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Title

A STUDY OF CORPORATE GOVERNANCE- EVOLUTION AND CHALLENGES WITH SPECIAL REFERENCE TO IMPLEMENTATION OF E-GOVERNMENT IN INDIA

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Abstract:

While recent high-profile corporate governance failures in developed countries have brought the subject to media attention, the issue has always been central to finance and economics. The issue is particularly important for developing countries since it is central to financial and economic development. Recent research has established that financial development is largely dependent on investor protection in a country. With the legacy of the English legal system, India has one of the best corporate governance laws but poor implementation together with socialistic policies of the pre reform era has affected corporate governance. Concentrated ownership of shares, pyramiding and tunneling of funds among group companies mark the Indian corporate landscape. Boards of directors have frequently been silent spectators with the DFI nominee directors unable or unwilling to carry out their monitoring functions. E-Government is the use of information and communication technologies (ICTs) to improve the activities of government agencies. The e-readiness index of India is found to be low as compared to other countries. There are various challenges for the implementation of e-government in India. These challenges are like low literacy, low per capita income and limited financial resource. In this paper a conceptual framework is suggested for the effective implementation of e-government in India.

Key words: - Resource Allocation, Capitalization, Return on Assets, Shareholders' Wealth, Capacity Building, E-Readiness

Introduction:

The subject of corporate governance leapt to global business limelight from relative obscurity after a string of collapses of high profile companies. Enron, the Houston, Texas based energy giant, and WorldCom, the telecom behemoth, shocked the business world with both the scale and age of their unethical and illegal operations. Worse, they seemed to indicate only the tip of a dangerous iceberg. While corporate practices in the US companies came under attack, it appeared that the problem was far more widespread. Large and trusted companies from Parmalat in Italy to the multinational newspaper group Hollinger Inc., revealed significant and deep-rooted problems in their corporate governance. Even the prestigious New York Stock Exchange had to remove its director, Dick Grasso, amidst public outcry over excessive compensation. It was clear that something was amiss in the area of corporate governance all over the world.

Corporate governance has been a central issue in developing countries long before the recent spate of corporate scandals in advanced economies made headlines. Indeed corporate governance and economic development are intrinsically linked. Effective corporate governance systems promote the development of strong financial systems – irrespective of whether they are largely bank-based or market-based – which, in turn, have an unmistakably positive effect on economic growth and poverty reduction. There are several channels through which the causality works.

Effective corporate governance enhances access to external financing by firms, leading to greater investment, as well as higher growth and employment. The proportion of private credit to GDP in countries in the highest quartile of creditor right enactment and enforcement is more than double that in the countries in the lowest quartile. As for equity financing, the ratio of stock market capitalization to GDP in the countries in the highest quartile of shareholder right enactment and enforcement is about *four* times as large as that for countries in the lowest quartile. Poor corporate governance also hinders the creation and development of new firms.

Good corporate governance also lowers of the cost of capital by reducing risk and creates higher firm valuation once again boosting real investments. There is a variation of a factor of 8 in the "control premium" (transaction price of shares in block transfers signifying control transfer less the ordinary share price) between countries with the highest level of equity rights protection and those with the lowest.

Effective corporate governance mechanisms ensure better resource allocation and management raising the return to capital. The return on assets (ROA) is about twice as high in the countries with the highest level of equity rights protection as in countries with the lowest protection. Good corporate governance can significantly reduce the risk of nation-wide financial crises. There is a strong inverse relationship between the quality of corporate governance and currency depreciation. Indeed poor transparency and corporate governance norms are believed to be the key reasons behind the Asian Crisis of 1997. Such financial crises have massive economic and social costs and can set a country several years back in its path to development. Finally, good corporate governance can remove mistrust between different stakeholders, reduce legal costs and improve social and labor relationships and external economies like environmental protection.

