D. Prevention: What Businesses Can Do — Corporate Governance and Compliance Schemes

Chapter 9

Corporate Governance in India

■ **Omkar Goswami**

Since the second half of the 19th century, most modern industries and services in India have been structured under the English common law framework of joint stock limited liability. Despite this long corporate history, the term "corporate governance" remained unknown until 1993. It came to the fore at that time because of a spate of corporate scandals that occurred during the first flush of economic liberalization.[1]

The first was a major securities scam that was uncovered in April 1992. This involved a large number of banks, and resulted in the stock market nose-diving for the first time since the advent of reforms in 1991.[2] The second was a sudden growth of cases where multinational companies started consolidating their ownership by issuing preferential equity allotments to their controlling group at steep discounts to their market price (for details see Goswami 1996, pp. 124-25). The third scandal involved disappearing companies during 1993-94. Between July 1993 and September 1994 the stock index shot up by 120 percent. During this boom, hundreds of obscure companies made public issues at large share premiums, buttressed by sales pitch by obscure investment banks and misleading prospectuses. The management of most of these companies siphoned off the funds, and a vast number of small investors were saddled with illiquid stocks of dud companies. This shattered investor confidence and resulted in the virtual destruction of the primary market for the next six years.

---

[1] Similarly, in the United States corporate governance came into prominence only after the second oil shock in 1979. In the United Kingdom corporate governance started to be discussed only in the late 1980s and early 1990s in response to the collapse of the Bank of Credit and Commerce International and malpractice by the Maxwell group.

[2] Refer to the Mehta cartel case in the early 1990s, which resulted in the Bombay stock exchange, Sensex, being pushed up by almost 150 percent between December 1991 and April 1992, followed by a crash before the next boom began. The crash, which destroyed a large number of small retail investors and brokers, resulted in general questioning of the ability of banking and capital market regulators to ensure transparency and safety.

These three episodes led to the prominence of the concept of corporate governance among the financial press, banks and financial institutions, mutual funds, shareholders, more enlightened business associations, regulatory agencies, and the government. Note that unlike in Southeast and East Asia, the corporate governance movement did not occur because of a national or regionwide macroeconomic and financial collapse. Indeed, the Asian crisis barely touched India.

Today, increasing numbers of listed companies have begun to realize the need for transparency and good governance to attract both foreign and domestic capital. A growing number of chief executive officers now recognizes that complex cross-holdings, opaque financial disclosures, rubber-stamp boards, and inadequate concern for minority shareholders is a recipe for being shut out of competitive capital markets. Thus almost nine years after the start of economic liberalization, the beginnings of desirable corporate governance practices can be discerned, and indicators suggests that the trend will intensify in the next few years.

HISTORICAL BACKGROUND

In many ways India was unlike other former colonies in Asia or Africa. At the time of independence in 1947, India was one of the poorest nations in the world with a per capita annual income of less than $30. Yet manufacturing accounted for almost a fifth of national product, and half of that was contributed by the modern factory sector, which included cotton, iron and steel, and jute mills; collieries; nascent engineering units and foundries; and cement, sugar, and paper factories.

From the 1870s the growth of this sector was structured along corporate lines through joint stock limited liability companies, most of which were floated in India and listed on local stock exchanges. The Bombay Stock Exchange (BSE) was established in 1875, and began trading three years before the Tokyo Stock Exchange. At the beginning of the 20th century India had four fully functioning stock exchanges in Bombay, Calcutta, Madras and Ahmedabad, with well-defined listing, trading, and settlement rules.

The vehicle for corporate growth was the managing agency, a closely held company or partnership that functioned like a holding company. Managing agencies would float companies, and their imprimatur sufficed to ensure massive oversubscription of shares. Given excess demand, most major companies could split their shareholdings into small enough allotments to ensure that nobody other than the managing agency had enough stock to

ensure their presence on the board of directors. Thus dispersed ownership allowed managing agencies to retain corporate control with relatively low equity ownership, a trend that continued until some 10 to 15 years ago. Thus from the corporate governance point of view, the tendency for management in India to enjoy control rights that are disproportionately greater than residual cash flow rights goes back to the early years of the 20th century.

On the positive side, because much corporate growth in pre-independence India was financed through equity, by the 1950s urban investors had developed a sophisticated equity culture. Moreover, the banking sector was surprisingly well developed for a country as poor as India. Banks were privately owned, advanced working capital, maintained prudential lending and accounting norms, and were backed up by sound recovery laws and efficient processes.

As modern industrial growth was structured along corporate lines, it is not surprising that colonial India quickly put in place a substantive body of corporate law. For instance, the periodically amended 1956 Companies Act, which governs the legal and regulatory aspects of public and private limited companies, derives from earlier Indian companies acts. Similarly, most of today's legal jurisdiction for corporate matters and disputes predates independence, as does legislation aimed at prudent regulation of banks. The law that regulates stock exchanges and the transactions of securities was also passed in 1956.

