

# Corporate Governance Compliance Practices of Indian Companies

Prof. Mehul Raithatha<sup>1\*</sup>, Dr. Varadraj Bapat<sup>2</sup>

<sup>1</sup>Assistant Professor, Smt. MMK College of Commerce and Economics, Research Scholar, S J Mehta School of Management, Indian Institute of Technology, Powai, Mumbai - 400076, INDIA

<sup>2</sup> Assistant Professor, S J Mehta School of Management, Indian Institute of Technology, Powai, Mumbai - 400076, INDIA

\*E-mail: [mehular83@gmail.com](mailto:mehular83@gmail.com) or [Mehul.raithatha@outlook.com](mailto:Mehul.raithatha@outlook.com)

## Abstract

Recent financial scandals associated to accounting and other frauds allegedly blamed to top company managers (e.g. Enron, Worldcom, Paramalt, Satyam) have brought into public light the recurring question of whether companies are managed on the best interests of shareholders and other company stakeholders such as workers, creditors and the general community. The paper studies compliance of Corporate Governance requirements by Indian Companies. A model is developed to calculate the Corporate Governance Score of companies and then it is related to company attributes like size, profitability, leverage, foreign ownership etc. No significant correlation exists between Corporate Governance and company Characteristics however average compliance by Indian Companies has been satisfactory. Factor analysis of major sub-parameters of Corporate Governance Score, namely Composition of Board, Audit Committee, Number of Board Meetings and Remuneration Committee is done. Two factors namely Strength of Committee and Competency level of Board are identified as important factors.

**Keywords:** Corporate Governance Compliance, Disclosures & Transparency, Stakeholders, Factor Analysis

## 1. Introduction

Corporate governance has recently received much attention due to Adelphia, Enron, WorldCom, and other high profile scandals, serving as the impetus to such recent U.S. regulations as the Sarbanes-Oxley Act of 2002, considered to be the most sweeping corporate governance regulation in the past 70 years (Byrnes et al., 2003). Corporate Governance is the overall control of activities in a corporation. It is concerned with the formulation of long-term objectives and plans and the proper management structure (organization, systems and people) to achieve them. At the same time, it entails making sure that the structure functions to maintain the corporation's integrity and responsibility to its various constituents. The structure to ensure corporate governance includes the board of directors, top management, shareholders, creditors and others. Role of each of these stakeholders is crucial in guaranteeing responsible corporate performance.

Corporate governance is the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the management of a company. The term governance has been derived from the word '*gubernare*', which means "to rule or steer". It originally meant to be a 'normative' framework for exercise of power and acceptance of accountability thereof in the running of kingdoms, regions and towns. However, over the years it has found significant relevance in the corporate world on account of growing number and size of corporations, the widening base of their shareholders, increasing linkages with the physical environment, and overall impact on the society's well-being. Governance is the process whereby people in power make decisions that create, destroy or maintain social systems, structures and processes. Corporate Governance is therefore the process whereby people in power direct, monitor and lead corporations, and thereby either create, modify or destroy the structures and systems under which they operate.

According to James D. Wolfensohn, President of World Bank, "Corporate Governance is about promoting corporate fairness, transparency and accountability." Corporate Governance is more a way of business life than a mere legal compulsion. There is nothing laudable about complying with conditions/practices, which the companies are forced to adopt through the process of legal prescription. Of course, companies must focus on their core objective of earning profits, but the earning and sharing of profits needs to be aligned with the expectations of stakeholders. The investors tend to value and remain loyal to organisations having established credentials for making efforts aimed at benefiting various categories of stakeholders. Adoption of distinct corporate governance practices distinguishes a company from ordinary companies, which are content merely with complying with prescribed legal requirements. The companies adopting distinct corporate governance practices stand out from others.

Ancient Indian literature has laid down principals for corporate governance. The lessons from Kautilya's

Arthashastra (4th Century BC) can be integrated into the modern context of corporate management towards achieving the ultimate aim of corporate governance, which is to provide value to shareholders and stakeholders.

Public interest in corporate governance is nothing new. It dates back to 1970 when in the wake of the establishment, maintenance and review of internal control was passed in the trade way in the Trade- way commission was formed following the saving and loan crisis. In 1990 the Cadbury committee code of best practices in the U.K., the combined code of London Stock Exchange, the Blue ribbon committee of U.S., the OECD Code of 1998 and the joint efforts of World Bank and the OECD to develop benchmarks in corporate governance have kept public interest kindling.