Making sure that the managers actually act on behalf of the owners of the company – the stockholders – and pass on the profits to them are the key issues in corporate governance. Limited liability and dispersed ownership – essential features that the joint-stock company form of organization thrives on – inevitably lead to a distance and inefficient monitoring of management by the actual owners of the business. Managers enjoy actual control of business and may not serve in the best interests of the shareholders. These potential problems of corporate governance are universal. In addition, the Indian financial sector is marked with a relatively unsophisticated equity market vulnerable to manipulation and with rudimentary analyst activity; a dominance of family firms; a history of managing agency system; and a generally high level of corruption. All these features make corporate governance a particularly important issue in India.

Central issues in Corporate Governance:

The basic power structure of the joint-stock company form of business, in principle, is as follows. The numerous shareholders who contribute to the capital of the company are the actual owners of business. They elect a Board of Directors to monitor the running of the company on their behalf. The Board, in turn, appoints a team of managers who actually handle the day-to-day functioning of the company and report periodically to the Board. Thus mangers are the agents of shareholders and function with the objective of maximizing shareholders' wealth.

Even if this power pattern held in reality, it would still be a challenge for the Board to effectively monitor management. The central issue is the nature of the contract between shareholder representatives and managers telling the latter what to do with the funds contributed by the former. The main challenge comes from the fact that such contracts are necessarily "incomplete". It is not possible for the Board to fully instruct management on the desired course of action under every possible business situation. The list of possible situations is infinitely long. Consequently, no contract can be written between representatives of shareholders and the management that specifies the right course of action in every situation, so that the management can be held for violation of such a contract in the event it does something else under the circumstances. Because of this "incomplete contracts" situation, some "residual powers" over the funds of the company must be vested with either the financiers or the management. Clearly the former does not have the expertise or the inclination to run the business in the situations unspecified in the contract, so these residual powers must go to management. The efficient limits to these powers constitute much of the subject of corporate governance. The reality is even more complicated and biased in favor of management. In real life, managers wield an enormous amount of power in joint-stock companies and the common shareholder has very little say in the way his or her money is used in the company. In companies with highly dispersed ownership, the manager (the CEO in the American setting, the Managing Director in British-style organizations) functions with negligible accountability. Most shareholders do not care to attend the General Meetings to elect or change the Board of Directors and often grant their "proxies" to the management. Even those that attend the meeting find it difficult to have a say in the selection of directors as only the management gets to propose a slate of directors for voting. On his part the CEO frequently packs the board with his friends and allies who rarely differ with him. Often the CEO himself is the Chairman of the Board of Directors as well. Consequently the supervisory role of the Board is often severely compromised and the management, who really has the keys to the business, can potentially use corporate resources to further their own self- interests rather than the interests of the shareholders.

Common areas of management action that may be sub-optimal or contrary to shareholders' interests (other than outright stealing) involve excessive executive compensation; transfer pricing, that is transacting with privately owned companies at other-than- market rates to siphon off funds; managerial entrenchment (i.e. managers resisting replacement by a superior management) and sub-optimal use of free cash flows. This last refers to the use that managers put the retained earnings of the company. In the absence of profitable investment opportunities, these funds are frequently squandered on questionable empire-building investments and acquisitions when their best use is to be returned to the shareholders.

Keeping a professional management in line is only one, though perhaps the most important, of the issues in corporate governance. Essentially corporate governance deals with effective safeguarding of the investors' and creditors' rights and these rights can be threatened in several other ways. For instance, family businesses and corporate groups are common in many countries including India. These range from *Keiretsus* in Japan and *Chaebols* in Korea to the several family business groups in India like Birlas and Ambanis. Inter-locking and "pyramiding" of corporate control within these groups make it difficult for outsiders to track the business realities of individual companies in these behemoths. In addition, managerial control of these businesses are often in the hands of a small group of people, commonly a family, who either own the majority stake, or maintain control through the aid of other block holders like financial institutions. Their own interests, even when they are the majority shareholders, need not coincide with those of the other – minority – shareholders. This often leads to expropriation of minority

Shareholder value through actions like "tunneling" of corporate gains or funds to other corporate entities within the group. Such violations of minority shareholders' rights also comprise an important issue for corporate governance.

