Corporate Governance in India

From Policies to Reality

Indian Institute of Corporate Affairs

Partners in Knowledge, Governance, Transformation

THOUGHT ARBITRAGE

Bridging the thought divide

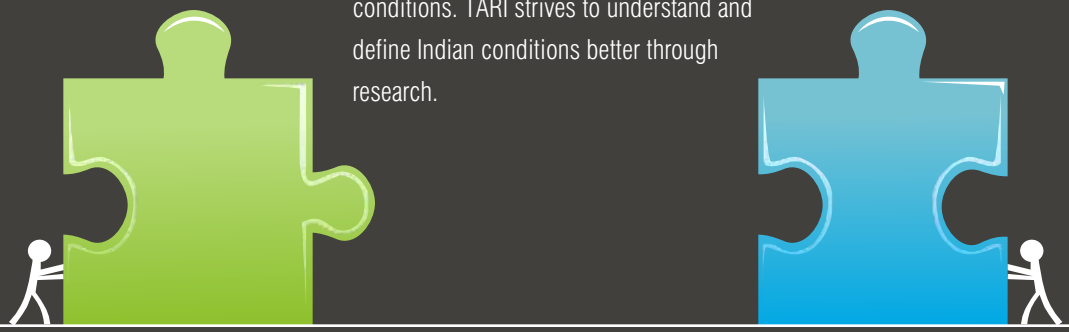
INDIAN INSTITUTE OF MANAGEMENT CALCUTTA

Project Partners

Indian Institute of Corporate Affairs (IICA) was established by The Ministry of Corporate Affairs, Government of India as a unique world-class institution to function as a think tank, action research, service delivery and capacity building support to the Ministry, corporate sector, professionals and related stakeholders. IICA's functions involve capacity building and training in corporate regulation and governance such as corporate and competition law, accounting and auditing issues, compliance management, corporate governance, business sustainability through environmental sensitivity and social responsibility, e-Governance and enforcement etc.

Thought Arbitrage Research Institute (www.tari.co.in) is a not for profit organisation set up under Section 25 of the Indian Companies Act. TARI's mandate is to develop intellectual capital for the country in the areas of Corporate Governance, Sustainability, Economics and Public Policy. In India there is very little privately funded research that puts forth unbiased points of view. TARI attempts to bridge this gap in the area of thought development. Tomorrow's arbitrage will not be labour, cost or capital – but on knowledge, ideas and thought. Countries that are at the forefront in these areas will control the course of global economic power. India's ascent to economic power have to be driven by home grown ideas and solutions tailored to Indian conditions. TARI strives to understand and define Indian conditions better through research.

Indian Institute of Management Calcutta (IIMC) was established as the first national institute for Post-Graduate studies and Research in Management by the Government of India in collaboration with Alfred P. Sloan School of Management (MIT), the Government of West Bengal, The Ford Foundation and Indian industry. Over the years IIMC has grown into a globally reputed institution, imparting high quality management education. It has been playing a pioneering role in professionalising Indian management through its Post Graduate and Doctoral level programs, Executive Training Programs, Research and Consulting Activities.



डॉ० एम. वीरप्पा मोइली
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MINISTER OF POWER & CORPORATE AFFAIRS
GOVERNMENT OF INDIA

MESSAGE

Good corporate governance is rapidly becoming one of the major factors for the economic success of companies. Good corporate governance practices also reduce the perceived risks of investing in companies. This helps to raise the investment profile of the country as a whole.

The Government of India is committed to helping Indian companies adopt best practices in corporate governance. Indian Institute of Corporate Affairs (IICA) is instrumental in translating this vision into actions through its capacity building and research programs.

I compliment IICA for bringing out this series of thought papers on various aspects of corporate governance in partnership with Thought Arbitrage Research Institute and Indian Institute of Management-Calcutta. I am sure these papers will enrich both academicians and business leaders and contribute to the body of knowledge in the vital field of corporate governance.

My best wishes to all the collaborators for success in this and future endeavours.

(Dr. M. Veerappa Moily)

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Foreword

The principles of accountability, probity, fairness and transparency have never been more important for the Indian economy. Corporate India is a crucial part of the Indian economy and is therefore expected to lead the way in adopting these principles which lead to good corporate governance.

Several guidelines, notifications and regulations have been issued over the past few years which are aimed at improving corporate governance particularly among listed companies. Some of these are drawn from global best practices which, however, are designed for Anglo-Saxon economic models. India needs regulations that are designed for, and responsive to, local conditions and business realities.

The Indian Institute of Corporate Affairs (IICA) is committed to provide a special focus on ethical corporate behaviour and enabling a clear understanding of the changing national and global business environment. This would help to catalyse appropriate regulatory responses to ensure that these are calibrated to Indian economic conditions. IICA is also committed to collaborating closely with institutions and think tanks for conducting research and contributing to developing intellectual capital for the country.

With this objective in mind, IICA has collaborated with Indian Institute of Management Calcutta and Thought Arbitrage Research Institute to bring out a series of papers covering various aspects of corporate governance in India. The research was carried out in close consultation with academicians and practitioners working in the area of corporate governance to provide a comprehensive view of the subjects. The research papers are notable for use of quantitative analysis rather than relying on anecdotal evidence to support the hypotheses.

The series begins with setting the background of corporate governance including its evolution, examines the role of the three major gatekeepers of corporate governance and closely analyses the role of earnings management in ensuring exemplary corporate governance.

I hope the research findings will help to closely align regulations and laws with Indian business realities.

Dr. Bhaskar Chatterjee
Director General & CEO
Indian Institute of Corporate Affairs

Introduction

> Good governance has always been an important element in human interactions and in an increasingly uncertain global climate has now become an imperative.

Good governance has always been an important element in human interactions and in an increasingly uncertain global climate has now become an imperative. Business and economy are closely aligned to the fortunes and well-being of people which makes corporate governance a subject of great importance.

Thought Arbitrage Research Institute and Indian Institute of Management, Calcutta have collaborated to conduct research in corporate governance to develop relevant, new, workable intellectual capital for the country; so that business decision quality is enhanced as it comes to be based on researched facts. The research model is unique in that it relies on empirical data to analyse hypotheses and support its conclusions rather than anecdotal narratives.

This series begins by tracing the evolution of corporate governance and major global factors that have shaped its contours. Corporate governance norms and regulations in India are in a state of constant refinement, in search of the balance between voluntary and mandatory approaches. More importantly, Indian regulations are based on the Anglo-Saxon model of corporate governance which has limitations in its applicability to the Indian environment. Our study analyses these aspects of the corporate governance journey in India and suggests areas where robust research is needed to support policy formulation in corporate governance in India.

As with any other system, corporate governance is as strong as its oversight mechanism. Therefore, the next part of this series focusses on a very important component in the system, namely the gatekeepers or conscience-keepers of corporate governance. Keeping the economic and business landscape of India in mind, we have focussed on three major gatekeepers: Reserve Bank of India, Securities and Exchange Board of India and Auditors. Each of these plays a critical role in maintaining the integrity of the corporate governance system and the focus of our research has been to assess their effectiveness as gatekeepers. We have based our findings on analysis of financial, economic and other numerical data. The final score is a mixed report card for each of the gatekeepers where some areas of working are strong, while some areas need to be strengthened for them to fulfil their role fully.

Credible financial information is the lubricant that keeps the capital market system functioning smoothly. But what is the quality of information that flows through the Indian capital markets? Can users rely on financial information produced in the system to take informed decisions? The objective of the next study in the series is to present a more comprehensive study of the association between corporate governance variables and earnings management with firm level data, in the emerging market context of India- characterized by concentrated corporate and government ownership and family control of firms. The rationale for the study is provided by considerable earnings management observed across a cross-section of Indian firms across the period 2006-2011 when benchmarked against Benford's law (1938), which elucidates an expected normal probability distribution of numbers as they

occur in the real world. The results of the study give us reasonable grounds to believe that firms with better corporate governance would have relatively lesser incentives for earnings management, due to lower agency problems of conflict of interest between the agent and the principal -- primarily the dominant and the minority shareholders in the Indian context.

The study is an endeavour to take stock of the corporate governance environment in India as it exists today. Simultaneously, it is an attempt to puzzle out, in concrete terms, the pressing issues and the resultant course of action going forward particularly some specific action points beneficial for the Indian business environment. The journey in that direction has already begun: the incorporation of SEBI with a stated aim of creating open and participative markets and its fair success in managing the markets in what has been clearly a very dynamic and challenging decade for them; the new Companies Bill with an explicit emphasis on promoting best practices in corporate governance and MCA's more active redefined role in it; RBI's notable management of the Indian banking sector in the last few years of widespread failures in the financial sector in other parts of the world. Corporate Governance in India is nearing a threshold. Deep understanding of underlying factors and issues is going to become important. This study is one of the many contributions that will be required to complete the journey successfully.

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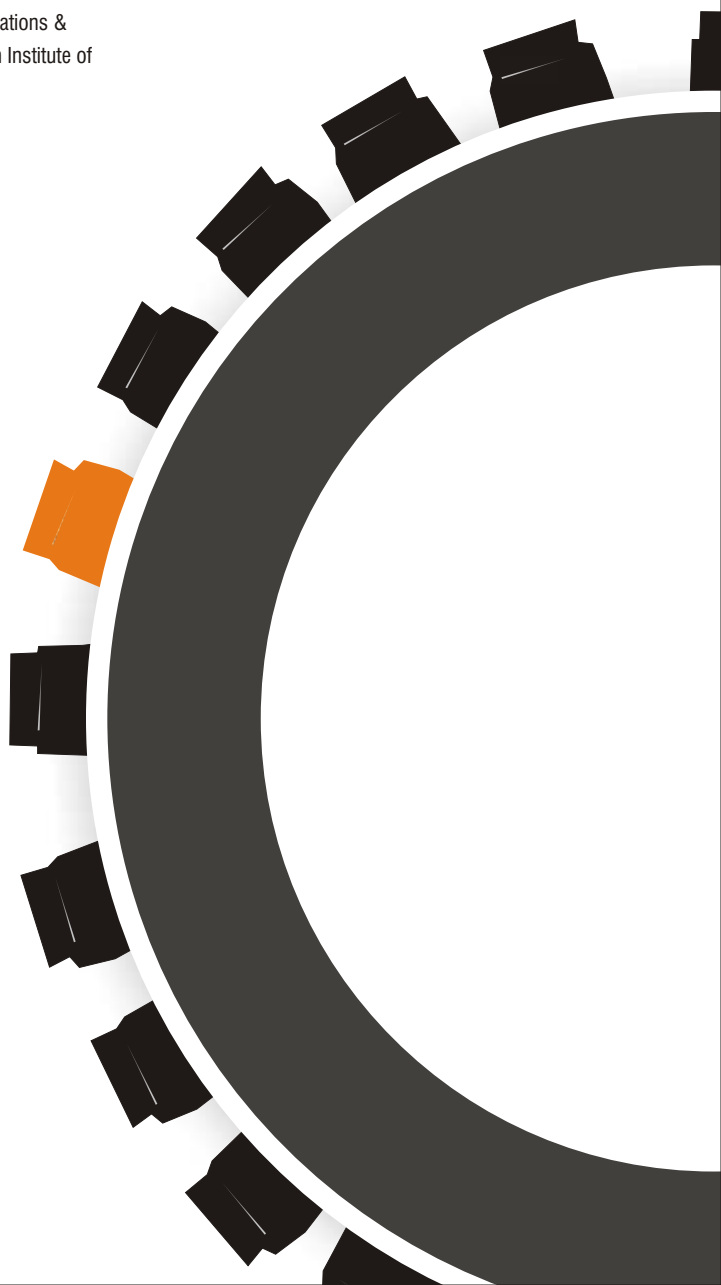


Corporate Governance in India: Tracing the Journey

Corporate Governance in India: Tracing the Journey

Santosh Pande, Kshama V. Kaushik

Executive Summary

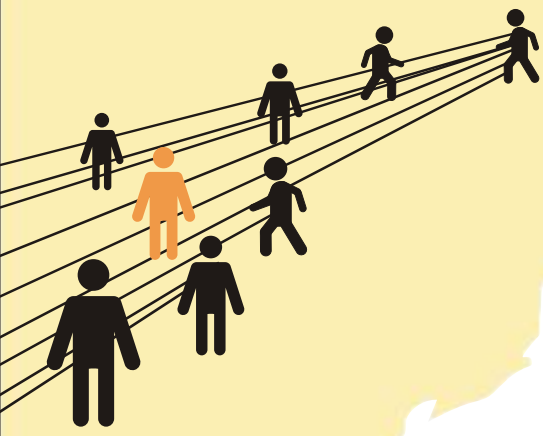
In some ways Corporate Governance is not a new concept; responsibility in the handling of money and conduct of business and commerce has always been important. In the last century or so, with the increasing complexity and power of corporations, it has come to the fore emphatically. A decisive beginning was made in this direction when after the introduction of liberal-market reforms, the Indian Corporate Sector, led by CII, drew up a voluntary code of Corporate Governance (CG). Further developments from this point vacillated between making CG voluntary or mandatory. Studies have found reasonably good levels of adherence to the mandatory CG rules in India. But, there is still a long way to go; the Indian model is based on the Anglo-Saxon example, which may not be wholly suited to the peculiar Indian conditions.

Evolution of Corporate Governance in India

The concept of CG gained prominence in India post liberalization, voluntarily introduced by CII, the leading industry association in India. By the year 2000, the same had been incorporated as a necessity in the clause 49 of the listing agreement administered by the market regulator SEBI. It was followed by the Naresh Chandra Committee report with major stress on independent oversight of board and audit, and improvements in disclosures (financial as well as non-financial). In the subsequent years, two more committees were constituted under the leadership of Mr Narayan Murthy and Mr J J Irani, with the explicit aim of bringing in best practices from around the world to create a well regulated environment that promotes entrepreneurship. In 2009, the Satyam fiasco shook the Indian industry, bringing home the point that proper governance is indispensable to further growth and development. Since then efforts to create a framework have gained urgency. The Ministry of Corporate Affairs (MCA) came out with guidelines in 2009. A lot of diverse ideas have been introduced in parts over these years, which will be synthesised into law when the new Companies Bill is passed.

Corporate Governance Peculiarities in India: Key Issues

Significant work has been done in the last couple of decades, but some key issues remain unresolved.



Agency Gap: The western approach to CG focuses more on regulating management actions to align them with the interest of stakeholders, as ownership is reasonably dispersed. This is the classic agency problem, but in India the agency problem primarily exists between the dominant/majority shareholder (typically the promoter) and other stakeholders. Indian businesses are also dominated by family-business-promoted firms where they exercise disproportionate control. Even in the case of MNCs and PSEs the majority shareholder has been found to exercise dominant control. The underlying characteristics of this system need to be researched and identified, so that the CG framework can be fine-tuned to Indian needs.

PSE vs. MNC vs. Family Business: The three different kinds of firms- PSEs, MNCs and Family Businesses- have their own unique characteristics and public perceptions. PSEs are answerable to ministries, need to comply with norms laid down by Department of Public Enterprises, and are subject to scrutiny under Right to Information act and other authorities such as CAG and CVC. PSEs though subject to controls operate in a relatively complex setting.

The MNCs on the other hand are perceived as the most advanced in terms of CG, as they are required to comply with the standards set down by the parent company. However, even MNCs have had instances where they have made an attempt to acquire minority shareholding at unfair valuations.

Family Businesses dominate Indian market; as per a study by Credit Suisse in 2010, 663 of the listed 983 companies are family businesses. They exercise undue control over a company either directly through the promoter or promoter family stake or through a holding company. In the recent Satyam debacle the Promoter Raju (and family) had no more than 5 percent stake, yet exercised significant control.

Regulatory Framework: SEBI, MCA and the Stock Exchanges together share jurisdiction over the markets. There are bound to be overlaps. The Companies Bill should create a regulatory regime detailed enough to satisfactorily address such issues. Also, CG needs to be discussed within the broader context of the handicaps and delays in the Indian Judicial System. Currently, there is no mechanism for settling class action / appeals. Moreover, civil courts are barred from hearing security fraud matters. Only SEBI can hear these cases and the amount collected goes to the consolidated fund of India.

In Conclusion

In order to be successful, CG needs to be based on sound theory rather than popular perception or results of spontaneous discussions with the concerned parties. They also need to be tested empirically and linked to concrete performance indicators.