## **2. Evolution of Corporate Governance Code in India**

Ancient Indian literature has laid down principals for corporate governance. While it is beyond the scope of this paper to describe the recommendations by the committee's in detail, an effort is made to summaries the gist of various committees and the subsequent evolution of Corporate Governance Code in India.

**CII Code on Corporate Governance (1998):** In 1996, CII took a special initiative on Corporate Governance – the first institutional initiative in Indian industry, to develop and promote a code for Corporate Governance. This initiative by CII flowed from public concerns regarding the protection of investor interest, especially the small investor; the promotion of transparency within business and industry; the need to move towards international standards in terms of disclosure of information by the corporate sector and, through all of this, to develop a high level of public confidence in business and industry. A National Task Force set up with Mr. Rahul Bajaj, as the Chairman presented the draft guidelines and the code of Corporate Governance in April 1997.

**Birla Committee on Corporate Governance (1999):** The Committee was set up by SEBI to promote and raise the standards of Corporate Governance. The Committee's terms of reference included suggesting suitable amendments to the listing agreement executed by the stock exchanges with the companies in order to enhance corporate governance standards of listed companies, drafting a code of corporate best practices; and suggest safeguards to be instituted within the companies to deal with insider information and insider trading. Several of the Committee's recommendations were incorporated in Clause 49 of the listing agreement of stock exchanges.

**Naresh Chandra Committee Report on Corporate Audit and Governance (2002):** Following the corporate scandals of the US, the Department of Corporate Affairs (DCA), Government of India set up the Naresh Chandra Committee to examine various corporate governance issues. Many recommendations of the report were incorporated in the Companies (Amendment) Bill 2003.

**Narayana Murthy Committee Report on the Corporate Governance (2003):** The Committee was constituted by SEBI to review the performance of corporate governance in the country as well as to determine the role of companies in responding to rumour and other price sensitive information circulating in the market in order to enhance the transparency and integrity of the market.

**Dr. J.J.Irani Report on New Company's Act (2004/05):** The recommendations of this committee were primarily on revision of existing Companies Act, 1956 so as to bring about compactness by reducing the size of the Act and removing redundant provisions and facilitate easy and unambiguous interpretation by recasting the provisions of the law. This enabled provision of greater flexibility in rule making, to enable timely response to ever-evolving business models and protecting the interests of the shareholders and investors.

## **3. Review of Literature**

Gupta, Nair and Gogula (2003) analyzed the CG reporting practices of 30 selected Indian companies listed in BSE. The CG section of the annual reports for the years 2001-02 and 2002-03 had been analyzed by using the content analysis, and least square regression technique was used for data analysis. The study found variations in the reporting practices of the companies, and in certain cases, omission of mandatory requirements as per Clause 49.

Bhattacharyya and Rao (2005) examined whether adoption of Clause 49 predicts lower volatility and returns for large Indian firms, they compare a one-year period after adoption (starting June 1, 2001) to a similar period before adoption (starting June 1, 1998). The logic is that Clause 49 should improve disclosure and thus reduce information asymmetry and thereby reduce share price volatility. The authors find insignificant results for volatility and mixed results for returns.

Collett and Hraskey (2005) analyzed the relationships between voluntary disclosure of CG information by the companies and their intention to raise capital in the financial market. A sample of 299 companies listed on Australian stock exchange had been taken for the year 1994 and Connect-four database had been used for collection of annual reports of companies. The study found out that "only 29 Australian companies made voluntary CG disclosure, and the degree of disclosures were varied from company to company."

Barako et al., (2006) examined the extent of voluntary disclosure by the Kenyan companies over and above the mandatory requirements. This study covered a period of 10 years from 1992 to 2001. The results revealed that “the audit committee was a significant factor associated with level of voluntary disclosure, while the proportion of non-executive directors on the board was negatively associated.” Subramanian (2006), he identified the differences in disclosure pattern of financial information and governance attributes. A sample of 90 companies from BSE 100 index, NSE Nifty had been taken. The data with respect to disclosure score had been collected from the annual reports of the companies for the financial year 2003-04. The study used the Standard & Poor’s “Transparency and Disclosure Survey Questionnaire” for collection of data. The study finally concluded that “there were no differences in disclosure pattern of public/private sector companies, as far as financial transparency and information disclosure were concerned.”