Thus in 1947 India had a sizable corporate sector that accounted for at least 10 percent of gross domestic product; it had well functioning stock markets and a developed banking system; it had a substantial body of laws relating to the conduct of companies, banks, stock markets, trusts, and securities; and it had an equity culture among the urban populace. It was probably the former colonial country that was best equipped to practice good corporate governance, maximize long-term corporate interests, and protect stakeholder rights. However, it did not do so.

The first barrier to investment came with the 1951 Industries (Development and Regulation) Act, which required all existing and proposed industrial units to obtain licenses from the central government. The licensing regime led to widespread rent-seeking. Entrepreneurial families and business groups that had built their fortunes in textiles, coal, iron and steel, and jute now used licenses to secure monopolistic and oligopolistic privileges in new industries such as aluminum, paper, cement, and engineering. Over the years licensing became increasingly stringent and was accompanied by multiple

procedures that required clearances from many ministries. For instance, a typical private manufacturing company needed government permission to establish a new plant, manufacture a new article, expand its capacity, change its location, import capital goods, and do many other things that fell under the rubric of normal corporate activity. This law was abolished in 1991.

A more serious barrier to entry occurred in 1956, when in a move toward socialism the Industrial Policy Resolution stipulated that the public sector would dominate the economy and specified those industries for which the state would exclusively or increasingly be responsible. This resulted in the creation of a massive state-owned industrial and services sector that brought with it specific dysfunctionalities, inefficiencies, cost disadvantages, and corporate governance problems.

The trend to limit private investment and foster inefficient manufacturing intensified during the late 1960s and early 1970s. The 1969 Monopolies and Restrictive Trade Practices Act linked industrial licensing with an assets-based classification of monopoly that applied only to the private sector. As a result private sector businesses whose assets exceeded a paltry amount varying from Rs.10 million to Rs1 billion had to apply for additional licenses to increase capacity, and more often than not, such applications were rejected. Widespread nationalization followed, beginning with insurance companies and banks, and then encompassing petroleum companies and collieries. One of the goals of nationalization was to preserve employment. Thus the 1970s and early 1980s saw successive governments taking over financially distressed private sector textile mills and engineering companies, thereby converting private bankruptcy to high-cost public debt.

In addition, the government made a fetish out of "small is beautiful." First, successive governments set up mini-plants, and the 1980s saw a mushrooming of technologically nonviable mini-steel, mini-cement, and mini-paper units whose profitability hinged on heavy tax concessions, high initial leveraging, subsidized long-term financing, high tariffs and import quotas, and the munificence of government orders. Second, the government actively encouraged small-scale industries. While this is not necessarily a bad thing—small and medium enterprises are often more efficient and flexible than larger firms—the small-scale sector was fostered through a plethora of artificial means, such as tax concessions and product reservations. Even today more than 800 product lines are reserved for the small-scale sector, of which more than 600 are not even manufactured in India.

Such distortions could not have existed in an outward-oriented, open economy. Despite preferential tariffs for the United Kingdom and other countries of the British empire, no major barriers to trade were in effect during the colonial era. Consequently, the major industries that had existed prior to independence (cotton textiles and yarn, jute, tea, and coal) were internationally competitive, and the jute and tea industries were driven by exports. Things began to change from the mid-1960s, intensifying with the import substituting regime of the 1970s and early 1980s. Import substitution made it incumbent upon a company to demonstrate to bureaucrats why any import was essential, and the doctrine of indigenous availability ensured the purchase of Indian inputs even when lower-quality products cost more than superior imports. Import substitution was sustained by quantitative restrictions, governed by various types of import licenses, and high tariffs. By 1985, the mean tariff rate was 146 percent for intermediate goods and 107 percent for capital goods.

While some of the policies certainly helped to establish industrial capacity, especially in engineering, drugs and pharmaceuticals, chemicals, fertilizers, and petrochemicals, they also created highly protected markets, fostered uncompetitiveness, and promoted large-scale rent-seeking, thereby providing fertile ground for corporate misgovernance.

Added to this was the corporate and personal income tax structure. At its peak, the corporate tax rate was as high as 55 percent and the maximum marginal rate for personal income tax was an astronomical 98.75 percent. Such rates created huge incentives for cheating, which took many forms, including undeclared cash perquisites, private expenses footed by company accounts, complicated emolument structures, and complex cross-holdings of shares to confound calculations regarding dividends and wealth taxes. The message was simple and profoundly negative. Thus what mattered was how to expropriate larger slices of a small pie, and how to do so in ways that escaped the tax net. Incentives to grow the pie, create wealth, and share it among stakeholders in transparent and equitable ways were completely lacking.

Following independence, the government set up 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 (ICICI). In addition, state governments set up state financial corporations. Until the early 1990s, the goal of these public sector DFIs was to foster industrialization by advancing long-term loans at low, often subsidized, real interest rates.

There is nothing wrong with a government with a fiscal surplus pushing subsidized long-term funds for creating competitive industrial capacities, as illustrated by the Republic of Korea's extensive industrial base. However, when careful project appraisal is abandoned for loan pushing—DFIs were evaluated on the basis of the number of loans approved and disbursed and not their asset quality—and when this occurs in a tightly controlled, rigidly licensed, highly protected, import-substituting milieu, it invariably results in crony capitalism, rent-seeking, inefficiency, and corporate misgovernance with public funds. This is precisely what occurred in India in the 1970s and 1980s.