Evolution Of Corporate Governance Reforms In India: A Chronological Perspective

Corporate governance is perhaps one of the most important differentiators of a business that has impact on the profitability, growth and even sustainability of business. It is a multi-level and multi-tiered process that is distilled from an organization's culture, its policies, values and ethics, especially of the people running the business and the way it deals with various stakeholders.[1]

Creating value that is not only profitable to the business but sustainable in the long-term interests of all stakeholders necessarily means that businesses have to run—and be seen to be run—with a high degree of ethical conduct and good governance where compliance is not only in letter but also in spirit.

Historical Perspective

At the time of Independence in 1947, India had functioning stock markets, an active manufacturing sector, a fairly developed banking sector, and also a comparatively well-developed British-derived convention of corporate governance. From 1947 through 1991, the Indian Government pursued markedly socialist policies when the State nationalized most banks and became the principal provider of both debt and equity capital for private firms.

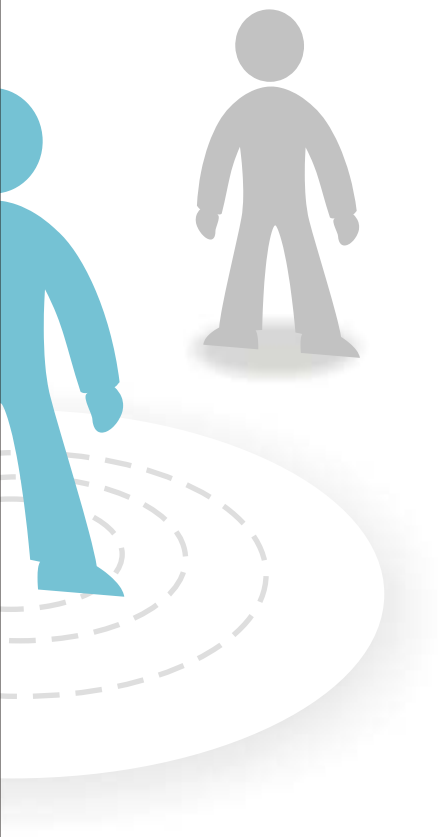
The government agencies that provided capital to private firms were evaluated on the basis of the amount of capital invested rather than on their returns on investment. Competition, especially foreign competition, was suppressed. Private providers of debt and equity capital faced serious obstacles in exercising oversight over managers due to long delays in judicial proceedings and difficulty in enforcing claims in bankruptcy.

Public equity offerings could be made only at government-set prices. It was natural that in such an environment, corporate governance deteriorated as, historically, there had been little emphasis on corporate governance mechanisms in India. Public companies in India were only required to comply with limited governance and disclosure standards enumerated in the Companies Act of 1956, the Listing Agreement, and the accounting standards set forth by the Institute of Chartered Accountants of India (ICAI).

Faced with a fiscal crisis in 1991, the Indian Government responded by enacting a series of reforms aimed at general economic liberalization. The Securities and Exchange Board of India (SEBI)—India's securities market regulator—was formed in 1992, and by the mid-1990s, the Indian economy was growing steadily, and Indian firms had begun to seek equity capital to finance expansion into the market spaces created by liberalization and the growth of outsourcing.

Corporate governance is a multi-level and multi-tiered process that is distilled from an organization's culture, its policies, values and ethics, especially of the people running the business and the way it deals with various stakeholders.

[1] 'India Means Business: How the Elephant Earned its Stripes', Kshama V Kaushik, and Kaushik Dutta, Oxford, 2012, page 324



The need for capital, amongst other things, led to corporate governance reform and many major corporate governance initiatives were launched in India since the mid-1990s; most of these initiatives were focused on improving the governance climate in corporate India, which was far from satisfactory.

Codifying Good Governance Norms

The first major initiative was undertaken by the Confederation of Indian Industry (CII), India's largest industry and business association, which came up with the first voluntary code of corporate governance in 1998. More than a year before the onset of the East Asian crisis, the CII had set up a committee to examine corporate governance issues, and to recommend a voluntary code of best practices.

Drawing heavily from the Anglo-Saxon Model of Corporate Governance, CII drew up a voluntary Corporate Governance Code. The first draft of the code was prepared by April 1997, and the final document titled *Desirable Corporate Governance: A Code*[2], was publicly released in April 1998. The code was voluntary, contained detailed provisions, and focused on listed companies.

Although the CII Code was welcomed with much fanfare and even adopted by a few progressive companies, it was *"felt that under Indian conditions a statutory rather than a voluntary code would be far more purposive and meaningful, at least in respect of essential features of corporate governance".*[3] Consequently, the second major corporate governance initiative in the country was undertaken by SEBI. In early 1999, it set up a committee under Kumar Mangalam Birla to promote and raise the standards of good corporate governance.

The Birla Committee specifically placed an emphasis on independent directors in discussing board recommendations and made specific recommendations regarding board representation and independence. The Committee also recognized the importance of audit committees and made many specific recommendations regarding the function and constitution of board audit committees.
In early 2000, the SEBI board accepted and ratified the key recommendations of the Birla Committee, which were incorporated into Clause 49 of the Listing Agreement of the Stock Exchanges.

The Naresh Chandra committee[4] was appointed in August 2002 by the Department of Company Affairs[5] (DCA) under the Ministry of Finance and Company Affairs, to examine various corporate governance issues. The Committee submitted its report in December 2002. It made recommendations in terms of two key aspects of corporate governance: financial and non-financial disclosures, and independent auditing and board oversight of management.

[2] The first formal initiative to develop and promote a corporate governance code for Indian corporates was taken by the Confederation of Indian Industry (CII), which, after detailed consultation among its members, released in April 1998 the final report entitled Desirable Corporate Governance: A Code (CII Code); Available at: <http://www.acga-asia.org/public/files/CII_code_1998.pdf>.

[3] From the preface to the 'Report of the Committee Appointed by the SEBI on Corporate Governance under the Chairmanship of Shri Kumar Mangalam Birla' (Birla Committee Report); Available at: <http://www.sebi.gov.in/commreport/corpgovhtml>.

[4] Following the corporate scandals of the US, the Department of Company Affairs (DCA), Government of India, set up the Naresh Chandra Committee to examine various corporate governance issues; the report of the Committee is available at: <http://www.nfcgindia.org/executive_summary.htm>.

[5] The Department of Company Affairs under the Ministry of Finance was designated as a separate Ministry in 2004 to function under the Minister of State with Independent Charge. The Ministry of Corporate Affairs (MCA) is primarily concerned with the administration of The Companies Act, 1956, other allied Acts, and rules and regulations framed thereunder, mainly for regulating the functioning of the corporate sector in accordance with the law.

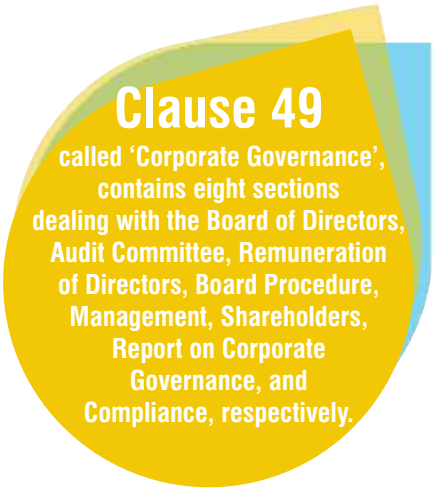
It also made a series of recommendations regarding, among other matters, the grounds for disqualifying auditors from assignments, the type of non-audit services that auditors should be prohibited from performing, and the need for compulsory rotation of audit partners.

The fourth initiative on corporate governance in India is in the form of the recommendations of the Narayana Murthy Committee.[6] This committee was set up by SEBI under the chairmanship of Mr. N.R. Narayana Murthy, in order to review Clause 49, and to suggest measures to improve corporate governance standards. Some of the major recommendations of the committee primarily related to audit committees, audit reports, independent directors, related party transactions, risk management, directorships and director compensation, codes of conduct and financial disclosures.

The Murthy Committee, like the Birla Committee, pointed out that international developments constituted a factor that motivated reform and highlighted the need for further reform in view of the recent failures of corporate governance, particularly in the United States, combined with the observations of India's stock exchanges that compliance with Clause 49 had up to that point been uneven.

Like the Birla Committee, the Murthy Committee examined a range of corporate governance issues relating to corporate boards and audit committees, as well as disclosure to shareholders and, in its report, focused heavily on the role and structure of corporate boards, while strengthening the definition of director independence in the then-existing Clause 49, particularly to address the role of insiders on Indian boards.

In its present form, Clause 49[7], called 'Corporate Governance', contains eight sections dealing with the Board of Directors, Audit Committee, Remuneration of Directors, Board Procedure, Management, Shareholders, Report on Corporate Governance, and Compliance, respectively. Firms that do not comply with Clause 49 can be de-listed and face financial penalties. In the light of the clear consideration of Anglo-American standards of governance in both the Birla and Murthy Committees, it is not surprising that India's corporate governance reform effort should contain similar provisions to the reform efforts undertaken outside India that adopted such models. In its final report, the Birla Committee noted its dual reliance on international experiences—both as an impetus for reform following *"high-profile financial reporting failures even among firms in the developed economies",*[8] and as a model for reform. Significantly, the Birla Committee singled out the corporate governance reports and codes being applied in the US and UK, such as the Report of the Cadbury Committee, the Combined Code of the London Stock Exchange, and the Blue Ribbon Committee on Corporate Governance



[6] Securities and Exchange Board of India, Report of the SEBI Committee on Corporate Governance (February 2003), Available at: http://www.sebi.gov.in/commreport/corpgov.pdf. (Narayana Murthy Committee Report). The need for a review of Clause 49 was in part triggered by events that occurred in the US such as the collapse of Enron and WorldCom; see, Narayana Murthy Committee Report, at para. 1.6.1; "Recent events worldwide, primarily in the United States, have renewed the emphasis on corporate governance. These events have highlighted the need for ethical governance and management, and for the need to look beyond mere systems and procedures. This will ensure compliance with corporate governance codes, in substance and not merely in form."

[7] Clause 49 of the Listing Agreement contains the guidelines on Corporate Governance for all Listed Companies and applies to all Listed Companies (or those that are seeking listing), except for very small companies (that is, those that have a paid-up capital of less than Rs. 30 million and a net worth of less than Rs. 250 million throughout their history). While several requirements of Clause 49 are mandatory in nature, there are certain requirements (such as the setting up of a remuneration committee, training of board members and whistleblower policy) that are merely recommendatory in nature. See Securities and Exchange Board of India circular no. SEBI/CFD/DIL/CG/1/2004/12/10 dated 29 October 2004, Available at: < http://www.sebi.gov.in/circulars/2004/cfdcir0104.pdf>.

[8] Birla Committee Report, Supra. Refer Note 3.

in the US. The Committee even directly sought out the input of Sir Adrian Cadbury, chair of the Cadbury Committee, commissioned by the London Stock Exchange, in addition to Indian business leaders.

While the report of the Murthy Committee did not explicitly cite the Anglo-American models of governance, it was clearly a reaction to events in the United States, particularly given the timing of the report, which followed just a few months after the enactment of the Sarbanes-Oxley Act (SOA). There are striking similarities between Clause 49 and the leading Anglo-American corporate governance standards, in particular the Cadbury Report, the OECD Principles of Corporate Governance, and Sarbanes-Oxley Act.

India's corporate governance reform efforts did not cease after the adoption of Clause 49. In parallel, the review and redrafting of the Companies Act, 1956 was taken up by the Ministry of Corporate Affairs (MCA) on the basis of a detailed consultative process and the Government constituted an Expert Committee on Company Law under the Chairmanship of Dr. J.J. Irani on 2 December 2004 to offer advice on the new Companies Bill.

Based, among other things, on the recommendations of the Irani Committee, the proposed Companies Bill, 2008, sought to enable the corporate sector in India to operate in a regulatory environment characterized by best international practices that fosters entrepreneurship and investment. However, due to the dissolution of the Fourteenth Lok Sabha, the Companies Bill, 2008, lapsed but, since the provisions of the Companies Bill, 2008, were broadly considered to be suitable for addressing various contemporary issues relating to corporate governance, the Government decided to re-introduce the Companies Bill, 2008, as the Companies Bill, 2009[9], without any change in it except the Bill year.
In the meantime, in January 2009, the Indian corporate community was rocked by a massive accounting scandal involving Satyam Computer Services (Satyam), one of India's largest information technology companies. The Satyam scandal[10] prompted quick action by the Indian government, including the arrest of several insiders and auditors of Satyam, investigations by the MCA and SEBI, and substitution of the company's directors with government nominees.

For corporate leaders, regulators, and politicians in India, as well as for foreign investors, this necessitated a re-assessment of the country's progress in corporate governance. As a consequence, India's ranking in the CLSA *Corporate Governance Watch 2010* slid from third to seventh in Asia.

Shortly after the news of the scandal broke, the CII began examining the corporate

Companies Bill, 2008

seeks to enable the corporate sector in India to operate in a regulatory environment characterized by best international practices that fosters entrepreneurship and investment.

[9] The Companies Bill, 2009 was introduced in August 2009 in the Lok Sabha; Available at: <http://www.mca.gov.in/Ministry/actsbills/pdf/Companies_Bill_2009_24Aug2009.pdf>.

[10] At the end of 2008, India experienced a massive corporate governance scandal involving Satyam Computer Services (Satyam), one of India's largest technology companies. The Satyam scandal has been described as India's Enron. India's Enron, ECONOMIST, 8 January 2009, Available at: <http://www.economist.com/business/displaystory.cfm?story_id=12898777>.

governance issues arising out of the Satyam scandal and in late 2009, the CII task force listed recommendations on corporate governance reform.[11] In his foreword to the Task Force Report, Mr Venu Srinivasan, President of CII, while emphasizing the unique nature of the Satyam scandal, suggested that it was is a one-off incident and that the overwhelming majority of corporate India does business in a sound and legal manner. Nonetheless, the CII Task force put forth important recommendations that attempted to strike a balance between over-regulation and promotion of strong corporate governance norms by recommending a series of voluntary reforms.

In addition to the CII, a number of other corporate groups have joined the corporate governance dialogue. The National Association of Software and Services Companies (NASSCOM) also formed a Corporate Governance and Ethics Committee chaired by N.R. Narayana Murthy, a leading figure in the field of Indian corporate governance reforms. The Committee issued its recommendations in mid-2010, focusing on the stakeholders in the company. The report emphasized recommendations relating to the audit committee and a whistle-blower policy, and also addressed the issue of the need to improve shareholder rights. Additionally, the Institute of Company Secretaries of India (ICSI) has also put forth a series of corporate governance recommendations.

Inspired by industry recommendations, including the influential CII recommendations, the MCA, in late 2009, released a set of voluntary guidelines for corporate governance. These Voluntary Guidelines[12] address a myriad corporate governance matters, including the independence of the boards of directors; the responsibilities of the board, the audit committee, auditors, and secretarial audits; and mechanisms to encourage and protect whistle blowing.

The MCA also indicated that the guidelines constituted a first step in the process of facilitating corporate governance and that the option to perhaps move to something more mandatory remains open.

In parallel, subsequent to the introduction of the Companies Bill, 2009 in the Lok Sabha, the Central Government received several suggestions for amendments in the said Bill from the various stakeholders and the Parliamentary Standing Committee on Finance who also made numerous recommendations in its report. In view of the large number of amendments suggested to the Companies Bill, 2009, arising from the recommendations of the Parliamentary Standing Committee on Finance and suggestions of the stakeholders, the Central Government decided to withdraw the Companies Bill, 2009 and introduce a fresh Bill incorporating the recommendations of Standing Committee and suggestions of the stakeholders.

[11] The CII Task Force on Voluntary Governance was headed by Shri Naresh Chandra and submitted its report in November 2009; Available at: http://www.mca.gov.in/Ministry/latestnews/Draft_Report_NareshChandra_CII.pdf.

[12] The Ministry of Corporate Affairs issued the Voluntary Corporate Governance Guidelines in December 2009; Available at: http://www.mca.gov.in/Ministry/latestnews/CG_Voluntary_Guidelines_2009_24dec2009.pdf

A significant feature of the corporate governance reforms in India has been its voluntary nature and the active role played by public listed companies in improving governance standards in India.