K. C. Gupta (2006) traced out the differences in CG practices of few local companies of an automobile industry. The data with respect to governance practices had been collected from the annual report of the companies for the year 2004-05. The study “did not observe significant deviations of actual governance practices from Clause 49.”

Subramanian (2006) identified the differences in disclosure pattern of financial information and governance attributes, namely board and management structure, process and ownership structure, and investors relations of Indian companies. A sample of 90 companies from BSE 100 index, NSE Nifty and Nifty Junior had been taken. It is classified into public sector and private sector including the subsidiaries of multinational companies. The data with respect to disclosure score had been collected from the annual reports of the companies for the financial year 2003-04. The researcher had used the Standard & Poor’s ‘Transparency and Disclosure Survey Questionnaire’ for collection of data. This questionnaire was based on 98 items, divided into three categories such as financial disclosure, board and management structure disclosure, and ownership structure and investors relations related disclosure. Disclosure score on board attributes, financial information and ownership structure had been taken as dependent variable. On the other hand, management control in the form of government control, private promoter control and MNCs control had been taken as independent variables. Foreign institutional investors’ holdings, sales and listing status were used as control variables in this study. Multivariate regression technique was used for the analysis. The researcher observed that there were no differences in disclosure pattern of public sector and private sector companies as far as financial transparency and information disclosure were concerned. It had also been observed that private companies disclose more information under the category of board and management structure. The researcher had also pointed out that his study did not differentiate between mandatory and voluntary items of disclosure index.

#### 4. Objective of the Study

- To examine the level of compliance with disclosure requirements of the Corporate Governance Code by Indian companies
- To determine whether any relationship exists between the compliance with Corporate Governance Code and a number of key company characteristics like Market Capitalization, Net Profit Margin, Leverage Ratio, FII Stake and Promoter Stake.
- To conduct Factor analysis for important sub-parameters of Corporate Governance Compliance score.

#### 5. Data and Methodology

##### 5.1 Data

A sample of 30 companies was selected from the companies listed on the BSE. All the selected companies are “A” group companies. Annual reports of the selected companies were the major sources of data. Corporate Governance Score (CG Score) is taken as Dependent variables and several Company attributes are considered as Explanatory Variables.

##### 5.2 Calculation of Corporate Governance Score

In this study the Corporate Governance Score (CG Score) is calculated for each Company under consideration based on the extent of compliance of the Company to the various parameters of Corporate Governance and the weightage allotted to that parameter. Clause 49 is considered as a basic framework here for calculating the CG Score across the different parameters. Calculation of Corporate Governance Score is explained in Table 1.

##### 5.3 Explanatory Variables and Hypotheses

Researchers have addressed the impact of various corporate characteristics on the disclosures in annual report. These characteristics include size, profitability, listing status, size of equity market, leverage, etc. The procedure for operationalizing the variables in the regression analysis and the rationale for expecting them to explain disclosure variability are outlined in Table 2.

Following Hypothesis was framed using the above variables.

Null Hypothesis (H0) There is no relationship between Company Attributes and CG Score.

#### **Size**

Theoretically, size of a firm is assumed to affect the level of disclosure in the annual reports. Larger the firm, the more is the information disclosed in the annual reports. Many reasons have been advocated in the literature to support this relationship. For example, generating and disseminating information are costly exercises. Only large firms would be having necessary resources and expertise for the production and publication of more sophisticated financial statements with maximum disclosures required by the users.

**H1: Larger Companies have higher CG score.**

#### **Profitability**

Corporate profitability affects the disclosure in annual reports in many ways. Moreover, agency theory suggests that managers of very profitable firms will use external information to their personal advantage. So they will disclose detailed information in order to support the continuance of their positions and compensation agreements.

**H2: Companies with larger profits have higher CG score.**

#### **Leverage**

A positive relationship can be expected between leverage and disclosure level. Companies having higher levels of debts are seen to be more risky and incur more monitoring costs. The disclosure of information reduces the monitoring costs and facilitates the creditors in assessing the firms risk and cost of debt.

**H3: Companies with higher Leverage have a higher CG score.**

#### **FII stake**

Ownership of FII seems to be making company more responsible in their behaviour to comply with the disclosure requirements.