The relationship between DFIs and corporation misgovernance has two aspects, one related to excess leveraging and the second with DFls' role as shareholders. By the early 1980s, many term loans for industrial projects allowed project promoters to start projects with a relatively low equity base. During the industrial expansion of the 1970s and 1980s, the average share ownership of the controlling groups declined to 15 percent. In other words, it was possible to embark on a Rs500 million project with only Rs100 million of equity, of which a mere Rs15 million came from the promoters and sufficed for control. This set the state for moral hazard of limited liability. Given subsidized loan funds and various tax incentives to set up industries, most promoters recovered their relatively meager equity within a year or two of operation. Thereafter, in many cases after borrowers had recouped their outlay they failed to continue making loan repayments. The relationship between business groups and politicians ensured that defaulted debts would invariably be rescheduled in the name of rehabilitating financially sick industrial companies. Played out against the backdrop of inefficient implementation of bankruptcy laws, this created widespread corporate misgovernance, including a major diversion of DFI funds for other ventures.

With regard to shareholding, even now, nine years after the advent of economic liberalization, the DFIs, the nationalized insurance companies, and the government-owned mutual fund (the Unit Trust of India) hold a substantial portion of the equity of India's private sector companies. This kind of indirect state ownership of equity also fostered poor corporate governance through inefficient monitoring. The institutional shareholders insisted on nominating their directors to corporate boards; however, at best most of these nominee directors were incompetent; at worst they were instructed to support the incumbent management irrespective of its performance.

In theory, the three DFIs were well placed to play the role of corporate governance watchdogs in the 1970s and 1980s. If they had done their job

well, they could have simultaneously reduced the agency costs associated with debt and equity, but they did not. On the equity side, the failure was related to the distorted incentives of government ownership and management of the DFIs and the state-business nexus that induced directors to invariably vote with project promoters. On the debt side, it had much to do with inadequate income recognition and provisioning norms, as well as with poor bankruptcy and debt recovery procedures.

Thus by the time India embarked on economic liberalization, the waters had become muddied. On the one hand, the country had an equity base that was substantially greater than in most developing countries, had laws that regulated companies and protected the rights of shareholders, and had a large and active industrial sector ranging from complex petrochemicals to simple toy manufacturing. On the other hand, a combination of other factors had created an environment that did not punish poor corporate governance.

STRUCTURE OF CORPORATE INDIA

To understand the structure of India's corporate sector at the end of the 20th century, it is important to highlight the disruption that has been unleashed by less than a decade of economic liberalization. This has led to yesterday's giants, in many cases still family run, being dwarfed by the forces of change and being replaced by modern, professionally managed companies. Furthermore, economic liberalization, competitiveness, and the dismantling of controls have reduced entry barriers and permitted new entrepreneurs to race to the top of the market capitalization table. This trend away from family-run business to professionally-run businesses has augured well for corporate governance. The new breed of managers believes in professionalism and the credo of running businesses transparently to increase their corporate value. Thus the need for good corporate governance is being appreciated as a sound business strategy and as an important facilitator for tapping domestic and international capital.

India's corporate sector consists of closely held (private limited) and publicly held (public limited) companies, with the closely held companies vastly outnumbering the publicly held ones and constituting the bulk of small-scale enterprises; however, the public limited companies, including the listed ones, account for almost two thirds of the book value of equity. In addition the government corporate sector, while consisting of a mere 0.24 percent of the total number of companies in India accounts for 39 percent of paid-up capital. Finally, while India has 32 registered stock exchanges, many of them

are moribund,[3] and only two really matter in terms of size, efficiency, and liquidity. These are the BSE and the National Stock Exchange, and any company with a good reputation is listed on one or the other, or even both. With a total of Rs10.3 trillion of market capitalization of companies listed on the two stock exchanges at the end of February 2002, the market capitalization of India's listed companies accounts for almost 53 percent of the country's gross domestic product. The BSE lists only 73 government companies, which accounts for less than 2 percent of the listing, yet these stocks account for almost 15 percent of market capitalization. This particular characteristic has important policy implications for corporate governance.

The Companies Act governs most corporations. This law is largely based on its British counterpart; however, many sections have been amended over time. In addition, the following three laws are also important from the point of view of corporate governance: The Securities Contracts (Regulation) Act of 1,956, the Securities and Exchange Board of India (SEBI) Act of 1992, and the Sick Industrial Companies (Special Provision) Act (SICA) of 1995.

AGENCY COSTS

Corporate ownership and control in Asia is characterized by three dominant themes. First, relative to their size, most Asian companies have low equity. Second, given the low equity base, promoters have found it relatively cheap to own majority shares. Third, equity ownership is invariably camouflaged through complex corporate cross-holdings.