The revised Bill, namely, the Companies Bill, 2011[13] was introduced in the Lok Sabha on 14th December 2011; however the same was withdrawn by the Government on 22nd December and sent back for consideration by the Standing Committee on Finance.[14]

The Companies Bill, 2011 is expected to be presented in Parliament in 2012.

Though the corporate governance efforts in India have been spearheaded by SEBI over the last decade, the more recent steps have been taken by the MCA. Also there has been an effort to consolidate corporate governance norms into the Companies Act, 1956. Towards that end, the Companies Bill, 2011, does contain several aspects of corporate governance which have hitherto been the mainstay of Clause 49. This represents a trend towards legislating on corporate governance rather than leaving it to the domain of the Listing Agreement. It also signifies a shift in corporate governance administration from SEBI, which oversees the implementation of Clause 49, towards the MCA, which administers the Companies Act.

Full Circle

A significant feature of the corporate governance reforms in India has been its voluntary nature and the active role played by public listed companies in improving governance standards in India. CII—a non-government, not-for-profit, industry-led and industry-managed organization dominated by large public listed firms—has played an active role in the development of India's corporate governance norms.

What began as a voluntary effort soon acquired mandatory status through the adoption of Clause 49, as all companies (of a certain size) listed on stock exchanges were required to comply with these norms, a trend which was further reinforced by the introduction of stringent penalties for violation of the prescribed norms. While the Voluntary Corporate Governance guidelines of 2009 represented a move back to a voluntary framework for corporate governance, recent efforts to consolidate corporate governance norms into the Companies Act, 1956 marks a reversal of the earlier approach.[15]

In that sense, the corporate governance norms in India appear to have completed two full cycles of oscillating between the voluntary and the mandatory approaches.

Literature Review

A comprehensive study by Chakrabarti, Megginson, and Yadav[16] has traced the evolution of the Indian corporate governance system and examined how this system has both supported and held back India's ascent to the top ranks of the world's economies. The authors of the study have found that while on paper, the framework of the country's legal system provides some of the best investor protection in the world;

[13] The Companies Bill, 2011; available at http://www.mca.gov.in/Ministry/pdf/The_Companies_Bill_2011.pdf.

[14] As reported in http://articles.economictimes.indiatimes.com/2011-12-22/news/30546669_1_companies-bill-development-authority-bill-bjp-leaders, the opposition BJP leaders argued that since the government had consulted other stakeholders after the Standing Committee had given its report on the Companies Bill,2009 in August 2010, it should be sent back to the committee again.

enforcement is a major problem in view of the slow functioning of the over-burdened courts and the widespread prevalence of corruption.

Furthermore, ownership of enterprises remains concentrated in a few hands, and family business groups continue to be the dominant business model. However, Chakrabarti, et al have also found that corporate governance in India does not compare unfavorably with that in any of the other major emerging economies of the world, viz. Brazil, China and Russia.

Gupta and Parua[17] attempted to find out the degree of compliance of the Corporate Governance (CG) codes by private sector Indian companies listed in the Bombay Stock Exchange (BSE). Data regarding 1245 companies for the year 2004-2005 was taken for the study from the CG reports (which are included in the Annual Reports) of these companies and 21 codes (of which 19 are mandatory and 2 non-mandatory) were selected for study.

The compliance rate of the CG codes was first tested individually for each company. Further, the mean compliance rate (taking into account all the companies under the study) and the variation among the companies from the mean compliance rate were also tested. It was observed that more than 70 per cent of the sample companies comply with 80 per cent or more of the codes. As regards the code-wise compliance rate, the compliance rate is greater than 80 per cent in respect of 17 codes. Almost all the companies had a compliance rate which is significant even at the 1 per cent level. *The authors have stated that nothing more should be concluded from the findings other than that the financial reporting practice of the Indian companies, in general, mostly followed the CG codes contained in Clause 49.*

The enforcement of the corporate governance reforms in India has been analyzed by Khanna[18], who has attempted to find an answer to the paradox of foreign institutional investors (FIIs) increasing their presence and interest in the Indian stock markets when reforms were enacted but not immediately enforced. Khanna has argued that given the high returns available in India, FIIs may have thought that the need for enforcement was not pressing initially (as the chance of insider diversion may not be high at that time), but could become so during the next few years when the market eventually matured.

Khanna's[19] analysis suggests that enforcement is important to the growth of stock markets, but the active civil enforcement of corporate laws may not always be critical to their initial development.

An important empirical study by Dharmapala and Khanna[20] acknowledged the importance of enforcement in corporate governance reform and studied the impact of the

[15] See Varrotil, Umakanth, India's Corporate Governance Voluntary Guidelines 2009: Rhetoric or Reality? (2010); Available at: http://ssrn.com/abstract=163482, for a detailed evaluation of the substance of the Voluntary Guidelines, and whether a voluntary approach would deliver results in the Indian context. Also see Afsharipour, Afra, A Brief Overview of Corporate Governance Reforms in India (December 2010), Available at: www.conferenceboard.org, for an overview and assessment of the effectiveness of corporate governance reforms in India.

[16] Chakrabarti, Rajesh; Yadav, Pradeep K. and Megginson, William L., "Corporate Governance in India", Journal of Applied Corporate Finance, Forthcoming, Available at SSRN: http://ssrn.com/abstract=1012222

[17] Gupta, Arindam and Parua, Anupam, An Enquiry into Compliance of Corporate Governance Codes By the Private Sector Indian Companies (18 December 2006). Tenth Indian Institute of Capital Markets Conference Paper. Available at <SSRN: http://ssrn.com/abstract=962001>

[18] Khanna, Vikramaditya, Law Enforcement and Stock Market Development: Evidence from India (January 2009). Paper prepared for the Law and Economy in India Project at the Centre on Democracy, Development, and The Rule of Law. Freeman Spogli Institute for International Studies Stanford University; Available at: <http://cddrl.stanford.edu>.

[19] Ibid.

[20] Dharmapala, Dhammika and Khanna, Vikramaditya S., "Corporate Governance, Enforcement, and Firm Value: Evidence from India" (23 June 2011). University of Michigan Law and Economics, Olin Working Paper No. 08-005; Third Annual Conference on Empirical Legal Studies Papers, Available at: SSRN: http://ssrn.com/abstract=1105732.

introduction of Section 23E to the Securities Contracts (Regulation) Act, 1956 in 2004, which imposed large penalties of Rs. 25 crore for non-compliance with the Listing Agreement (that also includes Clause 49) containing the corporate governance norms. Using a sample of over 4000 firms during the period 1998-2006, this study revealed a "large and statistically significant positive effect (amounting to over 10% of firm value) of the Clause 49 reforms in combination with the 2004 sanctions."[21] Since Clause 49 did not apply to all listed firms, the researchers could analyse the response of 'treatment' groups (firms subject to Clause 49) and compare the same with a 'control' groups (firms not subject to Clause 49). The study shows a positive correlation between the introduction of stringent enforcement norms and the market value of the companies.

Jayanth Varma[22] has argued that the corporate governance problems in India are very different from those found in the Anglo-Saxon world and would need a different model for corporate governance, which has a significant external focus. The governance issue in the US or the UK is essentially that of disciplining the management that has ceased to be effectively accountable to the owners. As against this, the problem in the Indian corporate sector (be it the public sector, the multinationals or the Indian private sector) is that of disciplining the dominant shareholder, who is the principal block-holder, and of protecting the minority shareholders. According to Varma, in the Indian context, it is not possible to resolve the conflict between the dominant shareholder and the minority shareholders.[23]

[21] Ibid.

[22] Varma, Jayanth Rama, (1997), "Corporate Governance in India: Disciplining the Dominant Shareholder", IIMB Management Review, December 1997, 9(4), 5-18; Available at: <http://www.iimahd.ernet.in/~jrvarma/papers/iimbr9-4.pdf>

Khanna and Palepu have concluded that it did not appear that concentrated ownership in India was entirely associated with the ills that the literature has ascribed to it in emerging markets.[24] On the other hand, they felt that if the concentrated owners are not exclusively, or even primarily, engaged in rent-seeking and entry-deterring behaviour, concentrated ownership may not be inimical to competition.

Indeed, they argued, as a response to competition, at least some Indian families have consistently tried to leverage internal markets for capital and talent inherent in business group structures to launch new ventures in environments wherein external factor markets are deficient. An important observation of Khanna and Palepu[25] was that concentrated ownership was a result, rather than a cause, of inefficiencies in markets. Even in the low capital intensity, relatively unregulated setting of the Indian software industry, they found that concentrated ownership persisted in a privately successful and socially useful way.

Pratip Kar[26] has explored the dynamics of culture and corporate governance in India by calling attention to three areas wherein the clash between the Indian cultural ethos and the Anglo-Saxon norms for good governance are the strongest, viz. related-party transactions; the promoter's or large shareholder's actions; and the board's nominations, deliberations, and effectiveness, and has suggested that Western best practices need to be suitably adapted to be in line with the Indian cultural sensitivities in these areas.

In a study that used only balance sheet information from four selected sectors of the Indian industry, Mukherjee and Ghosh[27] analysed the efficacy of corporate governance. Their findings, by and large, painted a disappointing picture with the overall conclusion that corporate governance was still in a very nascent stage in the Indian industry.

The authors found that decision and policy-making was still taken mostly as a routine matter and among the institutional investors also, it seemed that the foreign institutional investors were the most consistent in stock picking whereas the performance of the domestic institutional investors was sporadic and volatile, at best. They also found serious shortcomings in the capital market in not being able to enforce better governance on the part of the directors or performance on the part of the managers.

[23] Ibid. In Varma's view, some of the most glaring abuses of corporate governance in India have been defended on the principle of 'shareholder democracy', since they have been sanctioned by resolutions of the general body of shareholders, and the Board of the Company has been powerless to prevent such abuses. Therefore, in his view, the remedies against corporate governance abuses can lie only outside the company itself.

[24] Khanna, Tarun and Krishna G. Palepu. "Globalization and Convergence In Corporate Governance: Evidence From Infosys and The Indian Software Industry," Journal of International Business Studies, 2004, v35 (6, Nov), 485-507.

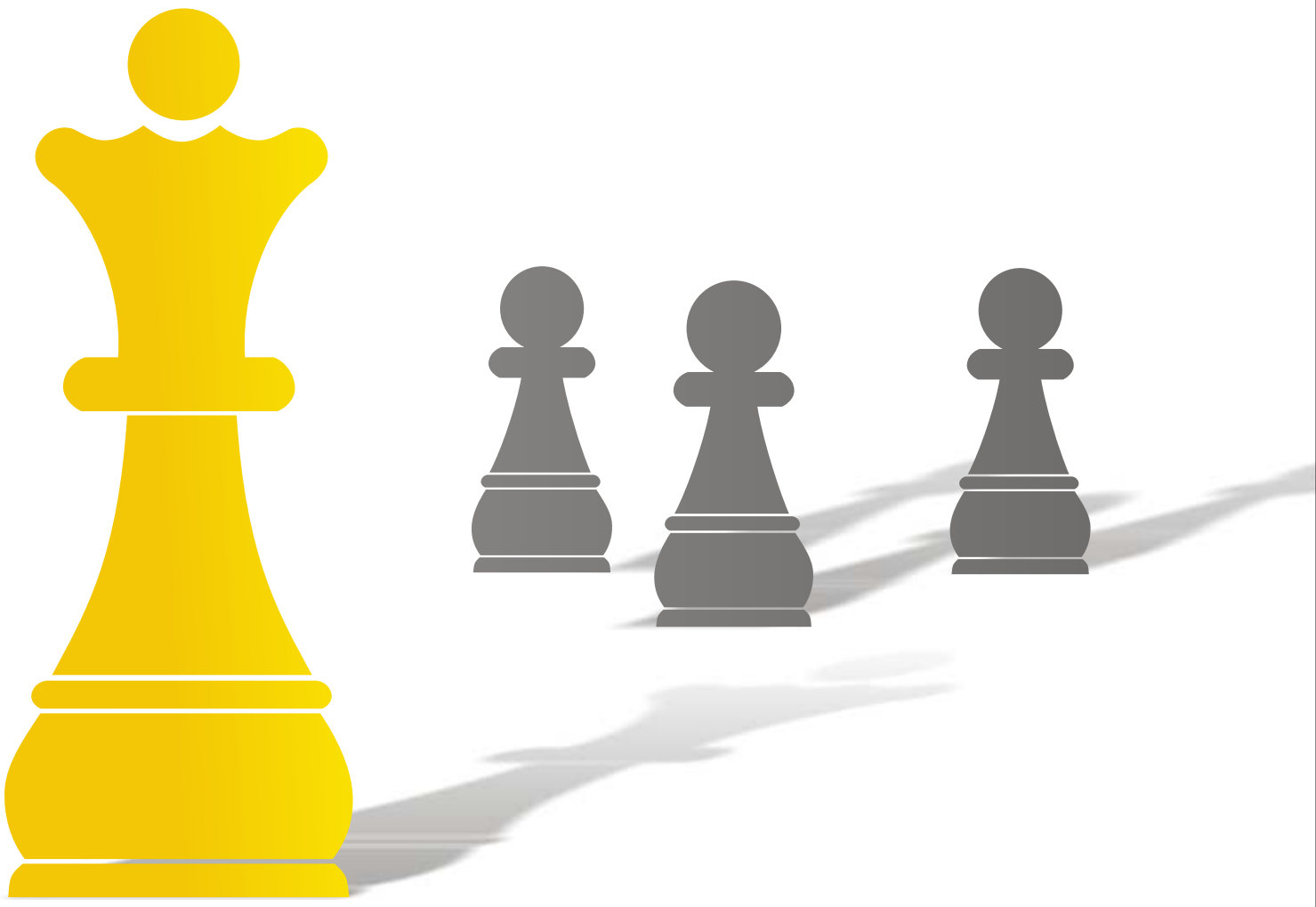
[25] Ibid.

[26] Kar, Pratip; Culture and Corporate Governance Principles in India: Reconcilable Clashes? Available at: <http://www.ifc.org/ifcext/cgf.nsf/Content/PSO_23_Pratip>.

[27] Mukherjee, Diganta and Ghosh, Tejomoy, "An Analysis of Corporate Performance and Governance in India: Study of Some Selected Industries", Discussion Paper 04-19,Available at: <http://www.isid.ac.in/~pu/dispapers/dp04-19.pdf>

[28] Varrotil, Supra. Note 15.

In the backdrop of the key role played by the dominant shareholder or the promoter, in the Indian context, Varrotil[28] makes the case that the source for strengthening Indian corporate governance lies within, and the emulation of other systems of corporate governance, or even adopting best practices that may have been successful elsewhere, would only lead to further incongruity with the traditional business systems and practices that are prevalent in India.



Regulatory Framework for Corporate Governance in India and Challenges in Enforcement

As a part of the process of economic liberalization in India, and the move toward further development of India's capital markets, the Central Government established regulatory control over the stock markets through the formation of the SEBI. Originally established as an advisory body in 1988, SEBI was granted the authority to regulate the securities market under the Securities and Exchange Board of India Act of 1992 (SEBI Act).29

Public listed companies in India are governed by a multiple regulatory structure. The Companies Act is administered by the Ministry of Corporate Affairs (MCA), and is currently enforced by the Company Law Board (CLB). The MCA, SEBI, and the stock exchanges share jurisdiction over listed companies, with the MCA being the primary government body charged with administering the Companies Act of 1956, while SEBI has served as the securities market regulator since 1992.

SEBI serves as a market-oriented independent entity to regulate the securities market akin to the role of the Securities and Exchange Commission (SEC) in the United States. The stated purpose of the agency is to protect the interests of investors in securities and to promote the development of, and to regulate, the securities market.

The realm of SEBI's statutory authority has also been the subject of extensive debate and indeed some people30 have raised doubts as to whether SEBI can make regulations in respect of matters that rightfully fall within the jurisdiction of the Department of Company Affairs.