**H4: Companies with higher FII Ownership have CG score.**

### **5.4 Formulation of Model**

In order to determine the effect of company characteristics on compliance with CG score Multiple Regression technique is used.

Considering calculated CG Score as dependent variable and other company attributes as explanatory variables following equation can be framed.

$$CG\ Score = \alpha + \beta_1 MCAP + \beta_2 NPR + \beta_3 DE + \beta_4 FIIOWN$$

## **6. Results and Discussions**

### **6.1 Descriptive Statistics**

Table 3 shows that Average CG Score is 76.63%, whereas maximum and minimum is 94% and 58% respectively.

### **6.2 Correlation matrix**

The correlation is calculated between the Corporate Score and the other financial parameters. At 5% Level of Significance there is no correlation between Corporate Score and the financial parameters which are considered. However at the given level of significance we find correlation between Net Profit Margin and Normalized Market Capitalization (Table 4).

### **6.3 Regression results**

Multi-linear Regression of Corporate Score against NPM, FII Stake, Normalized Market Capitalization and Leverage Ratio is performed. The analysis (Table 5) shows that no variables are significant at 5% level of significance. Hence we cannot reject null Hypothesis. However the level of significance value for Leverage ratio is 8.5%, thus at 10% level of significance we would be able to reject the null hypothesis of no relation between Leverage Ratio and Corporate Score.

### **6.4 Factor Analysis**

Factor analysis of four sub parameters of Corporate Governance Score, namely Composition of Board, Audit Committee, Number of Board Meetings and Remuneration Committee is done. From the factor analysis (Table 6) two factors are derived which explain 66% of the variance between the four parameters of Corporate Governance. The first factor which alone explains 35% of the variance is substantially extracted from Audit Committee and Remuneration Committee. Thus the first factor hints at the strength of the Committees in a given Company. The second factor which explains 31% of the variance is substantially extracted from Composition of Board and Number of Board Meetings. The second factor hints at the competency level of the Board. Lower the competency level higher the number of times the Board meets. Thus two factors namely 'Strength of Committee' and 'Competency level of

Board' are derived from this Factor Analysis.

## 7. Conclusions

The paper concludes that financial parameters like Net Profit Margin, Market Capitalization, FII Stake and Leverage Ratio resulted in co-efficient values which were found to be not significantly related to Corporate Governance score. From the empirical data and analysis done it may be concluded that in India the state of Corporate Governance may not be an important factor for FFIs to decide on buying stakes in the company. Also the myth that generally Companies with Small and Medium Market Capitalization do not have a very strong and sound Corporate Governance was proved false by the regression analysis as there was no significant relationship found between coefficient of Normalized Market Capitalization and Corporate Governance Score of the Companies. The significant coefficient of Leverage Ratio to Corporate Governance hints possibility of two cases, one being that unlike Fund Managers of FIIs, Creditors are very conservative in their approach and do a thorough check of the Corporate Governance state of a Company before lending debts or it may also be so that Companies would have to prove a robust and sound Corporate Governance so as to raise debt from the market. Factor Analysis revealed that 'Strength of Committee' and 'Competency level of Board' are two important sub parameters.

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## APPENDIX

**Table 1: Computation of Corporate Governance Score**

Sr.No	Parameter	Break-up	Weightage
1.	Corporate Governance Philosophy	-	2
2.	Composition of Board of Directors	-	20
2a.	- Proportion of Non Executive directors to total number of directors	4	
2b.	- Proportion of Independent directors to total number of directors	4	
2c.	- Average Directorship per member of the board	4	
2d.	- Average Committee Chairmanship per member of the board	4	
2e.	- Average Committee Membership per member of the board	4	
3.	Number of Board Meetings in a year	-	5
4.	Code of conduct	-	3
5.	Audit Committee		15
5a.	- Number of Non executive Directors in the Committee	2	
5b.	- Number of Independent Directors in the Committee	4	
5c.	- Audit Committee chaired by Independent Director	2	
5d.	- Presence of the Chairman of the Audit Committee in the last AGM	2	
5e.	- Number of Audit Committee Meetings	3	
5f.	- Quorum at the Audit Committee Meeting	2	
6.	Shareholder's Grievance Committee	-	5
7.	Whistle Blower Policy	-	4
8.	Disclosure	-	15
8a.	- Contingent Liabilities	3	
8b.	- Related Party Transactions	3	
8c.	- Remuneration to Directors	3	
8d.	- Non compliance, Penalty or Stricture	3	
8e.	- Accounting treatment	3	
9.	Management Discussion and Analysis Report	-	5
10.	CEO/CFO Certification	-	5
11.	Compliance Report on Corporate Governance	-	5
12.	Remuneration Committee	-	10
12a.	- Number of Non Executive Directors in the Committee	3	
12b.	- Committee chaired by the Independent Director	3	
12c.	- Presence of the Chairman of Remuneration Committee in the last AGM	2	
12d.	- Quorum at the Remuneration Committee Meeting	2	
13.	Training of the Non Executive Directors	-	3
14.	Postal Ballot	-	3
		<b>Total</b>	<b>100</b>