One way to solve the corporate governance problem is to align the interests of the managers with that of the shareholders. The recent rise in stock and option related compensation for top managers in companies around the world is a reflection of this effort. A more traditional manifestation of this idea is the fact that family business empires are usually headed by a family member. Managerial ownership of corporate equity, however, has interesting implications for firm value. As managerial ownership (as a percentage of total shares) keeps on rising, firm value is seen to increase for a while (till ownership reaches about 5% for Fortune 500 companies), then falling for a while (when the ownership is in the 5%-25% range, again for Fortune 500 companies) till it begins to rise again.10 The rationale for the decline in the intermediate range is that in that range, managers own enough to ensure that they keep their jobs come what may and can also find ways to make more money through uses of corporate funds that are sub-optimal for shareholders.

Legal environment, ownership patterns and Corporate Governance:

The legal system of a country plays a crucial role in creating an effective corporate governance mechanism in a country and protecting the rights of investors and creditors. The legal environment encompasses two important aspects – the protection offered in the laws (*de jure* protection) and to what extent the laws are enforced in real life (*de facto* protection). Both these aspects play important roles in determining the nature of corporate governance in the country in question.

In India, enforcement of corporate laws remains the soft underbelly of the legal and corporate governance system. The World Bank's Reports on the Observance of Standards and Codes (ROSC) publishes a country-by-country analysis of the observance of OECD's corporate governance codes. In its 2004 report on India23, the ROSC found that while India observed or largely observed most of the principles, it could do better in certain areas. The contribution of nominee directors from financial institutions to monitoring and supervising management is one such area. Improvements are also necessary in the enforcement of certain laws and regulations like those pertaining to stock listing in major exchanges and insider trading as well as in dealing with violations of the Companies Act – the backbone of corporate governance system in India. Some of the problems arise because of unsettled questions about jurisdiction issues and powers of the SEBI. As an extreme example, there have been cases of outright theft of investors' funds

with companies vanishing overnight. The joint efforts of the Department of Company Affairs and SEBI to nail down the culprits have proved to be largely ineffective. As for complaints about transfer of shares and non-receipt of dividends while the redress rate has been an impressive 95%, there were still over 135,000 complaints pending with the SEBI. Thus there is considerable room for improvement on the enforcement side of the Indian legal system to help develop the corporate governance mechanism in the country.

Corporate Governance in India – a background:

The history of the development of Indian corporate laws has been marked by interesting contrasts. At independence, India inherited one of the world's poorest economies but one which had a factory sector accounting for a tenth of the national product; four functioning stock markets (predating the Tokyo Stock Exchange) with clearly defined rules governing listing, trading and settlements; a well-developed equity culture if only among the urban rich; and a banking system replete with well-developed lending norms and recovery procedures.24 In terms of corporate laws and financial system, therefore, India emerged far better endowed than most other colonies. The 1956 Companies Act as well as other laws governing the functioning of joint-stock companies and protecting the investors' rights built on this foundation. The beginning of corporate developments in India were marked by the managing agency system that contributed to the birth of dispersed equity ownership but also gave rise to the practice of management enjoying control rights disproportionately greater than their stock ownership. The turn towards socialism in the decades after independence marked by the 1951 Industries (Development and Regulation) Act as well as the 1956 Industrial Policy Resolution put in place a regime and culture of licensing, protection and widespread red-tape that bred corruption and stilted the growth of the corporate sector. The situation grew from bad to worse in the following decades and corruption, nepotism and inefficiency became the hallmarks of the Indian corporate sector. Exorbitant tax rates encouraged creative accounting practices and complicated emolument structures to beat the system.