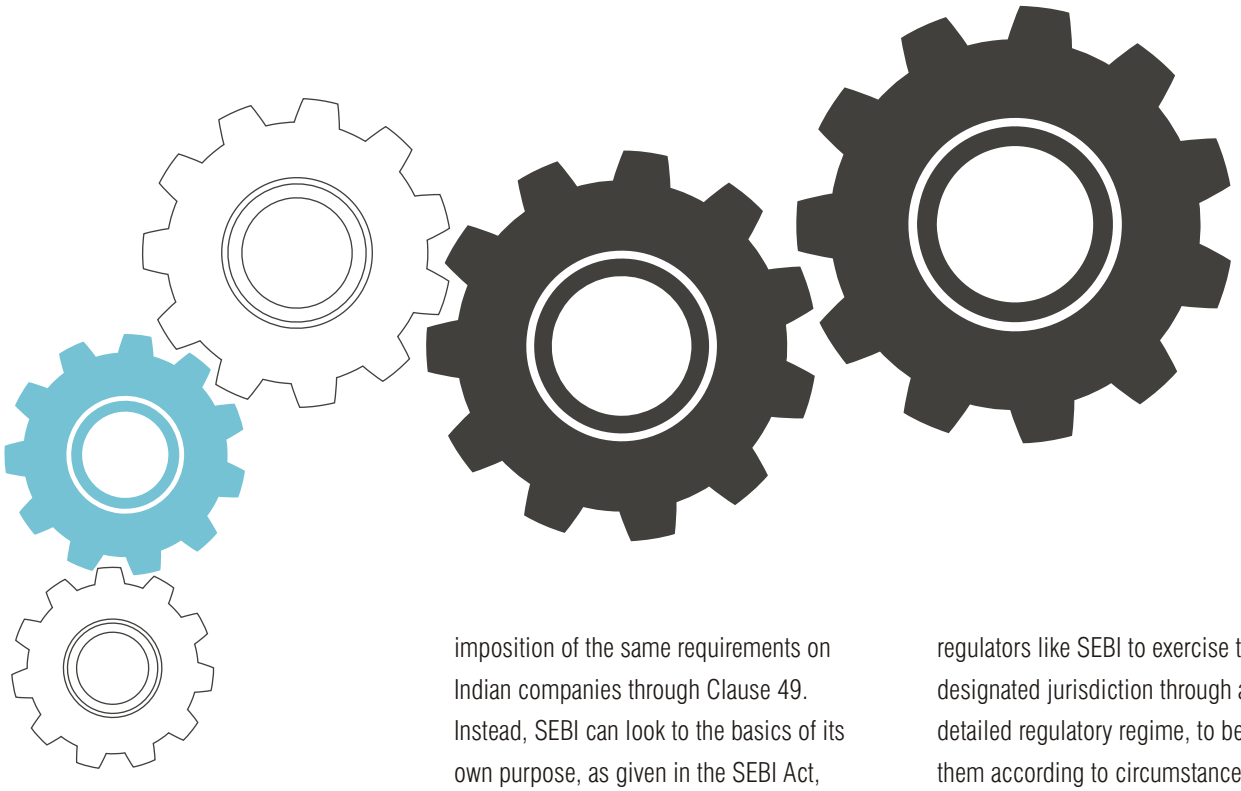
SEBI's authority for carrying out its regulatory responsibilities has not always been clear and when Indian financial markets experienced massive share price rigging frauds in the early 1990s, it was found that SEBI did not have sufficient statutory power to carry out a full investigation of the frauds.31 Accordingly, the SEBI Act was amended in order to grant it sufficient powers with respect to inspection, investigation, and enforcement, in line with the powers granted to the SEC in the United States.

A contentious aspect of SEBI's power concerns its authority to make rules and regulations. While SEBI has made significant amendments to the Listing Agreement to substantially increase the responsibilities of listed companies, some have disputed that SEBI was ever granted the authority to impose additional governance rules in this fashion. Unlike in the United States, where the SEC can point to the Sarbanes-Oxley Act, which specifically confers upon it the authority to prescribe rules to implement governance legislation, SEBI, on the other hand, cannot point to a similar piece of legislation to support the

[29] The SEBI Act provides for the establishment of a Board to protect the interests of investors in securities and to promote the development of, and to regulate, the securities market in India, Available at: http://www.sebi.gov.in/acts/act15ac.pdf.

[30] Pandey, T.N.SEBI Move: Clause and Effect, Rediff.com, Dec. 29, 2003, available at http://www.rediff.com/money/2003/dec/29guest3.htm for a view that many of SEBI's actions have been beyond their intended jurisdiction. See also Afsharipour, Afra: Corporate Governance Convergence: Lessons from the Indian Experience (2009), Available at: http://ssrn.com/abstract=1413859 for a comprehensive coverage on the issue of the conflicting jurisdiction between SEBI and the Ministry of Corporate Affairs.

[31] The Securities and Exchange Board of India (Amendment) Act, 2002, amended the Securities and Exchanges Board of India Act, 1992 and enlarged its Board of Directors, besides conferring on SEBI the powers of search and seizure, with the approval of courts, and enhancing the fine for a better and hassle-free regulation of the capital market.
The Act is also aimed at avoiding recurrence of scams and other malpractices in the capital market by building confidence among investors.



imposition of the same requirements on Indian companies through Clause 49. Instead, SEBI can look to the basics of its own purpose, as given in the SEBI Act, wherein it is granted the authority to "specify, by regulations, the matters relating to issue of capital, transfer of securities and other matters incidental thereto . . . and the manner in which such matters shall be disclosed by the companies."32 In addition, SEBI is granted the broad authority to "specify the requirements for listing and transfer of securities and other matters incidental thereto."33

Recognizing that a problem arising from an overlap of jurisdictions between the SEBI and MCA does exist, the Standing Committee, in its final report, has recommended that while providing for minimum benchmarks, the Companies Bill should allow sectoral regulators like SEBI to exercise their designated jurisdiction through a more detailed regulatory regime, to be decided by them according to circumstances.34 Referring to a similar case of jurisdictional overlap between the RBI and the MCA, the Committee has suggested that it needs to be appropriately articulated in the Bill that the Companies Act will prevail only if the Special Act is silent on any aspect.

Further the Committee suggested that if both are silent, requisite provisions can be included in the Special Act itself and that the status quo in this regard may, therefore, be maintained and the same may be suitably clarified in the Bill. This, in the Committee's view, would ensure that there is no jurisdictional overlap or conflict in the governing statute or rules framed there under.

[32] SEBI Act, Supra. Refer Note 22.

[33] SEBI Act, Supra. Refer Note 22.

[34] The Standing Committee of the Parliament (Standing Committee) Bill submitted its report to the Indian Parliament in August 2010; Available at: http://www.nfcgindia.org/pdf/21_Report_Companies_Bill-2009.pdf

Enforcement of Corporate Governance Norms

The issue of enforcement of Corporate Governance reforms also needs to be discussed in the broader context of the substantial delay in the delivery of justice by the Indian legal system on account of the significant number of cases pending in the Indian courts.

A research paper by PRS Legislative Research[35] places the number of pending cases in courts in India, as of July 2009, as 53,000 pending with the Supreme Court, 4 million with various High Courts, and 27 million with various lower courts. This signifies an increase of 139 per cent for the Supreme Court, 46 per cent for the High Courts and 32 per cent for the lower courts, from the pending number of cases in each of them in January 2000. Furthermore, in 2003, 25 per cent of the pending cases with High Courts had remained unresolved for more than ten years and in 2006, 70 per cent of all prisoners in Indian jails were undertrials. Since fresh cases outnumber those being resolved, there is obviously a shortfall in the delivery of justice, and a consequent increase in the number of pending cases. In addition, the weight of the backlog of older cases hampers efficiency and creeps upward every year.

This backlog in the Indian judicial system raises pertinent questions as to whether the current regulatory framework in India, as enacted, is adequate to enable shareholders to recover their just dues.

[35] PRS Legislative Research (PRS) is an independent research initiative that works with Members of Parliament (MPs) across party lines to provide research support on legislative and policy issues. The summary of their findings on the pendency in Indian Courts is available at: http://www.prsindia.org/administrator/uploads/general/1310014291~~Vital%20Stats%20-%20Pendency%20of%20Cases%20in%20Indian%20Courts%2004Jul11%20v5%20-%20Revised.pdf

This concern is also articulated in the recent pleadings (filed in January 2010) in the United States District Court, Southern District of New York,[36] on the matter relating to the fraud in the erstwhile Satyam Computer Services,[37] wherein US-based investors were seeking damages from defendants that included, among others, Satyam and its auditors, PricewaterhouseCoopers (PwC) and has thrown up some very interesting and relevant issues. This case was filed on behalf of investors who had purchased or otherwise acquired Satyam's American Depository Shares (ADS) listed on the New York Stock Exchange and investors, residing in the United States, who purchased or otherwise acquired Satyam common stock on the National Stock Exchange of India or the Bombay Stock Exchange.

In their pleadings[38], the plaintiffs submitted declarations of two prominent Indian securities law experts: Sandeep Parekh[39], former Executive Director of SEBI, and Professor Vikramaditya Khanna[40] of the University of Michigan Law School, one of the foremost experts in the United States on the Indian legal system, who filed individual affidavits in which they detailed very cogent and compelling reasons as to why Indian courts cannot redress the harm done to the Class plaintiffs and why India itself does not provide a viable alternative forum for settling the claims of Class members.

In their depositions[41], among other things, Sandeep Parekh and Vikramaditya Khanna have explained that:

- The substantive laws of India provide no means of individual or class recovery for private investors in securities fraud matters because the civil courts in India are barred from hearing such cases where, as here, SEBI is empowered to act;
- Even if it did provide a substantive means of recovery, Indian law provides no viable class action mechanism under which investors' claims can be litigated; and
- Indian law does not recognize the fraud-on-the-market presumption of reliance in private civil actions, so that, even if both a substantive means of recovery and a viable class action mechanism existed under Indian law, investors would still be required to demonstrate individual reliance, thus effectively depriving the vast majority of Class members of any prospect of relief.

Khanna stated in his declaration[42] that "The lengthy delays in the Indian Judicial System would leave plaintiff shareholders with effectively no recovery even assuming, arguendo; there might be a potential cause of action."

Sandeep Parekh[43] argued on behalf of the plaintiff shareholders that, not only, as "private parties have no right to sue to

[36] A concise summary of the case and the pleadings before the United States District Court, Southern District of New York (Satyamcase in the USA) can be accessed at: <http://www.legallyindia.com/201102181822/Analysis/exclusive-satyams-settled-us-class-action-had-no-recourse-in-india>.

[37] Satyam, Supra. Refer Note 10.

[38] Memorandum of Law (Memorandum) filed by the Lead Plaintiffs in their opposition to the motion filed by the Defendants to dismiss the case before the United States District Court, Southern District of New York can be accessed at: <http://f.lgly.in/download/Satyam-plaintiffs.pdf>.

[39] Deposition filed by Sandeep Parekh (Parekh Deposition) as an expert witness on behalf of the Plaintiffs can be accessed at: <http://f.lgly.in/download/Satyam-Parekh.PDF>.

[40] Deposition filed by Vikramaditya Khanna (Khanna Deposition) as an expert witness on behalf of the Plaintiffs can be accessed at: <http://f.lgly.in/download/Satyam-Khanna.pdf>.

[41] Memorandum, Supra. Refer Note 38.

[42] Khanna Deposition, Supra. Refer Note 40.

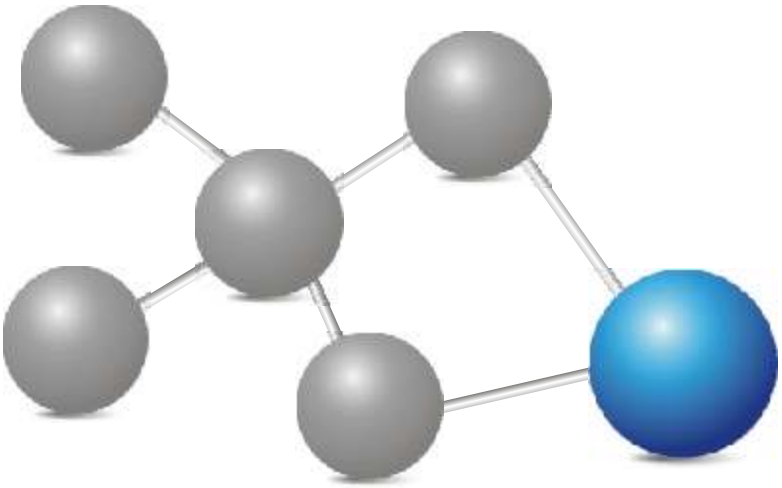
[43] Parekh Deposition, Supra. Refer Note 39.

recover damages resulting from the Satyam fraud under Indian statutory or common law because the Indian civil courts have no power to hear disputes where, as in this case, SEBI is empowered to act", but also that the Satyam investors would "not be able to use the representative action procedure to recover damages because Indian law bars their substantive claims in civil court and the representative action is only a procedural mechanism that cannot create any substantive rights".

Furthermore, Parekh[44] added that any penalties collected by SEBI related to the Satyam fraud would not go to shareholders of Satyam under the Indian securities law and, unlike the Fair Fund introduced in the United States, penalty amounts collected by SEBI go to the Consolidated Fund of India. He concluded that even if SEBI imposed monetary penalties against the various persons alleged to be a part of the fraud, Satyam shareholders cannot expect any relief from such action.

In 2011, the class action suit was settled by Satyam Computer Services[45]; also Satyam Computer Services Ltd and its former auditor PricewaterhouseCoopers agreed to settle U.S. probes[46] and Price Waterhouse Bangalore, PricewaterhouseCoopers Private Limited, and Lovelock & Lewes (PW India firms) and PwC U.S. and PwC International agreed to settle the New York securities class action suit.[47]

The proceedings in the United States District Court, Southern District of New York, on the Satyam issue have thrown up a number of issues as regards the admissibility and enforceability of the claims of investors many of which remain unresolved and would be tested in the future when similar cases are tried in courts.



[44] Ibid.

[45] As reported on 11 February 2011 on: <http://www.legallyindia.com/201102181822/Analysis/exclusive-satyams-settled-us-class-action-had-no-recourse-in-india>.

[46] The formal announcement of this settlement, made by the Public Company Accounting Oversight Board (PCAOB) in the US, can be accessed at - http://pcaobus.org/News/Releases/Pages/04052011_DisciplinaryOrders.aspx.

[47] Refer to the news story "The Grand Illusion: PwC Settles Satyam U.S. Class Action Claims" in Forbes.com available at; http://www.forbes.com/sites/francinemckenna/2011/05/06/the-grand-illusion-pwc-settles-satyam-u-s-class-action-claims/.

[48] TCIF has set up a website www.coal4india.com from where the full text of their letter to the Coal India Board can be accessed.

[49] Please refer to 'Tilting at windmills: Rebuttal of FP post on Coal India' by Pavan Ahluwalia posted on 11th April,2012 for a comprehensive coverage of the differing points of view on the TCIF- Coal India controversy, available at http://www.firstpost.com/business/tilting-at-windmills-rebuttal-of-fp-post-on-coal-india-272054.html

[50] As reported in The Economic Times dated April 4,2012 Mr Sriprakash Jaiswal , Union Minister for Coal told PTI that Coal India is a government company and its functioning cannot be left to the market and minority shareholders. He brushed aside the criticism that the government was running the Maharatna PSE with a diktat at the cost of minority shareholders and said, "whosoever bought Coal India shares, knew it well that it is a government company and that our government is committed to follow a socialist path. If someone had bought the Coal India shares thinking the company will run the way they want or the way the market wants, it is not possible," Please refer to the post at: Http://articles.economictimes.indiatimes.com/2012-04-04/news/31287519_1_agreements-with-power-producers-coal-india-sign-fuel-supply-agreements

[51] Ibid.

[52] Please refer to the Coal India DRHP available at http://www.sebi.gov.in/dp/coaldrhp.pdf

[53] "Risk Factor 17 -We sell our coal at prices lower than the prices otherwise in the Indian and international coal markets.

Although pricing of coal in India was completely deregulated with effect from January 1, 2000, since the price of coal has significant ramifications on the Indian economy in general and the thermal power sector in particular, we have followed a strategy of focusing on improving cost efficiencies to avoid price increases, particularly for our lower grade coal, and generally consult with the GoI in determining the price of our coal. In determining the price of our coal, we take into consideration general inflation levels, increase in production costs that cannot be offset through efficiency improvements, the need for generating internal resources to ensure viability of projects and, to a lesser

Key Issues In Corporate Governance In India

Managing the Dominant Shareholder(s) and the Promoter(s)

The primary difference between corporate governance enforcement problems in India and most western economies (on whose codes the Indian code is largely modeled) is that the entire corporate governance approach hinges on disciplining the management and making them more accountable. The 'agency gap' in western economies represents the gap between the interests of management and dispersed shareholders and corporate governance norms are aimed at reducing this gap. However, in India the problem—since the inception of joint-stock companies—is the stranglehold of the dominant or principal shareholder(s) who monopolize the majority of the company's resources to serve their own needs. That is, the 'agency gap' is actually between majority shareholders and other stakeholders.