**Table 2: List of Variables and Method of Calculation**

Variables	Represented by	Calculation
Size	Market Capitalization (Normalised)	Market Capitalization (Normalised)= Market Capitalization/(max(Market Capitalization)-min (Market Capitalization))
Profitability	Net Profit Margin	Net Profit Margin= Profit After Tax/Sales Turnover
Leverage	D/E Ratio	Debt/Equity
FII stake	% of FII Ownership	

**Table 3: Descriptive Statistics**

	CG Score	FII Stake	Leverage	NPM	Mark Cap (Normalized)
Mean	76.63	0.0915	0.7404	0.1032	0.1565
Median	76	0.06	0.577	0.1027	0.0376
Mode	72	0	0	0.0855	0.0012
Standard Deviation	8.4661	0.0877	0.7355	0.1399	0.2603
Range	36	0.3022	3.4999	0.9245	1
Minimum	58	0	0	-0.3772	0.0004
Maximum	94	0.3022	3.4999	0.5473	1.0004

**Table 4: Correlation Matrix**

**Table 5: Regression Results**

		Corporate_Score	FII_Stake	Leverage_Ratio	NPM	Market_Cap (Normalised)
Corporate_Score	Pearson Correlation	1	.002	-.282	.078	-.044
	Sig. (2-tailed)		.989	.112	.666	.806
	N	33	33	33	33	33
FII_Stake	Pearson Correlation	.002	1	-.051	.152	.075
	Sig. (2-tailed)	.989		.778	.399	.679
	N	33	33	33	33	33
Leverage_Ratio	Pearson Correlation	-.282	-.051	1	-.098	-.320
	Sig. (2-tailed)	.112	.778		.587	.070
	N	33	33	33	33	33
NPM	Pearson Correlation	.078	.152	-.098	1	.409*
	Sig. (2-tailed)	.666	.399	.587		.018
	N	33	33	33	33	33
Nor_Market_Cap	Pearson Correlation	-.044	.075	-.320	.409*	1
	Sig. (2-tailed)	.806	.679	.070	.018	
	N	33	33	33	33	33

\*. Correlation is significant at the 0.05 level (2-tailed).

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	95% Confidence Interval for B	
	B	Std. Error	Beta			Lower Bound	Upper Bound
(Constant)	79.883	3.062		26.089	0	73.611	86.155
FII_Stake	-1.863	17.363	-0.019	-0.107	0.915	-37.428	33.703
Leverage_Ratio	-3.86	2.164	-0.335	-1.784	0.085	-8.292	0.573
NPM	7.947	11.909	0.131	0.667	0.51	-16.448	32.342
Market_Cap (Normalised)	-6.632	6.663	-0.204	-0.995	0.328	-20.28	7.017

Dependent Variable: Corporate\_Score

**Table 6: Factor Analysis Output**

**Total Variance Explained**

Component	Initial Eigen values			Extraction Sums of Squared Loadings		
	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %
1	1.422	35.538	35.538	1.422	35.538	35.538
2	1.231	30.765	66.303	1.231	30.765	66.303
3	.775	19.368	85.671			
4	.573	14.329	100.000			

Extraction Method: Principal Component Analysis.

**Component Matrix<sup>a</sup>**

	Component	
	1	2
Composition_of_Board	.480	-.642
Board_Meeting	.021	.855
Audit_Committee	.789	.282
Remuneration_Committee	.753	.091

Extraction Method: Principal Component Analysis.