In the absence of a developed stock market, the three all-India development finance institutions (DFIs)– the Industrial Finance Corporation of India, the Industrial Development Bank of India and the Industrial Credit and Investment Corporation of India – together with the state financial corporation's became the main providers of long-term credit to companies. Along with the government owned mutual fund, the Unit Trust of India, they also held large blocks of shares in the companies they lent to and invariably had representations in their boards. In this respect, the corporate governance system resembled the bank-based German model where these institutions could have played a big role in keeping their clients on the right track. Unfortunately, they were themselves evaluated on the quantity rather than quality of their lending and thus had little incentive for either proper credit appraisal or effective follow-up and monitoring. Their nominee directors routinely served as rubber-stamps of the management of the day. With their support, promoters of businesses in India could actually enjoy managerial control with very little equity investment of their own. Borrowers therefore routinely recouped their investment in a short period and then had little incentive to either repay the loans or run the business. Frequently they bled the company with impunity, siphoning off funds with the DFI nominee directors mute spectators in their boards.

This sordid but increasingly familiar process usually continued till the company's net worth was completely eroded. This stage would come after the company has defaulted on its loan obligations for a while, but this would be the stage where India's bankruptcy reorganization system driven by the 1985 Sick Industrial Companies Act (SICA) would consider it “sick” and refer it to the Board for Industrial and Financial Reconstruction (BIFR). As soon as a company is registered with the BIFR it wins immediate protection from the creditors’ claims for at least four years. Between 1987 and 1992 BIFR took well over two years on an average to reach a decision, after which period the delay has roughly doubled. Very few companies have emerged successfully from the BIFR and even for those that needed to be liquidated, the legal process takes over 10 years on average, by which time the assets of the company are practically worthless.

While the Companies Act provides clear instructions for maintaining and updating share registers, in reality minority shareholders have often suffered from irregularities in share transfers and registrations – deliberate or unintentional. Sometimes non-voting preferential shares have been used by promoters to channel funds and deprive minority shareholders of their dues. Minority shareholders have sometimes been defrauded by the management undertaking clandestine side deals with the acquirers in the relatively scarce event of corporate takeovers and mergers.

Boards of directors have been largely ineffective in India in monitoring the actions of management. They are routinely packed with friends and allies of the promoters and managers, in flagrant violation of the spirit of corporate law. The nominee directors from the DFIs, who could and should have played a particularly important role, have usually been incompetent or unwilling to step up to the act.

Changes since liberalization:

The years since liberalization have witnessed wide-ranging changes in both laws and regulations driving corporate governance as well as general consciousness about it. Perhaps the single most important development in the field of corporate governance and investor protection in India has been the establishment of the Securities and Exchange Board of India (SEBI) in 1992 and its gradual empowerment since then. Established primarily to regulate and monitor stock trading, it has played a crucial role in establishing the basic minimum ground rules of corporate conduct in the country. Concerns about corporate governance in India were, however, largely triggered by a spate of crises in the early 90's – the Harshad Mehta stock market scam of 1992 followed by incidents of companies allotting preferential shares to their promoters at deeply discounted prices as well as those of companies simply disappearing with investors' money. These concerns about corporate governance stemming from the corporate scandals as well as opening up to the forces of competition and globalization gave rise to several investigations into the ways to fix the corporate governance situation in India.

One of the first among such endeavors was the CII Code for Desirable Corporate Governance developed by a committee chaired by Rahul Bajaj. The committee was formed in 1996 and submitted its code in April 1998. Later SEBI constituted two committees to look into the issue of corporate governance – the first chaired by Kumar Mangalam Birla that submitted its report in early 2000 and the second by Narayana Murthy three years later. Table 1 provides a comparative view of the recommendations of these important efforts at improving corporate governance in India. The SEBI committee recommendations have had the maximum impact on changing the corporate governance situation in India. The Advisory Group on Corporate Governance of RBI's Standing Committee on International Financial Standards and Codes also submitted its own recommendations in 2001.

