in management will automatically lead to better strategic planning, which will help optimum utilisation of resources and capital. A strong framework will help understand the regulatory environment better, discussing points of view with each other etc.
- **Attracting Human Resource-** Bringing in talented NED with required skills help drive organization towards sustainability.

1.5 Issues and Challenges of Corporate Governance

The issues and challenges which Indian corporations face related to following Corporate Governance (CG) norms are discussed hereunder.

- **Oversight**- Effective CG means the BoD should be aware of daily work in the company and if the objectives are being achieved.
- **Conflict of Interest-** Avoiding conflicts of interest is necessary, but sometimes the board members, controlling team, or the company officers have different vested interests that can create a challenge in fulfilling the company's goals. The role of agency costs comes into play to safeguard these.
- **Accountability**- Each level and department should be accountable and should give the regular working report a whole company can be in problem if even one person fails to account for its performance.
- **Transparency -** A company should be transparent and accurate in showing their profits and losses, figures and should not try to cheat or hide the actual standing of the company. If the company is found to be guilty, hiding its actual position can seriously damage its image and its relationship with stakeholders.
- **Ethics**- A company has a moral obligation to protect the social welfare of customers, stakeholders and others, and it should not misuse the resources and environment and fulfil its responsibility with its best efforts.

1.6 Corporate Governance Reforms in India

This section highlights the major provisions of Companies Act and SEBI guidelines.

1.6.1 Provisions of the Companies Act, 2013

This regulates the Companies from incorporation to dissolution of an organisation, including responsibilities of directors, appointment of auditors, transaction with related parties among others. The Act lays down provisions for governing all the listed as well as unlisted organisations in India. Under this Act, for the first time, duties of directors and policy of whistle-blower are addressed.

Table 1.1 – Comparison of **Companies Act**, **1956 and Companies Act**, **2013**

Comparison	**Analysis**
Maximum limit of Directors on Board - Companies Act, 1956 fixed the upper limit for # of directors to 12 or lower. Companies Act, 2013 increased # to 15. It further allowed the company to appoint a higher number of directors through a special resolution.	Allowed flexibility to the company in appointment of directors, to take benefit of more experience and competence to the Board of Directors.
Academic Qualifications of Director members of the Audit Committee (AC) - Companies Act, 1956 had not specified educational norms for the BoD. Act, 2013 provides that majority of the AC members should understand financial reports and statements.	Ensures that members are qualified to lead the organization effectively.
Woman Director - Companies Act, 1956 did not have any provision in this regard. Companies Act, 2013 has specified minimum 1 female member on the Board of Directors companies as may be prescribed.	Makes the BoD more gender-sensitive.
Residential Status of Directors - Companies Act, 1956 did not have any provision in this regard. Companies Act, 2013 provides that at least 1 director should have put up in India for majority days during the previous year.	Ensures that the BoD remains in India to provide adequate time to Companies operations/affairs.
Independent Directors - Companies Act, 1956 did not have any provision in this regard. Companies Act, 2013 provides for "at least 1/3rd" of the total strength of the BoD registered on the exchange.	Act, 2013 has made the Act compatible with the regulatory provisions of SEBI.
Board Meetings - Companies Act, 1956 did not have any provision with regards to providing notice period for convening a board meeting. Companies Act, 2013 provides "at least 7 days' notice" to	Provides sufficient time to the Board members. Increases the importance of Independent Directors, since a