These characteristics differentiate the Asian model from the U.S. corporate model of the 1970s and 1980s, with its large equity base, dispersed shareholdings, and profound separation of ownership from management. Agency costs are equally important in both models, but in the Asian model seem to affect minority shareholders' rights more than corporate efficiency. Under the Asian model a promoter who controls management and directly or indirectly owns more than 75 percent of a company's equity is not expected to perform in a value-destroying manner like many U.S. corporate managers and boards did up to the mid-1980s. However, promoters have the discretion to behave in a manner that deprives minority shareholders of their *de jure* ownership rights without adversely affecting a corporation's profits, including

[3] Many regional stock exchanges see no active trade whatsoever, and survive only on the basis of companies' annual listing fees.

by issuing preferential equity allotments to promoters and their allies at discounts or transferring shares through private buy-out deals at prices well below those prevailing in the secondary markets

Until the mid-1990s, India suffered from the worst of both types of agency costs. Dysfunctional economic and trade policies combined with low equity ownership to allow companies to thrive in uncompetitive ways, which became problematic when the economy started opening up to international competition. Corporate value eroded dramatically as measured in terms of economic value added, which is the difference between the return on capital employed and the opportunity cost of capital. However, ascertaining how much of this value destruction was due to poor corporate governance and how much was due to the companies' inertia and historical inability to deal with increased competition is difficult (Goswami, Karthikeyan, and Srivastava 1999).

Another problem was the expropriation of minority shareholder rights, facilitated in part by the nominee directors of banks, financial institutions, and DFIs, who invariably voted with management, and in part by inadequate legal provisions. For example, until seven years ago certain provisions of the Companies Act restricted the acquisition and transfer of shares. However, these provisions no longer apply, and a transparent legal framework is available for facilitating the market for equity-driven corporate control. In addition, transaction costs for trading shares have been reduced, allowing minority shareholders to enter and exit at will. Moreover, the market has begun to punish underperforming companies and those that disregard minority shareholders' interests.

DEBT AND EQUITY

While the market for corporate control has greatly improved on the equity side with a well-defined takeover code, the debt side remains as bad as it was during the days of control by licenses. The prevalence of widespread corporate misgovernance in countries with ineffective bankruptcy laws and procedures is not a coincidence. Poor protection of creditors' rights gives enormous—and ultimately deleterious—discretionary space to inefficient management. It allows companies to reallocate funds to highly risky investments, given that the management fears neither attachment nor bankruptcy; it needlessly raises the cost of credit; it debases the disciplining role of debt; and it eventually ruins the health of a country's financial sector. Unfortunately, India has poor bankruptcy reorganization laws and procedures, and its liquidation procedures are even worse.

Bankruptcy

The reorganization of insolvent large industrial companies is governed by the SICA, directed and supervised by the Board for Financial and Industrial Reconstruction (BIFR). Five fundamental flaws of poorly designed and inadequately implemented bankruptcy procedures are associated with the SICA-BIFR process, namely:

- *Late detection.* The law defines financial distress as the erosion of net worth. This is much worse than bankruptcy, which is basically a default on debt. When a company loses so much as to erode its net worth, the probability of a successful turnaround is low. Not surprisingly, between July 1987 and November 1998 only 11 percent of the 1,954 cases that BIFR considered "maintainable" have recovered.
- *Cumbersome and time-consuming procedures.* Between 1987 and 1992 the BIRF took an average of 851 days to arrive at a decision, and since then the average delay has doubled. The delay is caused by extensive quasi-judicial procedures whereby cases go through multiple loops before a final decision is taken. Naturally, such delays confer additional bargaining power to the management of the bankrupt company at the expense of secured and senior creditors.
- *Indefinite stay on all claims of creditors.* From the time a company is registered as bankrupt until the case is disposed of, the BIFR does not allow creditors to exercise any claims. All reasonable restructuring processes confer time-bound stays, but the BIFR's excessive delays make such legal stays a key strategic device for the promoters of debtor firms. All they need to do is to get the case registered, which then protects them from creditors' claims for at least four years.
- *Debtor in possession.* Neither SICA nor BIFR recognize that incumbent management always has a significant informational advantage compared with outside creditors. Therefore a procedure that allows existing management to control and run a bankrupt company during the period when it is being reorganized invariably results in secured creditors taking major hits on their exposures at the expense of shareholders and management.
- *Violation of the absolute priority rule.* This rule states that in any bankruptcy restructuring or liquidation process, the claims of senior creditors have to be settled in full before those of junior creditors are considered. BIFR's procedures violate this principal by often rewarding incumbent management and incumbent shareholders at the expense of fully secured creditors.