Table 1: Recommendations of various committees on Corporate Governance in India

CII Code recommendations (1997)	**Birla Committee (SEBI) recommendations (2000)**	**Narayana Murthy committee (SEBI) recommendations (2003)**
Board of Directors		
a) No need for German style two-tiered board	a) At least 50% non-executive members	a) Training of board members suggested.
b) For a listed company with turnover exceeding Rs. 100 crores, if the Chairman is also the MD, at least half of the board	b) For a company with an executive Chairman, at least half of the board should be independent directors , else at	b) There shall be no nominee directors. All directors to be elected by shareholders with same responsibilities and

should be Independent directors, else at least 30% .	least one-third.	accountabilities.
c) No single person should hold directorships in more than 10 listed companies.	c) Non-executive Chairman should have an office and be paid for job related expenses .	c) Non-executive director compensation to be fixed by board and ratified by shareholders and reported. Stock options should be vested at least a year after their retirement. Independent directors should be treated the same way as non-executive directors.
d) Non-executive directors should be competent and active and have clearly defined responsibilities like in the Audit Committee.	d) Maximum of 10 directorships and 5 chairmanships per person.	d) The board should be informed every quarter of business risk and risk management strategies.
e) Directors should be paid a commission not exceeding 1% (3%) of net profits for a company with (out) an MD over and above sitting fees. Stock options may be considered too.	e) **Audit Committee**: A board must have an qualified and independent audit committee, of minimum 3 members, all non-executive, majority and chair independent with at least one having financial and accounting knowledge. Its chairman should attend AGM to answer shareholder queries	e) **Audit Committee**: Should comprise entirely of "financially literate" non-executive members with at least one member having accounting or related financial management expertise.
f) Attendance record of directors should be made explicit at the time of re-appointment. Those	f) **Remuneration Committee**: The remuneration committee should	f) Boards of subsidiaries should follow similar composition rules as that of parent and should

with less than 50% attendance should not be reappointed.	decide remuneration packages for executive directors. It should have at least 3 directors, all nonexecutive and be chaired by an independent director.	have at least one independent director s of the parent company.
Disclosure and Transparency		
a)Companies should inform their shareholders about the high and low monthly averages of their share prices and about share, performance and prospects of major business segments (exceeding 10% of turnover).	a) Companies should provide consolidated accounts for subsidiaries where they have majority shareholding.	a) Management should explain and justify any deviation from accounting standards in financial statements.
b) Consolidation of group accounts should be optional and subject to FI's and IT department's assessment norms. If a company consolidates, no need to annex subsidiary accounts but the definition of "group" should include parent and subsidiaries.	b) Disclosure list pertaining to "related party" transactions provided by committee till ICAI's norm is established.	b) Companies should move towards a regime of unqualified financial statements.
c) Stock exchanges should require compliance certificate from CEOs and CFOs on company accounts	d) Management should inform board of all potential conflict of interest situations.	c) Management should provide a clear description, followed by auditor's comments, of each material contingent liability and its risks.

Other issues		
Creditors' Rights	**Shareholders' Rights**	**Special Disclosure for IPOs**
a) FIs should rewrite loan covenants eliminating nominee directors except in case of serious and systematic debt default or provision of insufficient information.	a) Quarterly results, presentation to analysts etc. should be communicated to investors, possibly over the Internet.	a) Companies making Initial Public Offering ("IPO") should inform the Audit Committee of category-wise uses of funds every quarter. It should get non-pre-specified uses approved by auditors on an annual basis. The audit committee should advise the Board for action in this matter.
b) In case of multiple credit ratings, they should all be reported in a format showing relative position of the company	b) Half-yearly financial results and significant events reports be mailed to shareholders	
c) Same disclosure norms for foreign and domestic creditors.	c) A board committee headed by a nonexecutive director look into shareholder complaints/grievances	

Components E-government Program in India:

Awareness and communication: The success of e-government plan highly depends on the awareness about the programme. Therefore the Government of India disseminates the information about the e-government plans.

 Assessment: The Government of India is investing significant part of its scare resource in e-government projects. Therefore it is necessary that a robust assessment strategy is devised for the existing e-government projects.