convene a Board meeting. To transact an urgent business, the Act relaxes the requirement and, requires a minimum of one Independent Director should attend the meeting. However, independent director should ratify decisions taken at a meeting convened without an independent director.	minimum of one ID is required to either attends the meeting or ratify the decisions.
Audit Committee - Companies Act, 1956 required constitution of Audit Committee for every public company (whether listed or not) with paid up capital > five corers. Companies Act, 2013 makes it compulsory "for all listed companies and other prescribed to form Audit committees". This also provides that the majority of directors in the Committee should be IDs.	The new act recognizes Audit Committee as the most important pillar of CG. The New Act also enhances their duties and powers.
Nomination and Remuneration Committee - Companies Act, 1956 did not have any provision in this regard. Companies Act, 2013 makes it compulsory requirement for "all companies listed on stock exchanges and other prescribed companies" to have such a committee. The Committee should comprise 3 or more NED, and at ½ of the BoD should be ID.	Brings professionalism and transparency in selecting and remuneration of directors, KMPs and other employees.
Stakeholder Relationship Committee - Companies Act, 1956 did not have any provision in this regard. Companies Act, 2013 requires a company with over 1,000 security holders to constitute such a committee.	The new Act broadens the scope by bringing in more stakeholders other than shareholders in the ambit of the BoD.
Independent Directors - Unlike 1956 Act, 2013 Act provides a comprehensive definition of "Independent Directors".	2013 Act places a great deal of responsibility on Independent Directors.
Insider Trading - Companies Act, 1956 did not have any provision in this regard. Companies Act, 2013 has introduced provisions relating prohibition of such trading and penalties.	This tries to level the stage for minority/retail shareholders.
Related Party Transactions - 2013 Act has made the law with regards to conduct of RPTs more stringent. One of the biggest difference form Companies Act, 1956 is that Companies Act, 2013 has broaden the scope of the term related parties to include shadow directors and relatives of managerial persons as well.	Objective is to broaden the concept of the related parties and makes the nature of RPTs more clear.

1.6.2 SEBI Guidelines (LODR)

In 1992, SEBI was formed under the Securities and Exchange Board of India Act. The main objectives of SEBI are to keep a check on corporate frauds such as late payments, lack of transparency, insider trading, price manipulation, violation of stock exchange and listing requirement rules and regulations. SEBI has the right to investigate cases and terminate such organisations from the securities list if found guilty.

Comparison of 2013 Act and the SEBI (LODR), 2015, is highlighted in below table.

Table 1.2 – Comparison of SEBI clause 49 and SEBI (LODR)

Basis of difference.	Clause 49 (October 2004) as amended	Amendments to Clause 35B (April 2014) since rescinded and forming part of SEBI(LODR) September 2015
Woman Director	Not Required	BoD shall necessarily have atleast one woman director.
Proportion of Independent Directors	Atleast one third of BoD	If the chairman of the Board is a NED, the proportion should be at least 1/3rd. If the Company has a chairman who is a promoter, the board should have at least ½ of its strength as ID.
Independent Director	Only had a few provisions, including appointment, # of ID and meaning of ID.	Following Companies Act, 2013, SEBI has introduced appointment of ID along with their duties, and code of conduct
Meeting of ID	Not Required	Minimum one meeting of ID in a year where all such members should be present.
Formal letter of appointment to Independent Directors, its display on website and information to stock Exchange	Not Required	Required
Detailed provisions regarding Performance Evaluation and continuation of Independent Directors on the basis of Performance Evaluation	Non-mandatory requirements.	Mandatory requirement.
Tenure and Rotation of Independent Directors	Non-mandatory requirement (Not exceeding nine years).	Mandatory requirement with detailed provisions.
Stock options to Independent Directors	Allowed	Not Allowed
Scope of Audit Committee	Scope was restricted	Scope has been broadened in light of the 2013 Act.
Nomination and Remuneration Committee	Non Mandatory requirement.	Mandatory requirement, with a compulsion of appointing an ID as Chairman.
Stakeholder Relationship Committee	Provision of a Shareholder Committee to address the grievances of the shareholders.	Enhanced scope and role with 2013 Act
Risk Management	Few Provisions	Detailed provisions. Further, for the top 100 listed companies determined, it is mandatory to set up such a Risk Management Committee.
Whistle-Blower	Non Mandatory requirement.	Mandatory requirements.

Related Party transactions	No specific approval was required.	Approval for all RPTs.