Designing a far better bankruptcy reorganization system is not difficult. The key features of a market-driven and incentive-compatible procedure would incorporate the following features:

- The definition of bankruptcy should be altered to debt default. This will result in earlier detection of financial distress and increase the likelihood of a successful turnaround.
- Up to a point, bankruptcy restructuring should be voluntary. The onus must be on the company to convince its secured and senior creditors with a satisfactory rescheduling and cash flow plan.
- The case should only be taken to the BIRF if negotiations between the company and senior creditors break down. If this additional time for negotiation does not succeed, the BIFR should appoint an independent administrator to advertise the sale of the company. During the advertising and sale period, the BIFR should impose a strictly time-bound stay on creditors' claims on the company's assets. In the meanwhile, an independent financial professional can determine the company's liquidation value, which will serve as the confidential reserve price.
- The sealed bid offers must be submitted within the given time period. During this period, subject to a confidentiality bond, all prospective bidders should be permitted to conduct due diligence. Existing promoters can also bid.
- The bids should be in two parts: (a) the post-restructuring profit and loss account, balance sheet, and cash flow projections; and (b) the financial bid, which can be in cash or in recognized securities.
- Secured and senior creditors should vote within their class on (a). Those bids that secure the assent of 75 percent of secured and senior credit should be short-Iisted. The best financial bid from the short-list is the winning bid.
- If the winning bid amounts to less than the liquidation value, then the company should go into liquidation. If it is greater than the liquidation value, but less than the secured debt, then the proceeds should be prorated across secured creditors (including wage dues), with unsecured creditors getting nothing.

Under such an arrangement the BIFR would act as a facilitator instead of behaving like a court. Such a scheme was laid down in the 1997 Sick Industrial Companies Bill, but political instability has kept the bill in limbo.

Liquidation

If bankruptcy restructuring under the BIFR is tedious, liquidation under the Companies Act is virtually impossible. High court delays in winding up companies that are beyond redemption take up to 10 years for most cases, but have been known to take as long as 50 years. These delays illustrate the failure (a) to understand that preserving the value of a company's assets is of primary importance, and that this is best achieved by ensuring that these assets are quickly reallocated to productive use by more efficient entrepreneurs; and (b) to realize that those most severely affected by delays are employees and secured creditors.

In 1996 – 1997 the Working Group on the Companies Act recommended an entirely new approach to this problem with the following key features:

- Encouraging voluntary winding up
- Separating the two aspects of liquidation by selling assets first and then distributing the proceeds
- Laying down a coherent description of the steps that have to be taken along with the order in which they have to be taken and time frames for each action
- Explaining how the act would catalyze a rapid, transparent, and market-determined sale of assets
- Laying down well-defined and non-subjective norms to ascertain whether a company's assets should be sold in their entirety as a going concern or in parts
- Permitting professionals, such as chartered accountants, lawyers, or company secretaries, to act as company liquidators.

However, none of these proposals have been adopted to date.

By law, creditors have prior claims over shareholders. When their contractual obligations are not adhered to, creditors can do one of three things: demand a bankruptcy reorganization under SICA/BIFR auspices, file for a winding up of the company, or apply for receivership. The first two options do not constitute credible threats. As for the speed with which creditors can obtain a receivership decree, this varies. The process is relatively efficient in Murnbai, extremely inefficient bordering on impossible in Calcutta, and somewhere in between elsewhere.

Since 1993 banks and DFIs have had recourse to the option of filing for recovery of debts through debt recovery tribunals. These quasi-judicial

bodies were set up in response to inordinate delays in the judicial system. However, the tribunals have their own problems. Many of them have not yet been established, and those that have been established have become backlogged.

Thus in reality, creditors have little protection. A consequence of this is extreme risk aversion, especially in the new milieu where public sector bank managers have to stop pushing loans and focus on their bottom line. As a result, banks are in a peculiar situation. On the one hand, they are flush with depositors' funds. On the other, they avoid lending to anyone other than blue chip companies and invest the remainder in Treasury bills, which are risk free, do not impair their capital adequacy, give a return that is at least 300 basis points above the average deposit rate, and, most important, require no effort at project appraisal. This pervasive debasing of debt is choking off funds to small and medium enterprises, and unless rectified by better implementation of creditors' rights will have serious negative implications for the future structure and sustainability of industrial growth.

Equity-Driven Takeovers

The SEBI, established in 1992, has significantly reformed the equity side of the market for corporate control. Until the introduction of the Takeover Code in 1997, companies could negotiate takeover deals that frequently left minority shareholders in the lurch. The code now regulates various aspects of share purchases. This has had two beneficial effects. First, it has created a transparent market for takeovers. Second, it has ensured that minority shareholders have the right to obtain a market-driven price in any takeover. Furthermore, in the case of a growing number of attempts of hostile takeovers, it has proved to be a robust instrument.

DISCLOSURE

According to the law, all companies must prepare audited annual accounts that are first submitted to the company's board for approval, then sent to all the shareholders, and finally provided to the registrar of companies. Listed companies must also submit their annual accounts to every stock exchange on which they are listed, prepare unaudited financial summaries for every quarter, and submit a cash flow statement. In theory, companies' most substantive financial disclosures are to be found in their annual reports, especially their balance sheets, profit and loss statements, and relevant schedules.

Balance sheets have to address both sources of funds as well as their application. With regard to the sources of funds, the reporting on secured loans, which includes a full line-by-line disclosure of debentures, is most problematic. Unfortunately, Indian accounting standards do not follow the principle of consolidation, and as a result companies can, and do, under- or overstate such transactions for strategic purposes. With regard to the application of funds, the quality of disclosure of fixed assets could be significantly improved by introducing the evaluation of all elements at either market price *or* historical cost, and by allowing for deferred tax liability. The disclosure of investments is an area that allows for most opaqueness, because investments in quoted and unquoted securities are evaluated in different ways. A possible solution to this problem could be to mandate consolidation according to U.S. Generally Accepted Accounting Principles or Internationally Accepted Accounting Standards and by insisting on full disclosure of all related party transactions.