Secondly, much of global corporate governance norms focus on boards and their committees, independent directors and managing CEO succession. In the Indian business culture, boards are not as empowered as in several western economies and since the board is subordinate to the shareholders, the will of the majority shareholders prevails.

Therefore, most corporate governance abuses in India arise due to conflict between the majority and minority shareholders. This applies across the spectrum of Indian companies with dominant shareholders—PSEs (with government as the dominant shareholder), multinational companies (where the parent company is the dominant shareholder) and private sector family-owned companies and business groups.

In **public sector units (PSEs)**, members of the board and the Chairman are usually appointed by the concerned ministry and very often PSEs are led by bureaucrats rather than professional managers. Several strategic decisions are taken at a ministerial level which may include political considerations of business decisions as well. The recent case of the PSE oil companies not being allowed to increase the price of oil products in line with the changes in the international crude prices is an example of how the dominant shareholder, the Indian Government, uses its dominance to force decisions that are not always linked to

business interests.) Therefore, PSE boards are seem to rarely act in the manner of an empowered board as envisaged in corporate governance codes and this makes several provisions of corporate governance codes merely a compliance exercise.

The recent issues raised by The Children's Investment Fund of UK (TCIF) in respect of the management of Coal India have bought the issue of management by the majority shareholder to the forefront and have raised a number of issues of corporate governance in respect of PSEs in India .TCIF is Coal India's second largest shareholder and owns around 1.1% of the company's equity whereas the government ownership in Coal India is 90%.

On March 12,2012 TCIF sent a of letter[48] to Coal India's Board of Directors in which they accused Coal India's Board of Directors of "not taking into account its fiduciary duty" and listed the following principal charges against the Board of Directors (1) not resisting government's "request" to roll back coal price hikes even though when, as claimed by TCIF, Coal India sells coal at a price that is 70% below landed international levels for Fuel Supply Agreements; (2) refusing to defy the orders of India's Prime Minister directing the company to urgently enter into fuel supply agreements with power producers with the stipulation that Coal India would supply at least 80% of the contracted quantity(even if meant that it would have to import coal) else Coal India would accept penalties; and (3) refusal to resist the Draft Mining Bill in India's Parliament, which the fund claims is detrimental to the interests of Coal India.

The Children's Investment Fund ended its letter by threatening Coal India's individual Board members with legal action.

The action by TCIF sparked of a lively debate in the Indian media[49] and also provoked a strong reaction from the Indian Government.[50]

The response of the Union Minister for Coal[51] drew the reference to the disclosures made by Coal India in its Draft Red Herring Prospectus (DRHP)[52], issued at the time of the IPO, where these risks were fully disclosed and should have been factored in by any prospective investor including TCIF. Specifically these risks were disclosed in the DRHP in a transparent manner in Clauses 17 and 55 under the section on Risk Factors[53] and it was argued that prospective investors were fully aware of these risks when they invested and had no rights to complain at a subsequent date.

However R. Jagannathan[54] has suggested that even a transparent disclosure that the Government of India influences Coal India's pricing is not enough and putting such a disclosure in the prospectus does not give the government a license to pursue bad corporate governance policies. Arguing that a company should not get away with bad governance even if that is indicated in the prospectus, Jagannathan[55] has stated that the

extent, the landed cost of comparative imported coal. The price of raw coal sold under our FSAs does not fully reflect market prices for coal in India or in international coal markets. In addition, in the event that our production costs or other costs associated with the purchase of our coal that are payable by our customers, such as transportation cost and statutory levies, were to increase, there can be no assurances that we would be able to increase the price of coal to offset any such increases. For policy or other reasons, we may not price our coal at levels that would adversely impact the power sector or the Indian economy.

Risk Factor 55- The interests of the GoI (Government of India) as our controlling shareholder may conflict with your interests as a shareholder.

Under the MoU signed with the MoC (Ministry of Coal) and our Articles of Association, the President of India may issue directives with respect to the conduct of our business or our affairs for as long as we remain a government owned Company, as defined under the Companies Act. For instance, under Article 33 of our Articles of Association, the President of India, by virtue of holding a majority of our Equity Share capital, has the power to appoint the non-retiring Directors on our Board, i.e. one-third of the members of the Board, and also has the power to appoint our Chairman and Managing Director and determine the terms and conditions including remuneration and tenure applicable to the appointment. The interests of the GoI may be different from our interests or the interests of our other shareholders. As a result, the GoI may take actions with respect to our business and the businesses of our peers and competitors that may not be in our or our other shareholders' best interests. The GoI could, by exercising its powers of control, delay or defer or initiate a change of control of our Company or a change in our capital structure, delay or defer a merger, consolidation, or discourage a merger with another public sector undertaking.

In particular, given the importance of the coal industry to the economy, the GoI has historically played a key role, and is expected to continue to play a key role, in regulating, reforming and restructuring the Indian coal mining industry. The GoI also exercises substantial control over the growth of the power industry in India which is dependent on the coal we produce and could require us to take actions designed to serve the public interest and not necessarily to maximize our profits".

In public sector units (PSEs), members of the board and the Chairman are usually appointed by the concerned ministry and very often PSEs are led by bureaucrats rather than professional managers.

disclosure of risk factors does not constitute adequate protection to Coal India against governance issues raised by TCIF. He goes on to add that by confusing between policy and board autonomy the government takes away a commercial undertaking's power of agency i.e. its power to protect itself from commercial decisions taken by the dominant shareholder.

Jagannathan's view does not have many takers. It has also been argued[56] that the listing of Public Sector Companies should not be construed to transform them into 'capitalist' entities that are solely focused on maximizing profits and while the listing of PSEs changed them into companies that are able to access large pools of capital, the inherent conflict of the 'national interest' (power at affordable prices for the nation) and the 'minority interest' (economic benefit of shareholders who became members of in the company in the post IPO phase) would remain. Furthermore, in a case where a conflict arises (as in the case of the pricing of coal and the Fuel Supply Agreements), the GoI, as the dominant shareholder in Coal India, is within its rights to resolve the issue in favor of the 'national interest' and the issuance of a presidential decree to Coal India is justified.

An analysis[57] by Espirito Santo Securities' suggests that while a successful legal outcome in the TCIF-Coal India issue in favor of the minority shareholder will be difficult, in an environment where enforcement is still weak TCI's rare example of activism is welcome. Also, contrary to common perceptions their analysis of the impact of ownership structure (PSEs, MNCs and Family Ownership) found that on performance yield, the PSEs fared better than the other two ownership categories and, interestingly, the worst performing companies were family dominated companies with over 76% family ownership.

In the backdrop of the efforts put in by the Department of Public Enterprises (DPE) to improve corporate governance practices in Central Public Sector Enterprises (CPSEs), the results from the survey[58] by Espirito Santo Securities should not come as a surprise. In June 2007 the DPE had issued Guidelines on Corporate Governance for CPSEs on an experimental basis which was adopted by CPSEs on a voluntary basis in 2008-09. In the light of the experience gained, the Guidelines were modified and then adopted on a mandatory basis in May 2010; these now form the cornerstone for corporate governances in all CPSEs.

The guidelines[59] on Corporate Governance for listed and unlisted CPSEs cover the following issues:

- Board of Directors
- Audit Committee
- Remuneration Committee
- Subsidiary Companies
- Disclosures
- Report, Compliance and Schedule of Implementation.

[54] For R. Jagannathan's arguments please refer to the post at :http://www.firstpost.com/business/tilting-at-windmills-rebuttal-of-fp-post-on-coal-india-272054.html

[55] Ibid.

[56] 'Taking a PSU to court' posted by Ajit Dayal on 9th April 2012, available at; http://www.equitymaster.com/ht/detail.asp?date=04/09/2012&story=2&title=Taking-a-PSU-to-court

[57] Espirito Santo Securities; the full report is available at: http://thebenchmark.in/wp-content/uploads/2012/03/Espirito_Governance.pdf

[58] Ibid

[59] The DPE guidelines are available at http://dpe.nic.in/sites/upload_files/dpe/files/gcgcpse10.pdf

In addition to the mandatory corporate governance guidelines issued by the DPE, the CPSEs are also governed by the Companies Act, 1956 and regulations of various authorities like Comptroller and Auditor General of India (C&AG), Central Vigilance Commission (CVC), Administrative Ministries, and other nodal Ministries. The Right to Information Act 2005 is also applicable to the CPSEs.

Because of the implementation of the DPE guidelines, key principles of Corporate Governance are in vogue in public sector because (a) the Chairman, Managing Director and Directors are appointed independently through a prescribed procedure; (b) Statutory auditors are appointed independently by the Comptroller & Auditor General; (c) Arbitrary actions, if any, of the Management can be challenged through writ petitions; (d) Remuneration of Directors, employees, etc. are determined on the basis of recommendations of Pay Committees constituted for this purpose; and so on.

However, despite the various initiatives that have been taken by the GoI and the guidelines that have been issued for better corporate governance in PSEs, the PSEs are constrained from acting as normal commercial organizations since some judicial pronouncements have declared public enterprises to be an extension or arm of the State under Article 12 of the Constitution[60] leading to their functioning in an environment which undermines the entrepreneurial and commercial functioning of public enterprises and puts them at a disadvantageous position vis-à-vis their private sector counterparts and competitors. As the State is the majority shareholder, the State owned enterprise have to work under the aegis of the State and are, therefore, subject to multiple levels of authority and reviews which can be quite onerous and time consuming.[61]

Multinational companies (MNCs) in India are perceived to have a better record of corporate governance compliance in the prescribed form, attributed to their applying global standards of transparency and accountability that are supposedly higher than most organizations in emerging markets. The MNC parent usually performs a very active role, closely monitoring the Indian affiliate. Furthermore, with adequate board representation, its influence over executive appointments and, given the magnitude of its stake, the MNC parent has a strong incentive to closely monitor its Indian affiliate.

However, in the ultimate analysis, it is the writ of the large shareholder (the parent MNC Company), which runs the Indian unit, that holds sway, even if it may be at variance with the wishes of the minority shareholders. There have been instances[62] of MNCs wishing to acquire the remaining equity in a company, where they had shareholding, when ownership regulations have changed,

[60] Report of the Ad-hoc Group of Experts on the Empowerment of central Public Sector Enterprises (Arjun Sengupta Committee), 2007: available at http://dpe.nic.in/publications/report_of_ad_hoc_group_of_experts_on_empowerment_of_cpses.
Under Article 12 of the Indian Constitution the definition of , 'State', unless the context otherwise requires, includes the Government and Parliament of India and the Governments and Legislature of each of the States and all local or other authorities within the territory of India or under the control of the Government of India. Although Article 12, in so many words, does not provide that CPSEs fall within the definition of the 'State', they are still deemed as being included in the category 'other authorities' and therefore, covered under the definition of 'State' as pronounced by different Courts including the Apex Court.

[61] Lamenting on this state of affairs Mr Arun Balakrishnan, CMD of HPCL has identified the inclusion of PSEs under the definition of State as,"……the genesis for a plethora of controls. Thus in addition to the audit committee, the statutory audit, internal audit the State owned enterprises have audits/reviews conducted by the parent ministry, the Department of Public Enterprises, Comptroller & Accountant General, the Chief Vigilance Commissioner, Parliament and Parliamentary Committees and the CBI.The State owned enterprises are also subject to writ petitions to the Supreme Court under Article 32 of the Indian Constitution and to the High Court under Article 226 of the Indian Constitution".
Available at-
http://www.hindustanpetroleum.com/Upload/En/ChairmansSpeech/files/SOE%20Corporate%20Governance%20June08.pdf

[62] Espirito Santo Securities, Supra. Refer Note 57; lists a few such instances, for instance HP's attempt, in 2002, to merge HP Digital Global Soft with HP India subsidiary at a distressed valuation which was successfully opposed by the minority shareholders or the delisting, by Luxottica, of its Indian Subsidiary, Rayban Sun Optics by apparently bringing the stock price down by as much as 50%after changing the exclusivity agreement.

but made/wanted to make the acquisition at a valuation that disadvantaged the minority shareholders. Such instances have, in cases, also been accompanied with suspicious declines in profitability in the quarters running up to the acquisition.

Moreover, the Indian affiliates of MNCs, at times, are encouraged to do riskier transactions for the benefit of their parent MNC which may endanger the interest of the minority shareholders in the Indian affiliate.[63] The compliance and other functions in an MNC is always geared towards the laws applicable to the parent company and the task of ensuring local compliance in India is usually left to a local manager who may not have the necessary authority to effectively carry out this role.

Family businesses and business groups as a category are perhaps the most complex for analyzing corporate governance abuses that take place. The position as regards family domination of Indian businesses has not changed; on the contrary, over the years, families have become progressively more entrenched in the Indian business milieu. As per a recent study by the global financial major Credit Suisse[64], India ranks higher than most Asian economies in terms of the number of family businesses and the market capitalization of Indian family businesses as a share of the nominal gross domestic product (GDP) has risen from 9 per cent in 2001 to 46 per cent in 2010.

This survey, which also covered China, South Korea, Taiwan, Singapore, Thailand, Hong Kong, Indonesia, Malaysia and the Philippines, contends that India, with a 67 per cent share of family businesses, ranks first among the ten Asian countries studied. Furthermore, 663 of the 983 listed Indian companies are family businesses and account for half of the total corporate hiring and are concentrated in the consumer discretionary, consumer staples and consumer healthcare sectors.

[63] Espirito Santo Securities, Supra. Refer Note 57; mentions that affiliates of MNCs in India, at times, do related party transactions that pose risks to minority shareholders and gives the example of Novartis India which, in 2008, had nearly 75% of its net worth outstanding as inter-company deposits with group companies resulting in heightened risk to the minority shareholders .

[64] See http://www.business-standard.com/india/news/india-pips-asian-peers-in-family-run-biz/454481/. Released in November 2011, the report defines family businesses as those wherein a family or any of its members holds at least 20 per cent of the cash flow rights in the firm, either directly or indirectly, through holdings in private or public entities.

In addition to the corporate governance issues arising from the dominant family holding in the Indian business companies, there exists an additional complexity on account of the 'promoter control' in Indian companies[65]. **Promoters**[66] (who may not be holding controlling shares) usually exercise significant influence on matters involving their companies, even though such companies are listed on stock exchanges and hence have public shareholders.

Promoters may be in control over the resources of the company even though they may not be the majority shareholders and, because of their position, have superior information about the affairs of the company than that accessible to non-promoters. As a corollary, in an organization, promoters and non-promoters constitute two distinct groups that may have diverse interests.

The Satyam episode[67] illustrated a scenario wherein a company with minimal promoter shareholding could still be subject to considerable influence by its promoters, thereby requiring a resolution of the agency problem between the controlling shareholders and the minority shareholders, even though such problems were not normally expected to arise at the low shareholding levels of the managing group. On 7 January 2009, when the Chairman of Satyam Computer Services, B. Ramalinga Raju, admitted that there had been a systematic inflation of cash on the company's balance sheet over a period of some seven years, amounting to almost $1.5 billion, the Raju family, who were the promoters of Satyam, held only about 5 per cent of the shares.

A company with 5 per cent promoter shareholding will usually be considered as belonging to the outsider model in terms of diffused shareholding, and hence would require the correction of agency problems between shareholders and managers.[68] However, despite the gradual decrease in the percentage holdings of the controlling shareholders, the concept of 'promoter' under Indian regulations made the distinction between an insider-type company and an outsider-type company somewhat hazy in this context, and the Raju family, as promoters, continued to wield significant powers in the management of the company despite a drastic drop in their shareholdings over the preceding few years. Furthermore, at Satyam, the diffused nature of the remaining shareholding of the company helped the promoter group to consolidate and exercise power that was disproportionate to their voting rights; while the institutional shareholders collectively held a total of 60 per cent shares as of 31 December 2008 in Satyam, the highest individual shareholding of an institutional shareholder was only 3.76 per cent.[69]

Shah[70] believes that companies wherein controlling shareholders hold limited stakes could be particularly vulnerable to corporate governance failures and adds that promoters

[65] Varottil, Supra. Refer Note 15.