 Capacity Building: The capacity building guidelines take into account of the fact that different states are at different levels of readiness for e-governance and have different levels of aspiration. The role of the capacity building team is at the programme level to provide leadership and vision including policy formulation, preparing roadmaps, prioritization, preparing frameworks and guidelines, monitoring progress & capacity management.

 Common Services Centre: Common Services Centre (CSC) scheme is the most prominent face of National e-Government Programme. Specific support is being provided for this scheme. The scope of support includes Identification of core components of CSC Scheme; Frame problem agendas related with application software, legal instruments, and essential backend for CSC etc.

 Infrastructural and Technical: This cell provides support to the Department of Information Technology in implementing those projects and components of e-Government.

 Monitoring and Evaluation: The Program Management, Monitoring and Evaluation Unit of the Programme Management Unit for National e-government programme develop a comprehensive MIS at programme level and track the physical and financial progress of various projects.

 Project and Financial Appraisal: The cell identifies resources to provide assistance in project conceptualization, development and implementation to various implementing agencies.

 Research and Development: The e-Governance R&D team provides consultancy and research inputs in the areas of e Governance Technical Standards including interoperability standards e-Government Enterprise architecture frameworks, Information Security etc.

India's Position on E-readiness:

E-Readiness is the ability to use Information and Communication Technologies (ICT) to develop one's economy and to foster one's welfare. Each year, the Economist Intelligence Unit produces a ranking of e-readiness across countries, based on six pillars of e-readiness: connectivity &

technology infrastructure, business environment, social & cultural environment, legal environment, government policy & vision and consumer & business adoption. United states is at 1st position with e-readiness score 8.95 out of 10 followed by Australia and United Kingdom (Table 1). India is at 54th position with e-readiness score of 4.96.

Table 1: Economist Intelligence Unit e-readiness rankings in 2011 of select countries

Sl. No.	**Country**	**e-readiness score (out of 10)**	**Rank**
1	United States	**8.95**	**1**
2	Australia	**8.83**	**4**
3	United Kingdom	**8.68**	**8**
4	Switzerland	**8.67**	**9**
5	Japan	**8.08**	**18**
6	Republic of China	**8.05**	**19**
7	India	**4.96**	**54**
8	China	**4.85**	**56**
9	Russia	**4.42**	**59**
10	Sri Lanka	**4.35**	**60**
11	Pakistan	**4.10**	**64**
12	Iran	**3.18**	**70**