Disclosure required in the profit and loss account is quite exhaustive and mostly corresponds to international standards. There are, however, two areas that can be misused. The first relates to manufacturing expenses, which can be inflated up to the point where it requires collusion with the government's sales tax and excise duty officials. The second has to do with sales, distribution, administration, and other expenses. However, the scope for misreporting on these two heads is far less than for some items on the balance sheet.

As far as incorporated companies go, the standards for financial disclosure in their annual accounts are better than prevailing standards in most of Asia; however, until 2001–2002 they were not in line with U.S. and international norms. While the Companies Act specifies punishments for noncompliance with financial disclosure requirements, these are light. In most instances the maximum penalty is either six months' imprisonment, a fine of no more than Rs2000 ($48), or both. In practice, few people have been imprisoned and the system is relatively lax. For instance, if the auditor's signed reports are not in conformity with the law, the maximum penalty is RsI,000 (US$24). Lengthy judicial delays further diminish the minimal deterrence provided by such penalties. Moreover, some ethically questionable acts are considered normal. For instance, while the Institute of Chartered Accountants of India prescribes detailed standards for external auditors, it has rarely taken any serious action against its members. Stock markets are carrying out their own enforcement. Increasingly, companies are enjoying premiums for good corporate disclosure, which has increased the demand for internationally respected and independent audit firms, especially when companies are seeking access to foreign capital. This might clean up the system faster than legally mandated enforcement.

Since the early 1990s companies must be rated by approved credit rating agencies before issuing any commercial paper, bonds, or debentures. India currently has five rating agencies, four of which are well established. Each agency has a set of ratings that ranges from extremely safe to poorer than junk bond status. Ratings have to be made public, and must be accompanied by the rating agencies' perceptions of risk factors that can affect the payment of interest and the repayment of principal. Company management has the right to comment on these risk factors. In the past companies have tended to "ratings shop," that is, to approach more than one rating agency and then publish the most favorable rating. The Confederation of Indian Industry is attempting to rectify this situation by mandating that companies reveal if they have been rated by more than one credit rating agency and to provide the ratings as determined by each agency. The three all-India DFIs hold stock in three of the credit rating agencies. Recently, SEBI has mandated that these agencies not be allowed to rate any companies in which the DFIs hold stock or their subsidiaries.

The Companies Act requires all companies to maintain a register of shareholders that must be updated whenever shares change hands. Even though the register is legally public domain information and a list of shareholders must be sent to the registrar of companies, in practice it is not as public as it is made out to be, especially for closely held, unlisted companies. Accessing shareholding information for listed companies is easier. Stock exchange listing agreements require a breakdown of shares by individual promoters, DFIs, foreign institutional investors, mutual funds, foreign holdings, other corporate bodies, top 50 shareholders, and other shareholders. However, this classification often fails to give a fully transparent picture of share control because of the prevalence of complex cross-holdings across most conglomerates controlled by a family or group. The objective of such cross-holdings within traditional family-dominated businesses, which constitute a sizable proportion of listed companies, was to avoid the steep wealth and inheritance taxes that characterized pre-1991 India. Abolition of both these taxes and the tax on individuals' dividend income, along with a reduction in personal income tax rates, has led many such businesses to slowly unwind their cross-holdings. The process of moving toward cleaner and more transparent share ownership is also being driven by an increasingly active stock market. Foreign institutional investors, who now account for 24 to 30 percent of the equity of highly traded companies, avoid companies with complex cross-holdings. Another factor that has diminished the importance of cross-holdings is the meteoric rise of new, technologically-oriented companies. Today, two internationally recognized information technology companies and eight drug companies are

among India's leading firms. These enterprises are run along highly professional lines.

While the 1992 SEBI Act clearly defines insider trading and states that one of the functions of the capital market regulator is to prohibit insider trading, as in most countries the problem lies in implementation. Even with sophisticated detection devices, pinpointing insider trades is extremely difficult. In the United States fewer than 1 percent of the trades that are initially identified as potential cases of insider trading are actually investigated, and fewer still result in convictions. In India, in addition to this same difficulty of flagging possible cases of insider trading, two additional problems are apparent. First, given the large number of brokers and middlemen who operate in the market, people with insider information can create enough firewalls between themselves and the traders to make identifying the real insiders extremely difficult. Second, while SEBI can conduct an investigation, prepare a report, and even suggest a penalty, it lacks the judicial power to impose that penalty. Only the courts can impose penalties, and given the judicial delays, such penalties carry little weight. Nevertheless, SEBI has investigated several cases of insider trading, primarily, but not exclusively, involving relatively small players.