[66] According to the market regulator SEBI, a Promoter has been defined as a person or persons who are in overall control of the company or persons, who are instrumental in the formulation of a plan or program pursuant to which the securities are offered to the public and those named in the prospectus as Promoters. A director/officer of the issuer or a person acting merely in their professional capacity is not to be included in the definition of the Promoter. Indian law and regulation require that for the sake of protection of the interest of the investing community at the initial stage of going public, Promoters should have a substantial stake in the company. The shareholding interest of the Promoters must not be less than 20 per cent of the post-issue share capital. Even in a subsequent issue, the Promoters shall either participate to the extent of 20 per cent of the proposed issue or ensure shareholding to the extent of 20 per cent of the post issue capital. Moreover, the minimum Promoter's contribution must be locked in for a minimum of 3 years. The requirement of minimum Promoter's contribution shall not be applicable if a company remains listed for three years and above in a stock exchange and has a track record of payment of dividend for at least three immediately preceding years. Subject to these restrictions, the fraction of shares held by the Promoters (and non-Promoters) would be determined by the interplay of various economic factors.

[67] Satyam, Supra. Refer Note 10.

[68] Varottil, Supra. Refer Note 15.

[69] Varottil, Supra. Refer Note 15. However, as pointed out by Varottil, it would be cumbersome to obtain the exact amount of voting shares held by the promoters, as large parts of those shares were pledged to lenders and those pledges were enforced by the lenders during the few months surrounding the revelation of mis-statements in Satyam's financial information, thereby possibly bringing the promoter holdings down to negligible levels at the time when the knowledge of the scam became public.

[70] Shah, Ajay, "Getting the Right Architecture for Corporate Governance", Financial Express, 13 January 2009, Available at: <http://www.mayin.org/ajayshah/MEDIA/2009/ushaped.html> Shah states, "The incentive for theft [in such cases] is the greatest: there is a great temptation for a CEO who owns 8% of a company to make a grab for 100% of the cash flow."

who are in the twilight zone of control, that is, where they hold shares less than those required to comfortably exercise control over the company, have a perverse incentive to keep the corporate performance and stock price of the company at high levels so as to thwart any attempted takeover of the company[71].

The Satyam case clearly demonstrates the inability of the existing corporate governance norms in India to deal with corporate governance failures in family-controlled companies, even where the level of promoter shareholding is relatively low.

Future governance reforms thus need to address the matter of promoters with minority shareholding, who are in effective control of managements in such companies that lie at the cusp of insider and outsider systems.

Increasing Public Float of Shares

Corporate governance theory suggests that widely held companies are better governed than closely held companies and that countries must work toward increasing the size of and deepening the capital markets.

A beginning in this direction was made by the Ministry of Finance in June 2010, when it amended the Securities Contract (Regulation) Act to set a limit of 25 per cent as the minimum public shareholding for initial as well as continued listings on Indian stock markets.[72]

This amendment seeks to increase the public float of shares so that companies in India necessarily have to have a degree of widely dispersed holding. Existing listed companies having less than 25 per cent public holding have to reach the minimum 25 per cent level by an annual addition of not less than 5 per cent to the public holding. Also, if the public shareholding in a listed company falls below 25 per cent at any time, such a company has to bring the public shareholding to 25 per cent within a maximum period of 12 months from the date of such a fall.

This is a good milestone for broadening the shareholder base in the country; however, the actual implementation of this requirement may be challenging, especially for public sector companies, not least because the capital market may not be ready to absorb what will certainly be large issue sizes to comply with the threshold limit. Hence in August 2010, there was another amendment to the Securities Contract (Regulation) Act, which exempted public sector companies from this threshold of 25 per cent public shareholding. The exemptions are at two levels: a) for companies that have a public shareholding of 10 per cent or more, they may raise it to 25 per cent over a period of three years, and b) for other PSEs, the threshold limit is kept at 10 per cent to be reached in three years.[73]

[71] Ramalinga Raju of Satyam referred to this dilemma in his confessional letter post the exposure of the scam, "As the promoters held a small percentage of equity, the concern was that poor performance would result in a take-over, thereby exposing the gap. It was like riding a tiger, not knowing how to get off without being eaten."

[72] www.finmin.nic.in/the_ministry/dept_eco_affairs/capital_market_div/Amendment_Securt_contract_1957.pdf
The Gazette of India, Extraordinary, Part-II, Section 3, Sub-section (I) Ministry of Finance (Department of Economic Affairs), New Delhi, 04 June 2010.

[73] http://finmin.nic.in/the_ministry/dept_eco_affairs/capital_market_div/Securt_contract_Rule_2ndAmnd.pdf, *The Gazette of India, Extraordinary*, Part-II, Section 3, Sub-section (I), Ministry of Finance, (Department of Economic Affairs), New Delhi, 9 August, 2010.

Corporate governance processes presently in convention are designed with a view to serve the shareholders and protect them from managerial excesses. However, this premise is turned on its head when companies are run by a dominant shareholder or group. A corporate governance regime which involves strengthening board processes alone would be rather irrelevant to solve the problems of governance abuses by dominant shareholders.

Interestingly, governance failures and abuses happen across all three categories of companies classified based on who has the dominant ownership i.e. GOI, Promoter Family and MNCs and all of them need careful monitoring. However, in the case of PSEs the situation is more complex because, at times, the GoI (who is the Dominant shareholder in PSEs) may have to take decisions in 'national interest' which may be contrary to the interest of the 'minority shareholders'.

Companies Bill, 2011 and its Impact on Corporate Governance in India

The foundations of the comprehensive revision in the Companies Act, 1956 was laid in 2004 when the Government constituted the Irani Committee[74] to conduct a comprehensive review of the Act. The Government of India has placed before the Parliament a new Companies Bill, 2011[75] that incorporates several significant provisions for improving corporate governance in Indian companies which, having gone through an extensive consultation process, is expected to be approved in 2012.

The new Companies Bill, 2011 proposes structural and fundamental changes in the way companies would be governed in India and incorporates various lessons that have been learnt from the corporate scams of the recent years that highlighted the role and importance of good governance in organizations.

Significant corporate governance reforms, primarily aimed at improving the board oversight process, have been proposed in the new Companies Bill; for instance it has proposed, for the first time in Company Law, the concept of an **Independent Director** and all listed companies are required to appoint independent directors with at least one-third of the Board of such companies comprising of independent directors.

The Companies Bill, 2011 takes the concept of **board independence** to another level altogether as it devotes two sections[76] to deal with Independent Directors. The definition of an Independent Director has been considerably tightened and the definition now defines positive attributes of independence and also requires every

[74] Irani Jamshed J., Report of the Expert Committee to Advise the Government on the New Company Law (2005).

[75] The Companies Bill,2011; Supra. Note 14

[76] Section 149 and 150 of The Companies Bill, 2011, Supra. Note 14.

Independent Director to declare that he or she meets the criteria of independence. In order to ensure that Independent Directors maintain their independence and do not become too familiar with the management and promoters, **minimum tenure** requirements have been prescribed[77]. The initial term for an independent director is for five years, following which further appointment of the director would require a special resolution of the shareholders. However, the total tenure for an independent director is not allowed to exceed two consecutive terms.

The new Companies Bill, 2011 expressly disallows Independent Directors from obtaining **stock options** in companies to protect their independence.

The new guidelines which set out the role, functions and duties of Independent Directors and their appointment, resignation and evaluation introduce greater clarity in their role; however, in certain places they are prescriptive in nature and could end up making the role of Independent Directors quite onerous.

In order to balance the extensive nature of functions and obligations imposed on Independent Directors, the new Companies Bill, 2011 seeks to **limit their liability** to matters directly relatable to them and limits their liability to "only in respect of acts of omission or commission by a company which had occurred with his knowledge, attributable through board processes, and with his consent or connivance or where he had not acted diligently"[78]. In the background of the current provisions in the Companies Act, 1956 which do not provide any clear limitation of liability and have left it to be interpreted by Courts[79], it is helpful to provide a limitation of liability clause.

The new Bill also requires that all resolutions in a **meeting convened with a shorter notice** should be ratified by at least one independent director which gives them an element of veto power. Various other clauses such as those on directors' responsibility statements, statement of social responsibilities, and the directors' responsibilities over financial controls, fraud, etc, will create a more transparent system through better disclosures.

A major proposal in the new Bill is that any undue gain made by a director by abusing his position will be **disgorged** and returned to the company together with monetary fines.

Other significant proposals that would lead to better corporate governance include closer regulation and monitoring of **related-party transactions, consolidation of the accounts of all companies within the group, self-declaration of interests by directors** along with disclosures of loans, investments and guarantees given for the businesses of subsidiary and associate companies.

[77] The Companies Bill, 2011; Supra.Note 14.

[78] Id.

[79] The 2009 experience of Nimesh Kampani, one of India's leading investment bankers is very relevant to see how unstable the position of independent directors is under the Companies Act, 1956.

Kampani served as an independent director on the board of Nagarjuna Finance from 1998 to 1999.21 The promoters and executives of Nagarjuna were later charged under the Andhra Pradesh Protection of Creditors Act for failing to repay depositors nearly Rs. 100 crore during 2001- 2002.Surprisingly, in addition to charging and arresting the founding promoter and another affiliated director, the Government also charged Kampani, who had left the board prior to any of the allegations surfacing. Kampani managed to avoid arrest and jail time by remaining in Dubai for nine months until a ruling by the Supreme Court of India in October 2009 stayed the proceedings against him.http://www.hindustantimes.com/News-Feed/India/Supreme-Court-stays-arrest-of-Nimesh-Kampani/Article1-395918.aspx

A significant first, in the proposals under the new Companies Bill, is the provision that has been made for **class action suits**; it is provided that specified number of members may file an application before the Tribunal on behalf of members, if they feel that the management or control of the affairs of the company are being conducted in a manner prejudicial to the interests of the company or its members. The order passed by the Tribunal would be binding on the company and all its members. The enhanced investor protection framework, proposed in the Bill, also empowers small shareholders who can restrain management from actions that they believe are detrimental to their interests or provide an option of exiting the company when they do not concur with proposals of the majority shareholders.

The Companies Bill, 2011[80] seeks to provide clarity on the respective roles of SEBI and the MCA and demarcate their roles while the issue and transfer of securities and non-payment of dividend by listed companies or those companies which intend to get their securities listed shall be administered by the SEBI all other cases are proposed to be administered by the Central Government. Furthermore, by focusing on issues such as Enhanced Accountability on the part of Companies, Additional Disclosure Norms, Audit Accountability, Protection for Minority Shareholders, Investor Protection, Serious Fraud Investigation Office (SFIO) in the new Companies Bill, 2011, the MCA is expected to be at the forefront of Corporate Governance reforms in India.

Policy Formulation - Need for Robust Research to Guide Future Policy Initiatives

High profile corporate scandals like Enron, Satyam, etc have brought into public consciousness the mundane subject of corporate governance reforms in the hope that implementing good governance in organizations would not only prevent the recurrence of such problems but also lead to good organizational performance.[81]

The last decade has also seen a flurry of regulations introduced across different countries in the world aimed at improving corporate governance practices in organizations; however, the results from such regulatory changes have been mixed. Indeed some have even argued[82] that introducing corporate governance regulations is no guarantee that we have seen the last corporate governance break down.

Effectiveness of corporate governance regulations depends on having satisfactory answers to the following two questions;

- Are the regulatory changes in corporate governance based on sound theory or are they based on popular perceptions and a common position that is arrived at based on the negotiation of the divergent views of

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[80] The Companies Bill,2011; Supra Note 13.

[81] Reporting on subject of corporate governance in the media has increased significantly after the various corporate scams surfaced in the beginning of the twenty-first century. As pointed out by Bhagat et al; The Promise and Peril of Corporate Governance (Supra. Note 82) in the nearly five years since Enron's collapse, there have been 1,342 New York Times news stories containing the phrase "corporate governance," whereas to reach a comparable count prior to that date, one has to cumulate news stories over ten years to 1986 (totaling 1,388), as searched in Lexis in September 2006.

[82] Mark J. Roe; The Inevitable Instability of American Corporate Governance (2004) downloaded from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=615561, points to the inherent brittleness in corporate governance regulation since it is based on negotiations between the regulator who believe that they must lock everything in and the regulated who is able to affect the regulator and weaken the output. Roe suggests that we will continue to face corporate governance crises from time to time as new stress points develop and only if we're lucky, someone will anticipate the problem and fix it up beforehand, if not, we'll muddle through another crisis once again.

various interest groups who are affected by the regulatory changes?

- How robust is the underlying theory of corporate governance, in particular the linkage of good governance to good performance–does it comprehensively model all the factors that impact corporate governance and accounts for differences in contextual and cultural factors that could impact governance. Also, has the corporate governance theory been tested empirically based on actual conditions and have the conclusions been tested for their validity?

Unfortunately, the world over, the current answer to both the above questions are not very satisfactory- and India is no exception. Quite often regulatory changes have been made without being rooted in sound theory.

The current status of corporate governance research, especially an understanding of the factors that links corporate governance to good performance, has several gaps and conclusions derived from such findings, at times, do not hold up to rigorous testing. Over the last decade, while significant steps have been taken by the regulatory authorities in India to enhance corporate governance measures in India; these developments have closely followed efforts in other jurisdictions such as the U.K. (the Cadbury Committee Report) and the U.S. (SOX). The mechanism of market forces in western economies presumes the existence of a deep and liquid market in shares, which is not a reality in India. Besides, stock markets have proven to be only partially successful in ensuring good corporate governance even in developed and mature economies.

The major challenges to corporate governance reforms in India are:

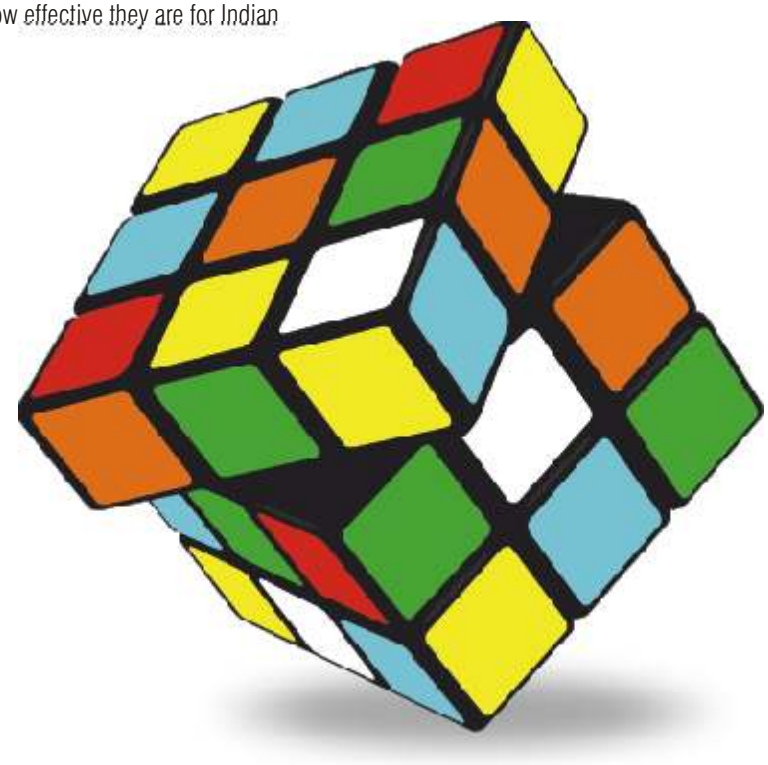
- **Power of the dominant shareholder(s)**
- **Lack of incentives for companies to implement corporate governance reform measures (no direct correlation between putting expensive governance systems and corresponding returns)**
- **Underdeveloped external monitoring systems**
- **Shortage of real independent directors**
- **Weak regulatory oversight including multiplicity of regulators**

India needs and deserves a well-designed policy framework that takes into account all these concerns while being aligned to global developments. That is, home-grown solutions to our unique problems. While the need to have public policy (relating to corporate governance) firmly grounded in sound theory is indisputable, there is the need to improve the robustness of research on corporate governance itself and develop a more robust theory for corporate governance– an area where several concerns exist at present. Despite a growing body of empirical literature on corporate governance reforms in India and their impact on Indian companies there is a need for further and more detailed research to fully understand the underlying issues that affect corporate governance in India. Only a proper understanding of the underlying issues would help in evolving a framework for reforms appropriate to the Indian situation and ethos, which would have much greater chance of success as compared to any ad hoc reform measures.