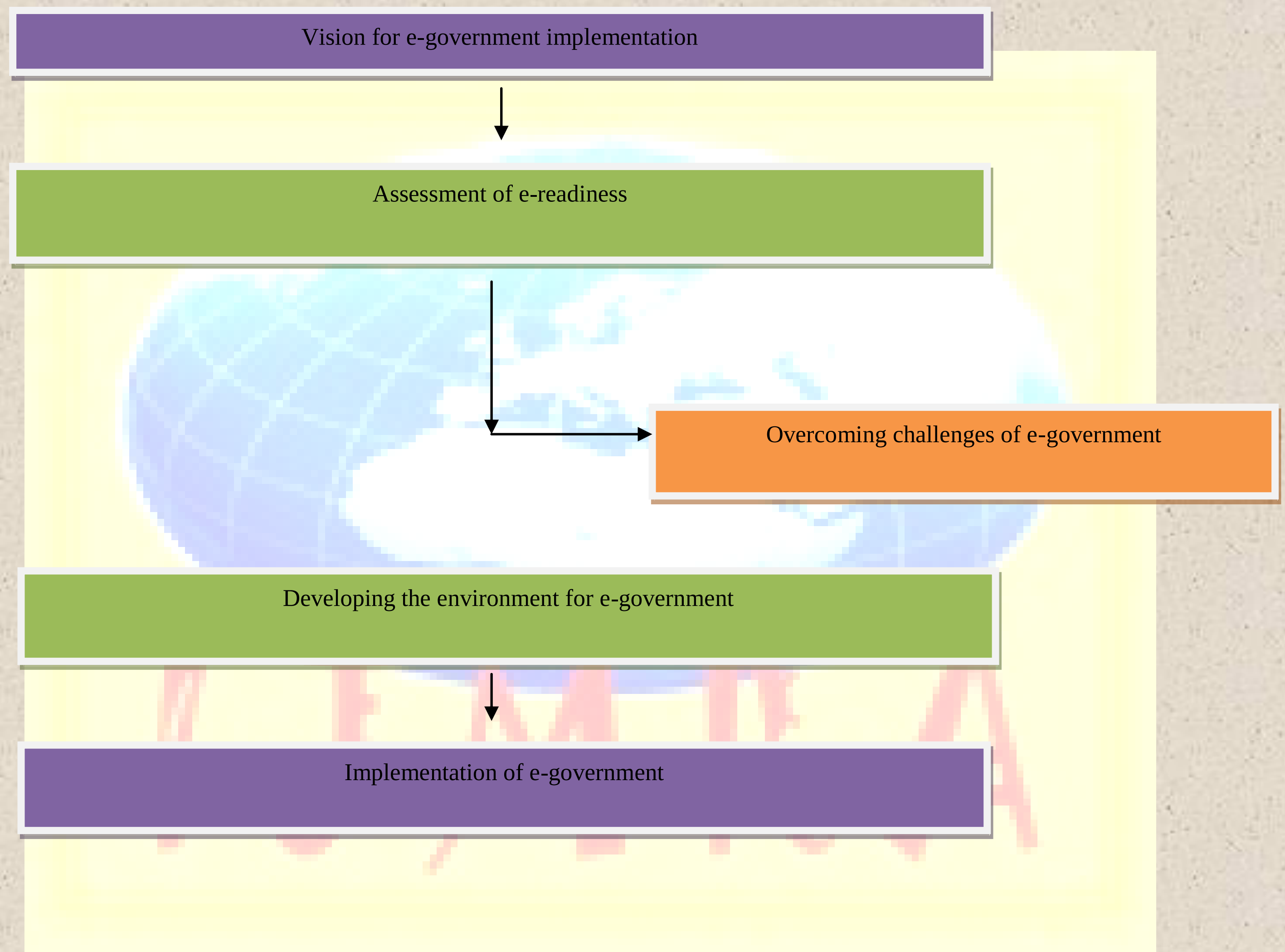
(Source: http://en.wikipedia.org/wiki/E-readiness)

Challenges for implementation of e-government in India:

- ***Low literacy***
- ***Low per capita income***

➢ ***Limited financial Resource***

A Strategic framework for implementation of e-government may be helpful:



Conclusion:

With the recent spate of corporate scandals and the subsequent interest in corporate governance, a plethora of corporate governance norms and standards have sprouted around the globe. The Sarbanes-Oxley legislation in the USA, the Cadbury Committee recommendations for European companies and the OECD principles of corporate governance are perhaps the best known among these. But developing countries have not fallen behind either. Well over a hundred different codes and norms have been identified in recent surveys and their number is steadily increasing. India has been no exception to the rule.

In the last few years the thinking on the topic in India has gradually crystallized into the development of norms for listed companies. The problem for private companies, that form a vast majority of Indian corporate entities, remains largely unaddressed. The agency problem is likely to be less marked there as ownership and control are generally not separated.

Development of norms and guidelines are an important first step in a serious effort to improve corporate governance. The bigger challenge in India, however, lies in the proper implementation of those rules at the ground level. More and more it appears that outside agencies like analysts and stock markets (particularly foreign markets for companies making GDR issues) have the most influence on the actions of managers in the leading companies of the country. But their influence is restricted to the few top (albeit largest) companies. More needs to be done to ensure adequate corporate governance in the *average* Indian company.

According to Economist Intelligence Unit the e-readiness index of India is low. There are various challenges for the implementation of e-government in India. These challenges are like low literacy, low per capita income, and limited financial resource. A vision is required to implement the e-government in India.

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