Although Indian banks and DFIs disclose more than their counterparts in East and Southeast Asia and, indeed, Switzerland, this is still considerably less than what is desirable. In particular, neither banks nor DFIs are required to disclose the structure and extent of any asset-liability mismatch. Moreover, while they follow the Basle standards for recognition of non-performing assets, this does not take into account some of the institutional realities of India, for example, the length of time taken for cases involving bad loans to be resolved. In this context, ICICI has taken the lead. Driven by the objective of becoming India's first truly universal bank, ICICI has decided to tap the US capital market. To this end it voluntarily re-cast its accounts for the fiscal year ended 31 March 1999 in terms of US generally accepted accounting principles. While the exercise eroded ICICI's bottom line by a third, it also created investor confidence.

BOARDS OF DIRECTORS

Perhaps the greatest drawback of corporate governance in India is the de facto lack of independent directors on the vast majority of boards. This is not caused by a lack of supply, but reflects the lack of demand, given the

prevailing attitude that boards are empty legal constructs that exist solely to justify the perpetuation of existing management.

While corporate law clearly stipulates the requirements for a board of directors and states that all directors are fiduciaries of the shareholders, most boards do not satisfy any of the conditions that accompany the principle of independent oversight. For example, there is no legal definition of independence in relation to directors, and nonexecutive directors tend to account for no more than one third of the total number of board members and often play a passive role. In public sector banks in particular, in they often do not understand their responsibilities and have little specialized knowledge, and thus do not use their position to exercise effective oversight. Agendas for board meetings rarely provide adequate information or are distributed sufficiently in advance of board meetings; board meetings are often scheduled for a short duration; and until recently there was no law or regulation that required boards to establish audit, remuneration, or nomination committees. All this reflects a basic malaise of the corporate sector whereby most companies are driven by their management and not by their boards.

How can one make the boards of Indian companies more active and interested in maximizing shareholder value? To begin with, measures could be taken to create the right kind of environment, for example, by raising directors' remuneration beyond the ceiling of Rs5,000 ($115) per meeting, which is hardly sufficient compensation for properly exercising fiduciary responsibilities, and by offering a commission on net profits and stock options to stimulate directors' interest in maximizing corporate value. In addition, listed companies should be mandated to disclose directors' attendance records in their annual reports. While attendance is not a proxy for performance, shareholders are likely to be more reluctant to re-elect directors who fail to attend meetings regularly than those who do.

Despite these criticisms, major changes are occurring in the boards of the top 20 or 30 private sector companies. Most have a majority of non-executive directors (if not genuinely independent ones), have at least an audit committee, and pay a commission to directors over and above their token sitting fees, and some are contemplating stock options. They send the right kind of agenda papers well in advance of board meetings, and board meetings last longer than a few hours.

STATE-OWNED ENTERPRISES

State-owned enterprises (SOEs) account for 20 percent of market capitalization among listed companies. Shareholders of private sector companies are the direct beneficiaries of profitable performance, and thus in theory have an incentive to monitor management so that it maximizes corporate value. In contrast, most SOEs, especially unlisted SOEs, do not have a substantial body of informed private shareholders whose income depends upon the performance of these companies. If anything, the major shareholder of SOEs has distinctly different objectives. The typical member of Parliament or minister is rarely concerned about commercial viability, profitability, quality, cost minimization, optimal investment decisions, and corporate value creation. As for civil servants, they are trained to slavishly adhere to procedures, however irrelevant such procedures may be.

In other words, governments and their agents are process oriented, whereas enterprises should be results oriented. This mismatch is further exacerbated by civil servants' aversion to risk taking. Thus when civil servants serve on the board of an SOE, they typically toe the ministry line, ensure that the SOE follows "proper" procedures, and avoid any risky decisions that may have harmful consequences for their ministries. Thus most chief executives of SOEs quickly adopt the line of least resistance. As a result important organizational changes are not made, poorly performing staff remain on the payroll, loss-making plants are neither downsized nor closed, wages are not linked to productivity, and excess workers are not let go.

State ownership has had a number of negative impacts, for example, all SOEs are expected to achieve a number of noncommercial objectives that are defined by the state and must adhere to affirmative action norms for employment to ensure that the percentage of representation of certain groups (scheduled castes and tribes, the handicapped, former members of the military, and so on) is equal to that in central government ministries. In addition, because of pressure from the comptroller and accountant general's annual audit, they are inclined to accept the lowest bidder for procurement tenders, even when quality is poor, and they have little autonomy in making major decisions, including the appointment of senior management personnel or financial investments.

As the current government recognizes, the only solution to these issues is systematic and transparent privatization of the SOEs. However, progress

to this end has been poor, partly because of resistance from the entrenched, rent-seeking bureaucracy, and partly because of the lack of sufficient political will. In the meantime the SOEs are losing corporate value and their best managers are leaving for jobs in the private sector.

RECENT CORPORATE GOVERNANCE INITIATIVES

Two major corporate governance initiatives have been launched in India since the mid-1990s, the first has been by the Confederation of Indian Industry, India's largest industry and business association, and the second by SEBI. More than a year before the onset of the 1997 Asian crisis the Confederation of Indian Industry set up a committee to examine corporate governance issues and recommend a voluntary code of best practices. The committee released "Desirable Corporate Governance: A Code" in April 1998 (see http://www.ciionline.org/busserv/corporate/backup/cgcode.htm). The code focuses on listed companies and provides detailed recommendations that address the items identified earlier.