It would augur well for Indian companies if the corporate governance debate in the country were to transcend beyond conventional anecdotal wisdom and is based on research to facilitate the development of models that take into account distinctive Indian factors which are characteristic of the business environment in India

In association with the Indian Institute of Corporate Affairs and Indian Institute of Management, Kolkata, Thought Arbitrage Research Institute (TARI) proposes to bring our a series of discussion papers, based on empirical research that has been conducted, which would focus on various facets of Corporate Governance in Indian companies. Placing these papers in the public domain would help to initiate a debate on these very important issues and provide an input for more robust policy formulation.

Indeed, corporate governance reforms in India now stand at an interesting crossroads, and the future development of the next generation reforms and in their implementation during the current decade, will decide how effective they are for Indian business.



Gatekeepers of Corporate Governance

- Reserve Bank of India (RBI)
- Securities and Exchange Board of India (SEBI)
- Auditors

Gatekeepers of Corporate Governance

Introduction

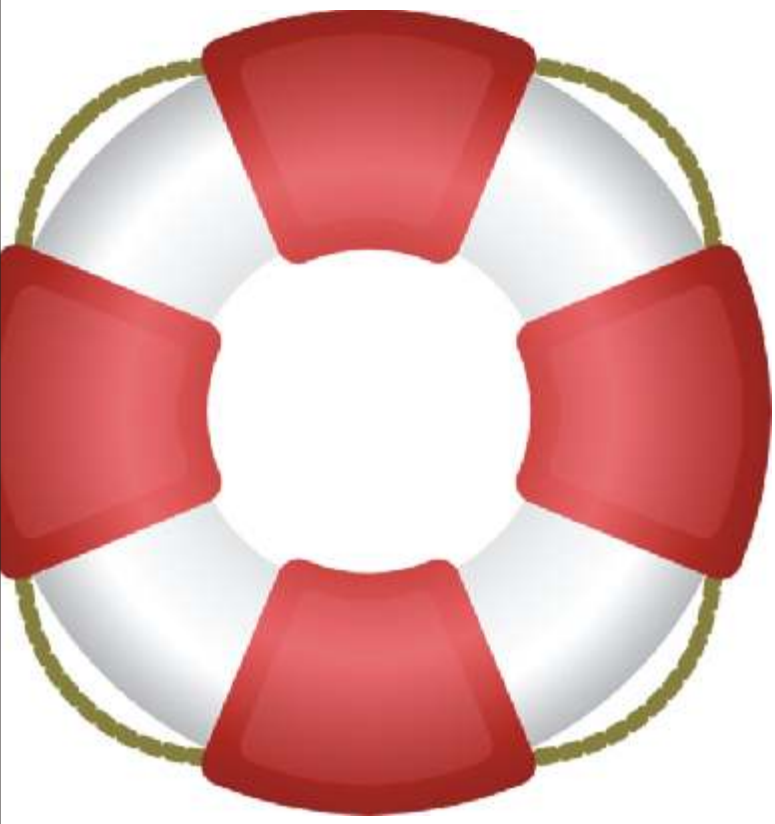
The primary duty of the capital market towards its constituents is to provide a fair and efficient platform for market transactions. In order to ensure a fair market, the efficacy of the oversight mechanism is paramount. For this purpose, the various companies concerned and their respective managements must know that 'somebody is watching over them' in order to ensure that a privileged few do not enjoy an unfair advantage in terms of the transactions performed or access to any extra information. Hence, there are third-party assurance providers like auditors, analysts, lawyers, rating agencies and even bankers, who are regarded as constituting the first line of defence for ensuring good governance. However, global experience has shown that these parties are not always the best gatekeepers. This leads to the inevitable question, 'who will guard the guardians?'

The corporate governance mechanism everywhere depends on the general legal, contractual and enforcement processes in any jurisdiction, rather than being left to the process of self-regulations and individual commitments. The quality of the enforcement environment, therefore, creates a foundation for investor protection and fair play.

Corporate governance and enforcement mechanisms are closely linked as they form an integrated framework of linkages to protect the interest of all stakeholders. Thus, the entire supervisory, monitoring and regulatory system has to operate in a series of inter-connected ways to provide varying degrees of gatekeeping services to the economy.

The oversight mechanism leading to good governance may be enforced through a contract—between either a company and its management, or a company and its auditors, analysts or lawyers—in order to enable the latter to perform their fiduciary duties. Alternatively, it may be enforced by the legal and regulatory framework within which corporations operate.

Stock exchanges and capital market regulators function as powerful agents for instilling good governance, especially in a country like India where capital markets are going through a process of transformation. Reforming listing rules is easier than reforming general securities or corporate laws; also, the threat of de-listing enables



stock exchanges to compel compliance. Likewise, lending institutions like banks enjoy self-enforcement capabilities through the leveraging of interest rates or repayment terms to ensure compliance with governance standards.

A combination of good regulations and efficient gatekeeping would lead to the development of stronger capital markets. Bringing about a reduction in the cost of governance and hence in the cost of capital necessitates the functioning of a range of private and public enforcement tools in a complementary manner.

Gatekeeper failure is often the by-product of the provision of for-fee services. Gatekeepers such as auditors, lawyers, rating agencies and analysts are particularly vulnerable to this sort of failure. Hence the role of other gatekeepers—regulators, the government, and the judiciary—becomes important for maintaining the robustness of the gatekeepers' role. Such institutions carry out their responsibilities beyond the contracted services in the form of cost-effective deterrence. One of the critical roles that a gatekeeper plays in maintaining corporate governance pertains to not only the detection but also the deterrence of corporate misconduct. Regulatory agencies, the government and the judiciary are well-placed to carry out this important role in enforcing corporate governance.

One of the critical roles that a gatekeeper plays in maintaining corporate governance pertains to not only the detection but also the deterrence of corporate misconduct.

In this study, we examine the role of the Securities and Exchange Board of India (SEBI), the Reserve Bank of India (RBI), the Comptroller and Auditor General (CAG), and of auditors and their regulatory body, the Institute of Chartered Accountants of India (ICAI) in maintaining and enforcing corporate governance. The role of gatekeepers other than these (such as the government and the judiciary) would be the subject of a separate study.

The study concludes with the recommendation that gatekeepers should operate in an interdependent rather than independent manner and that there must be a certain degree of collective responsibility among all gatekeepers in order to ensure that their total capacity is harnessed to deter wrongdoing.

Executive Summary

Gatekeepers are individuals, institutions or agencies that are interposed between investors and managers/owners, in order to play the role of a watchdog to help reduce agency costs (thereby the cost of capital). They are important because they are in a position to verify and certify the integrity of companies, which may otherwise remain opaque to the common investor. Institutions like RBI, SEBI, and individuals in their capacity as auditors and analysts can act as effective deterrents by withholding their co-operation from defaulters. This study is an attempt to review the impact they have recently had on the Indian Capital Markets; and search for possibilities of further sharpening and refinement of this role, so that it makes the overall system run better.

RBI

Banking Sector Regulation: Central banks are expected to be autonomous bodies, primarily concerned about keeping inflation in check and maintaining macro-economic stability. In a developing economy, however, they may be required to do a bit more of hand-holding, actively manage certain aspects of the economy and help build robust institutions. RBI has been acting as a facilitator by setting a framework of interest rates, Forex reserve management, setting down prudential norms for the financial sector. It also conducts periodic surveillance of the banking sector to enforce corporate governance norms

Framework for Corporate Governance of Banks: RBI performs corporate governance functions under the guidance of Board for Financial Supervision (BFS). BFS inspects and monitors banks using the 'CAMELS" approach (Capital adequacy, Asset Quality, Management, Earnings, Liquidity and Systems & Controls). These corporate governance norms follow a three-pronged approach of a) Disclosure and Transparency, b) Off-site surveillance, c) Prompt corrective action.

We have analysed financial information of banks which constitute 70% of total capital and reserves of the banking sector for a period of 5 years to examine whether RBI-prescribed corporate governance norms are effective.

Observations of Our Analysis: The commercial banking sector constitutes about 85% of the entire financial sector. It is required to maintain CAR of 9%, NPAs below 10% and ROA of 0.25%. The analysis affirmed RBI's success as a regulator as all banks have done better than the benchmark during the period (2006-10). Both the EPS and share price have also moved in a positive direction in line with the sector performance.

SEBI acts as a developer and regulator of the capital market in India which makes it a very important gatekeeper of corporate governance.

RBI has done a good job of steering the banking sector and the economy safely through some very trying and testing times in the recent years. However, our study was restricted to the study of RBI's effectiveness in regulating only the banking sector. There are several instances where RBI seeks information directly from the commercial sector and can therefore enforce checks and balances to instil good corporate governance. RBI's effectiveness as a gatekeeper of the corporate world directly is not covered here and is the subject of further research.

SEBI

SEBI acts as a developer and regulator of the capital market in India which makes it a very important gatekeeper of corporate governance. Its mandate extends only to listed companies and is exercised through two stock exchanges, National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE). SEBI has set out a basic standard of corporate governance which forms part of the Listing Agreement that each listed company signs with the stock exchange under the title 'Clause 49'. Clause 49 remains the most significant corporate governance reform and established a new corporate governance regime.

Impact of Clause 49 on Firm Value and Efficiency: Clause 49, introduced in 2005, specified requirements such as independent directors on the board, separate audit and remuneration committees, CEO/CFO's personal responsibility for the verity of financial statements, clearly stated whistle blower policy etc. Adoption of these norms is expected to improve the performance, thereby the valuation of the company.
We studied the movement of Tobin Q (an accepted measure impact of good governance on firm value the world over)for 100 companies comprising BSE 100 index over a period of seven years beginning 2004-05 ,to see examine the impact of adoption of Clause 49.No significant , positive shift in the mean Tobin Qs was observed in this period. Key financial ratios such as ROA, ROE, Net Profit, Emp. Cost/Sales percentage were also analysed. Due to general macroeconomic dynamism no clear relation could be established between Tobin Q and the other ratios for the period. Perhaps Corporate Governance (CG) has not had the expected impact as yet.

The SEBI Appeal Process and Consent Orders: Ever since its establishment, SEBI has been endowed quasi-judicial powers and functions to expedite any complaints arising on account of its role as a market regulator. SEBI has done significant work in this area; most of the appeals have been concerned with IPO or share price manipulation (56%).However there seems to be a bit of arbitrariness and opacity in handling and disposal of cases. We analysed 100 appeals between March 2010 and September 2011.In 51% of the cases the appellant was given full or partial relief. In 35% of 68 cases, where

the date of appointment of AO is available, it took SEBI more than four years to appoint the officer. Our analysis showed that the Adjudicating Officer is very powerful in the entire process by playing a significant role in the issue of show-cause notices, enquiry, forwarding the case for settlement and approving authority in consent orders which calls for greater transparency and clearer guidelines.

The study also analysed 100 consent orders from May 2009 to September 2011. Consent orders are meant to provide an alternative to lengthy litigation processes; our analysis showed that consent orders may be effective in settling cases but the system lacks transparency and is marred by opacity. In the final analysis, SEBI has been instrumental in instituting and enforcing basic standards of Corporate Governance. At the moment its ambit is limited to listed entities, but as adoption of these norms progresses, it is bound to have a rub-off on the rest of the economy. The SEBI appeal process is a significant constituent of this 'act'; it needs some tightening, which might already be taking place.

Auditors

Auditors as Reputational Intermediaries
The auditor plays a central role in upholding the integrity of financial information. They are regarded as gatekeepers to the entire public securities markets and, as it were, 'keeping the faith' of investors, regulators and other stakeholders. Genuine independence is very important to their performance of duties. In reality, fee based non-audit services often come in the way of impartial conduct. Many believe that the risk of loss of reputation should act as a powerful deterrent; any legal liabilities are not required.

Size of the audit firm is often cited as a good proxy for audit quality and dependability. Analysis of auditors of Bombay Stock Exchange (BSE) top 100 companies as well as BSE 500 shows that Indian companies and capital markets do not have auditor concentration of Big 4 as in the USA or Western Europe and neither do Indian owners make a clear distinction of quality between the Big4 and the national firms. In any case, as audits are complex processes involving a lot of subjective judgement, it is difficult to accurately evaluate audit quality.

Quality Financial Information: Three Pillars Quality of Accounting Standards: With increasing integration of the global economy, businesses need a commonly understood accounting language and IFRS has emerged as this common global standard. Institute of Chartered Accountants of India (ICAI) has a clearly stated goal of convergence of Indian standards with IFRS. IFRS is a principles-based set of standards rather than rule-based and calls for use of judgment to comply with the spirit of the principles.

Quality of Accounts Prepared by Companies: India has been found to rank on

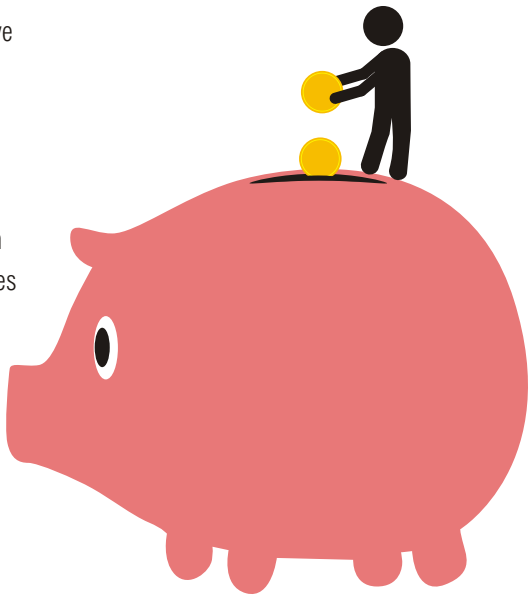
Gatekeepers are individuals, institutions or agencies that are interposed between investors and managers/owners in order to play a watchdog role to reduce agency costs.

the higher side with respect to aggressiveness in: earnings aggressiveness i.e. accrual of earning when they do not exist; loss avoidance i.e. postponing recording of transactions that are losses; and earnings smoothening. The quality of an audit is directly linked to the quality of financial statements; we found that since the proportion of promoter-led companies in India is very high, there is greater likelihood of managerial discretion which may raise information risk of the company.

Quality of Enforcement: Our analysis found very few instances of prosecution/ inquiries of companies for non-compliance with provisions of Companies Act, which could indicate that either Indian corporate accounts are of high quality requiring no further explanations or that the Registrar of Companies does not adequately scrutinise documents filed with it. Enforcement of quality of audit is through a system of self-regulation (even if this is through the apex body ICAI); this, however appears to leave room for laxity.

Our analysis has concluded with recommendations such as:

- There needs to be stronger division between audit and non-audit services rendered by a firm to ensure true independence of the auditor
- Firms need to be a minimum size to audit the accounts of public-interest/listed entities
- Regulators such as RBI and CAG should have access to client files and auditor's working papers to keep a tab on quality
- As per current rules, an audit firm's revenue from a single client cannot be more than 10% of the total revenue and revenue from consultancy charges cannot be more than 100% of the audit fees. However these rules may be circumvented by operating through various affiliate firms. The same could be avoided by setting more reasonable limits such as: a ratio of 1:4 between non-audit and audit revenues
- An independent regulatory body may be created on the lines of 'America's Public Company Accounting Oversight Board' to oversee auditing in India.



[83] Kraakman, R.H., 1986. "Gatekeepers: Anatomy of a Third-party Enforcement Strategy", Journal of Law, Economics and Organization, Vol. 2, pp. 53104 available at http://www.jstor.org/discover/10.2307/764916?uid=3738256&uid=2129&uid=2&uid=70&uid=4&sid=56016916433 last accessed on April 10, 2012

[84] Coffee, Jr., John C., 2001. "The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting", Columbia Law and Economics Working Paper No.191, May. Available at: SSRN:http://ssrn.com/abstract=270944 last accessed on April 10, 2012.