1.7 Corporate Governance - Key Variables

Good governance practices followed by companies help in long term sustainability of organisations. CG norms are now compulsory to follow for every company. But each company can vary in terms of CG characteristics. This sub section discusses main CG key variables in terms of their relevance for firm performance.

1.7.1 Board Independence

The BoD of companies formulates strategy and keeps an eye on their operations. The purpose of board is to bring a balance in various interests vested in the board. Independent directors can bring objectivity in the board processes and protect the minority interest of small stakeholders. It helps small shareholders voices being heard on the board. Independent directors (IDs) are supposed to take care of those stakeholders who are not represented in the board in terms of their interest, needs and aspirations being conveyed and protected. Independent directors have to see that their performance is not influenced by the management. The concept of IDs is created to monitor the EDs. They may challenge CEOs and management about their decisions and functioning by asking questions about product lines, operations, market segmentation, and other decisions.

Thus, board independence improves firm performance by bringing unbiased decision-making, making sure interest of all stakeholders are protected, bringing objectivity to the board, keeping a check on executive directors' decisions, and improving effectiveness of the decision-making and business performance.

1.7.2 Gender Diversity in the Board

The philosophy of business is to ensure high standards of ethics and fairness to stakeholders. The corporate culture should have transparency, integrity, accountability and professionalism. All this is possible by bringing board diversity to achieve higher performance. A diverse board gets advantages from diverse knowledge, skill set, industry experience, culture, gender, thought, and perspective, which helps a business gain a competitive advantage. Gender diversity on the board enhances board effectiveness. Having women directors on the Board has been made mandatory in the present Companies Act. The women director on the board brings more corporate credibility and also improves governance standards in the organisations. Gender diversity brings the diversity of thought, actions and brings a different perspective to the overall scenario. Companies may think of bringing diversity to match the required skill set.

Diversity on board can only come when members' perspectives are valued and listened to. There is more need to bring open communication to the board, and the CEO or chairman should allow a participatory approach to ensure that benefits of diversity can be taken. The board effectiveness will be achieved if the diverse boards have a more egalitarian culture, allowing integrating contrasting insights. Boards can create collegial boards to motivate acceptance and integrating differences of opinion.

If gender diversity and board diversity are implemented with an egalitarian culture, then board effectiveness can improve, which will improve firm performance and make a more socially responsible and sustainable business environment.

1.7.3 Board Meetings

Coles et al., 2008 states that **t**he BoD performs two functions – advising and monitoring. They should create a balance between both functions to improve firm performance. Advising function relates to strategic decision making, and monitoring function is towards observing the day-to-day operations and decisions. The advising role leads to value creation by helping the top management with strategic decisions. The monitoring function reduces agency problems and ensures proper accountability of the board. This is achievable through a higher frequency of meetings and the intensity of the discussion on the agenda. Meetings of the BoD also have a important role in ensuring the proper functioning of the business. The board's composition, board activities represented by board meetings enhance monitoring. The intensity and frequency of board meetings is a crucial factor for “good governance”. The firm performance will be impacted by the number of meetings, the portion of members attending those meetings, intensity of their discussion, objectivity followed by independent directors.

1.7.4 Audit Committees (AC)

Effective corporate governance can be implemented with an independent committee. The role of AC is to have an oversight of the auditing process, specifically. They need to function with objectivity and independence to bring fairness to the financial statements. They have a vital role in protecting investors. One member of the committee is a subject expert. The role of management is to prepare financial statements, establish ICFR. The independent auditor is responsible for ensuring that all laws are followed, and the financial

statement shows a fair picture of the financial health. The AC works in cohesion with these auditors and tries to identify the chances of any frauds likely to happen.

Thus, effective corporate governance is possible with the help of the transparent functioning of an independent committee. This also improves the financial performance of the business and builds sustainable organisations.

1.7.5 Financial Performance

Corporate Governance impacts firm performance in many ways. It impacts the financial and operational efficiency of business. It has an impact on social responsibility and the long term sustainability. The main financial performance indicators which have impact on corporate governance includes: market valuation, profit and returns, stakeholder related value, replacement value, solvency and sustainability, asset growth and market growth.