As for the functioning of boards of directors, the code recommends, for instance, the appointment of a core group of knowledgeable and professionally acclaimed nonexecutive directors; a minimum number of board meetings per year; the nonaccumulation of executive positions by one person; the payment of a commission to directors based on corporate performance and the provision of stock options; and the establishment of annual operating plans and budgets, accompanied by updated long-term plans. The code further recommends providing boards of directors with details of any joint ventures or collaboration agreements; information about transactions that involve substantial payment for goodwill, brand equity, or intellectual property; and information on the recruitment and remuneration of senior officers. In addition, the code recommends the establishment of audit committees. The code also makes recommendations with regard to disclosure of various aspects of companies' performance and staff, including the rating received from all credit rating agencies.

These efforts have started to bear fruit. For the financial year ended 31 March 1999, 23 large, listed companies accounting for 19 percent of India's market capitalization fully or partly adopted these disclosure norms. A more subtle effect of the initiative has been that companies have tended to look more positively at the concept of corporate governance rather than dismissing it as a passing fad.

The other major corporate governance initiative was taken by SEBI starting in early 1999. By early 2000 SEBI had prepared a number of mandated recommendations that apply to listed companies and are to be enforced at the level of stock exchanges through listing agreements (see http://www.sebi.com). Similar to the code drafted by the Confederation of Indian Industry, these recommendations cover such issues as board composition, define the notion of independent directors and the kind of information that needs to be provided to shareholders, and recommend the establishment of an independent audit committee at the board level. The recommendations furthermore define a number of disclosure requirements. These recommendations are to be implemented following a timetable. All companies listing for the first time must adhere to these recommendations at the time of listing. For companies that are already listed, depending on their share capital and/or net worth, they had to be in compliance by 31 March 2001 or 2002, or must be in compliance no later than 31 March 2003.

While most of SEBI's recommendations follow from the Confederation of Indian Industry's code, SEBI's mandate clearly has more teeth, in that unlike the code, it is not voluntary but mandatory. However, some issues raise concerns. One such issue is that of assuring compliance. While delisting is a credible threat for larger companies, this is not the case for the vast majority of listed companies that have little floating stock. A second issue is the fear that by legally mandating several aspects of corporate governance, SEBI might unintentionally encourage the practice of companies managing by means of checklists instead of focusing on the spirit of good governance.

This raises a question of what should be voluntary and what should be mandatory. In an ideal world with efficient capital markets such a question would not arise, because the market would distinguish between well-run companies and poorly-run companies and reward and punish them accordingly. Unfortunately, ideal capital markets exist only in theory. Thus what is needed is a small corpus of legally mandated rules, buttressed by a much larger body of self-regulation and voluntary compliance. This will no doubt happen in India. When all listed companies are forced to follow the SEBI guidelines, the better firms will voluntarily raise the bar so as to be measured according to best international practices in an effort to attract international funds.

CONCLUSION

While corporate governance has been slow in making its mark in India, the next few years will see a flurry of activity. This will be driven by several factors as follows:

- The increased competition to which corporate India has been exposed since the mid-1990s has forced companies to drastically restructure their management practices.
- There has been a major shift in company pecking order, with young companies managed by modern, outward oriented professionals who place a great deal of value on corporate governance and transparency clawing their way to the top.
- There has been a phenomenal growth in market capitalization, which has resulted in a fundamental change in mindset whereby creating and distributing wealth has become a rather popular maxim.
- Foreign investors have repeatedly demanded better corporate governance, more transparency, and greater disclosure, and have made this requirement felt by increasing their exposure in well-governed firms at the expense of poorly run ones. The same can be said for foreign pension funds, which are likely to increase in importance in the coming years.
- An increasingly strong financial press has induced a new level of disclosure, both with regard to companies' financial statements and to internal governance matters.
- Banks and DFIs are no longer willing to support management irrespective of performance. The tendency of more market-oriented DFIs to start converting some of their outstanding debt to equity and to set up mergers and acquisition subsidiaries to sell their shares in underperforming companies to more dynamic groups will further intensify over time.
- It is widely recognized among Indian corporations that improving corporate governance and applying internationally accepted accounting and disclosure standards is likely to facilitate access to U.S. capital markets.
- In a few more years India will have moved to full capital account convertibility. This will increase Indian investors' freedom to choose between Indian and foreign companies for placing their funds, and good corporate governance will be one of the major issues that these investors will consider.

Given these developments, the prediction that by the end of 2005 India might have the largest concentration of well-governed companies in South and Southeast Asia may well come to pass.

REFERENCES

Goswami, Omkar. 1996. Legal and Institutional Impediments to Corporate Growth. In *Policy Reform in India,* edited by Charles Oman. Paris: OECD, Development Centre.

Omkar Goswami, M. Karthikeyan, and G. Srivastava. 1999. Are Indian Companies Losing Shareholder Value? *Confederation of Indian Industry Corporate Research Series* 1 (1).