1.7.6 Social Performance

Its strategies and operations influence the performance of a corporation in a market or non-market setting. Traditionally, a firm’s performance is measured from an accounting perspective, where financial statements and reports portray a firm's status. With increased awareness among stakeholders, organisations realise the importance of non-market strategies. One of the significant components that fall into the non-market environment is corporate environmental and social responsibility performance.

They are drawing from agency theory and stewardship theory, the manager act as a steward of the owner, who has the right to know how managers are utilising his property. Similarly, as the organisations use society’s resources, it is the management duty to act as

a steward of society and timely justify their actions towards society's welfare. Further, drawing from stakeholder's theory of corporate governance that portrays an ethical approach to management, i.e. various parties who hold a stake in the organisation need to be identified as business parameters and have some responsibilities. It is essential to create a balance between shareholder and stakeholders' interests.

Corporate social performance (CSP) is considered an integral component of CG. Sometimes CSP and CSR are used interchangeably. Although CSR deals which the obligation that organisation has towards stakeholders and CSP is related to the outcome of CSR, i.e. the actual results achieved from CSR activities. Therefore, Corporate Social Performance (CSP) can be defined as the outcome of the company's action and relationship with various stakeholders such as consumers, Government, etc.

In the early 20th century, CSR was considered as an act of "repaying" the society, noble favour. But with time, it was realised that it is not about repaying instead, it is about reducing the negative externalities of an organisation or rectifying the consequences of business activities. However, business houses by themselves were not contributing enough towards CSR activities. Thus, under U.N. Global Compact, WTO established rules of conduct that bind organisations to contribute towards social and environmental welfare.

Similarly, in India, with an amendment in the Companies Act, establishing a CSR committee (sec. 135) for companies has been mandated. It applies to all listed entities above a defined threshold. MCA released a circular stating that the CSR committee should constitute 3 or more directors, with at least one ID, and "spend at least 2 percent of the avg. net profit of the last 3 years on CSR."

In 2011, Business Responsibility Reporting (BRR) was mandated "for the top 100 listed entities" to promote transparency and accountability towards stakeholders and increase the need for sustainability. In 2015, it was extended to "the top 500 Companies as per market capitalisation". BRR are disclosures in line with "National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business" (NVGs) issued by the MCA. These disclosures are about the environment, social and governance issues linked to Global Reporting Initiatives (GRI), sustainability reporting standards globally accepted standards.

CSR is a self-regulatory paradigm that allows a firm to be responsible towards the society. By practicing CSR, the Company or the corporate citizenship, companies can have positive impact on environment that includes both economic and social.

CSR as a concept can take many forms, and is dependent upon the company and its industry. Through CSR programs, organizations can benefit society and increase their brand value. CSR enables organization to make stronger bond within the organization as well.

To be socially responsible, Company needs to be first be accountable to itself and its shareholders. Therefore, often it is observed that only large enterprises that have grown to a certain level engage in CSR.

1.8 Concluding Remarks

The chapter discusses the genesis of corporate governance, recent developments, theories of Corporate Governance (CG), framework and models adopted by various countries, key variables and relationship of CG with financial performance and social performance.

CG is a mechanism that ensures that investors and shareholders get satisfactory return on investment and equitable treatment. It also aligns top management interest with the stakeholder's interest. However, in the past a number of corporate collapses that have been witnessed despite regulatory framework, the relevance of good corporate governance in modern organisations has increased manifold.

The main objectives of corporate organizations are wealth maximization and long term sustainability. However, to have these both it is important that organizations are governed by policies and procedures that have transparency, fairness and accountable and responsible management. Thus, it has become essential to have a broader perspective in measuring the firm's performance i.e. incorporating financial and social performance parameters while evaluating the organisation. Also, CG and its relationship with a "firm's performance" have been discussed in the present study.