Literature Review

Gatekeepers are individuals, institutions or agencies that are interposed between investors and managers/owners in order to play a watchdog role to reduce agency costs. If gatekeepers are absent or do their job inefficiently, then it would be reasonable to believe that there would be fewer checks on managers/owners to motivate them to behave in a manner that would facilitate placing investors' interests above self-interest. In other words, market efficiency would be lower which would, in turn, raise the cost of capital.

Kraakman (1986) defines gatekeepers as 'parties who are in a position to prevent misconduct by others by withholding their co-operation'[83]. Scholars like Kraakman and Coffee further define gatekeepers as reputational intermediaries who provide verification and certification services to investors. However, they also acknowledge that the role of gatekeepers as reputational intermediaries who can more easily be deterred than the principals they serve has been developed in theory but less often examined in practice.[84]

Gatekeepers essentially assess or vouch for corporate clients' own statements or a specific transaction—if this sounds like duplication, it is; however, this duplication is necessary because it is generally accepted that a gatekeeper has a lesser incentive to lie than the client and… the gatekeeper's word is regarded as being more credible.[85] Hamdani defines gatekeepers as "parties who sell a product or provide a service that is necessary for clients wishing to enter a particular market or engage in certain activities".[86]

Therefore, bankers, auditors and analysts are gatekeepers for clients wishing to enter the capital market. Extending the argument, it can be said that for clients who wish to raise money through shares, the capital market regulator (Securities Exchange Board of India or SEBI) is a major gatekeeper. Lending to the corporate sector is one of the main planks of a commercial bank; therefore, the banking sector regulator (RBI) is another gatekeeper for ensuring corporate governance through the regulatory mechanism of prudential lending norms and monitoring of the use of money, among other things.

Having a network or series of gatekeepers is, however, no guarantee that corporate wrongdoing would be detected or avoided. In a wave of corporate scandals starting with Enron, we have seen instances of multiple failure of gatekeepers in which wrongdoing went undetected through several levels of gatekeeping. "The failure of this network of gatekeepers was a recurring theme in business scandals. In too many instances, the gatekeepers in pursuit of their own financial self-interest compromised the values and standards of their profession in the recent round of corporate scandals, the

[87] Coffee, Jr., John C., "Understanding Enron: It's About the Gatekeepers, Stupid", Columbia Law School, p. 5 available at http://mba.tuck.dartmouth.edu/mdm/AlumniLearningLinks/CoffeeOnEnron.pdf last accessed on April 9, 2012.
Hamdani, Assaf, "Gatekeeper Liability", Southern California Law Review, Vol. 77, p. 7. Available at: SSRN:http://ssrn.com/abstract=466040 last accessed on April 10, 2012

[88] AAA&S, Report of the American Academy of Corporate Responsibility Steering Committee.
Gilson, Ronald J., 1990. "The Devolution of the Legal Profession: A Demand Side Perspective", Md. L. Rev., Vol. 49, pp. 869, 905. available at http://escholarship.org/uc/item/16476756 last accessed on April 9, 2012.

first tier—the managers—failed and then the gatekeepers failed as well."[87]

In fact, some scholars believe that theoretically at least, the services of gatekeepers can be performed either from within or outside the corporation.[88] Of course, the law mandates that certain gatekeepers such as auditors must be external to the organization, but there are other gatekeepers like lawyers or internal auditors who may serve their function just as effectively if they were to work from within the corporation.

The accountability of a gatekeeper requires a certain quantum of liability that s/he must bear. As far as individual gatekeepers such as auditors and lawyers are concerned, every country has some rules for punishing errant behaviour. However, there are few (if any) instances of accountability of gatekeepers that are institutions; for instance, if SEBI or RBI fails to detect or deter the abuse of governance norms by companies or banks, the investor has little recourse to hold them accountable. The liability of gatekeepers may not always be created for their own ways—though this is also a possibility—but for the wrongs attributed to the corporation that could have been deterred or at least minimized had the gatekeepers taken certain precautions.

Andrew Tuch's study shows that incentive problems will arise if gatekeepers are not capable of bearing the full liability imposed on them. In other words, the incentives offered to gatekeepers are diluted in cases where they are protected from full liability arising from their activities.[89]

A similar assertion is made by Steven Shavell in an optimal deterrence theory, which prescribes the legal rules that optimally deter socially harmful conduct and discusses the dilution of incentives arising from a wrongdoer's inability to pay for the losses that such conduct causes.[90]

A gatekeeper may even be shielded from the full effects of a liability regime by insolvency, though this rarely occurs in practice (with Arthur Anderson being a notable example). Some categories of gatekeepers may collaborate with each other to adopt risk-shifting arrangements; an example of such collaboration is the exchange of 'comfort letters' among bankers, analysts, auditors, etc. Likewise, communications among regulators (such as between SEBI and RBI) may also be termed as risk-shifting or risk-sharing arrangements. The objective of such an exercise may be varied, such as allocating liability, or procuring additional knowledge of the clients' affairs, or information exchange.

Corporate conduct is overseen by multiple gatekeepers, who act on different aspects of business transactions. This ought to lead to an interlocking web of protection against wrongdoing by all gatekeepers, calling into question the conception of the gatekeeper as a unitary actor.[91]

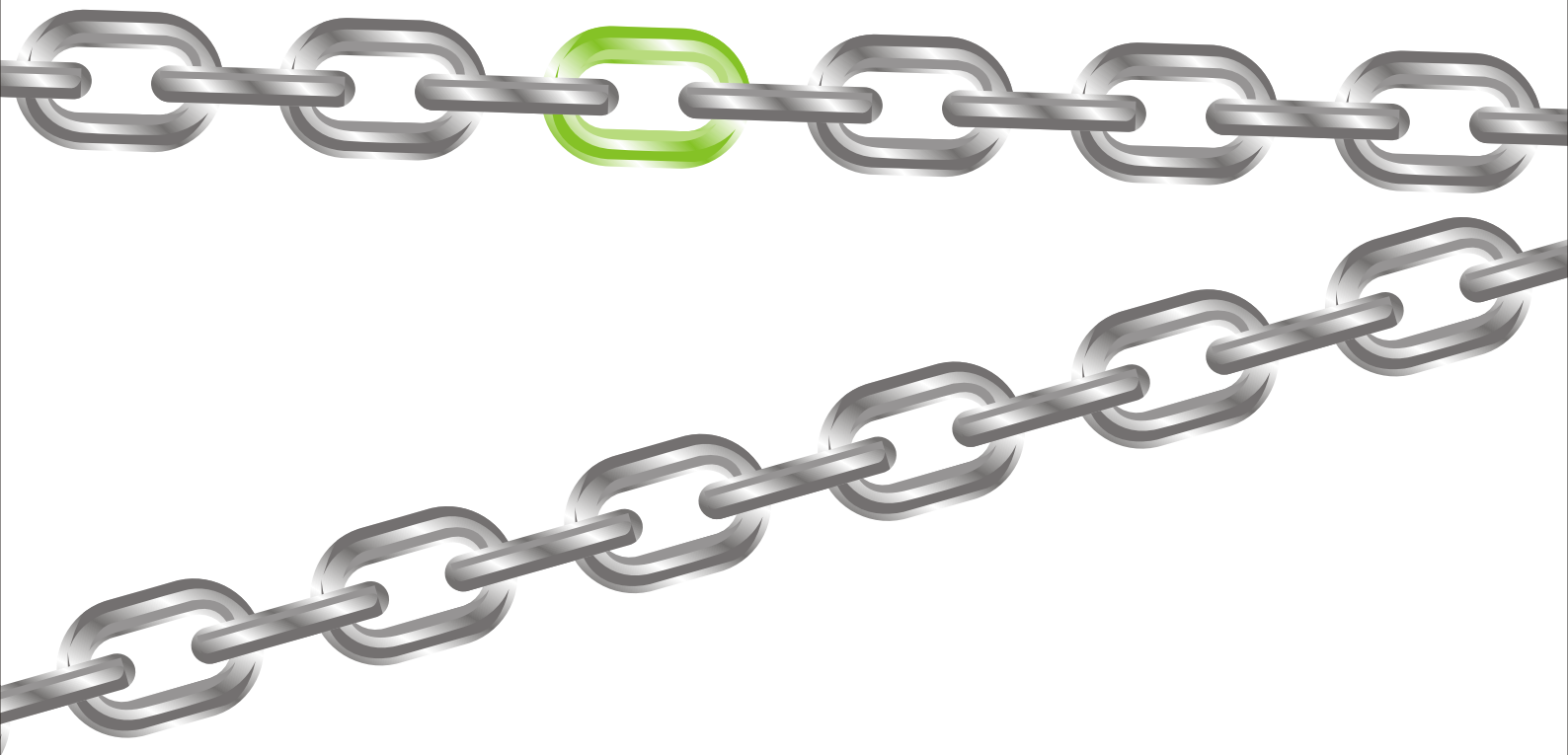
[89] Tuch, Andrew F., "Multiple Gatekeepers", Virginia Law Review, Vol. 96, No. 7, pp. 15831672. Available at: SSRN:http://ssrn.com/abstract=1577405 last accessed on April 9, 2012.

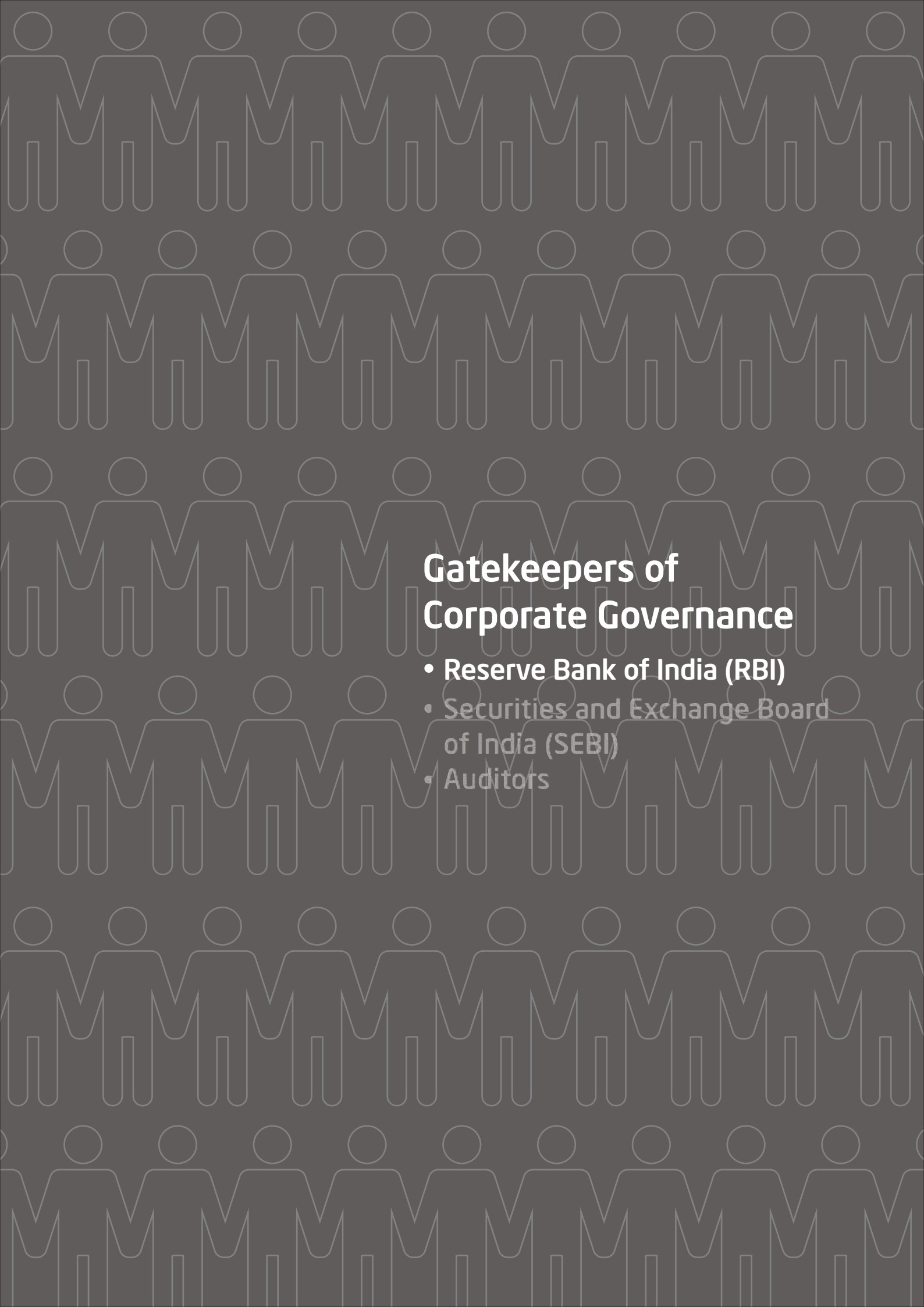
[90] Shavell, Steven, 1987. Economic Analysis of Accident Law, First Harvard University Press, Cambridge paperback edition, pp. 16768.

[91] Tuch, Andrew F., 2010. "Multiple Gatekeepers", Discussion Paper No. 33, March, Harvard Law School, Cambridge, MA.

[92] Ibid., p. 86

Gatekeepers operate in an interdependent rather than an independent manner and it is important to ensure a certain degree of collective responsibility among all gatekeepers in order to harness their total capacity to deter wrongdoing. A regime of fault-based liability, coupled with joint and several liability, would be optimal for advancing the cause of optimal deterrence.[92]





Gatekeepers of Corporate Governance

- Reserve Bank of India (RBI)
- Securities and Exchange Board of India (SEBI)
- Auditors

RESERVE BANK OF INDIA

Do the banks govern your money well?

Kshama V. Kaushik, Rewa P. Kamboj

The financial sector is very commonly referred to as the lifeblood of an economy. It has been a lynchpin of the impressive growth witnessed globally in the last couple of centuries. Struggling nations are often advised to get their 'financial act' together before they can hope to achieve anything significant. Needless to say, regulation of this sector is paramount to stability of any economic system. Theories abound on how to go about this. Many advocate a highly specialised central bank/regulator focussed on maintaining price stability. In a developing economy a completely hands-off approach may not be ideal; the central bank could contribute substantially to building robust institutions and mechanisms: by stipulating norms and requirements, and enforcing corporate governance and financial reporting/disclosure requirements.

Reserve Bank of India

Traditionally, central banks have performed the roles of currency authority, banker to the government and other banks, lender of last resort, supervisor of banks, and exchange control (now it would be more appropriate to call it exchange management) authority. Generally, central banks in the developed economies have price or financial stability as their prime objective and are often characterized by nearly complete autonomy. Milton Friedman[93] defines central bank relations with the government as being comparable to the relation between the judiciary and the government.

Rolf Hasse[94] says that central bank independence relates to three areas in which the influence of the government must be either excluded or drastically curtailed. These are:

a. Independence in personnel matters, that is, the extent of influence of the government in appointment procedures;
b. Financial independence, that is, the ability of the government to finance government expenditure either directly or indirectly through central bank credits; and
c. Policy independence, that is, the extent of freedom available in the formulation and execution of the monetary policy.

Literature suggests that independence on the central bank reduces inflation variability or fluctuations over time because it allows for monetary policies to have independent time horizons rather than those dictated by elected governments in order to satisfy other objectives. In other words, inflation and central bank independence are inversely related. As a corollary, high inflation over a

[93] Friedman, Milton, 1962. "Should There be an Independent Monetary Authority", *In Search of a Monetary Constitution*, Harvard University Press, Cambridge, Mass.

[94] Hasse, Rolf, 1990. *The European Central Bank: Perspectives for Further Development of the Monetary System"*, Bertelsman Foundation, Gutersloh.

sustained period would erode central bank independence if it were to breach a threshold value of inflation after which public opposition would force politicians to step in and restrain the central bank.[95]

However, this holds largely true for the industrialized nations.

In developing countries, the central bank plays a bigger role in the economy and cannot reasonably be expected to have a total hands-off approach or be totally independent of the government; it has to nurture a hand-holding approach and actively manage many aspects of the economy. To that extent, a central bank in a developing country plays both a traditional and a non-traditional role, which includes building independent institutions such as capital markets, sector regulators, and watchdogs, among others, as also playing both a regulatory and a development role.

Central banking functions in India have been carried out by the RBI since Independence, when it took over the erstwhile Imperial Bank of India that had been formed in 1935. RBI was originally set up to regulate the issue of currency, maintain foreign exchange reserves to enable monetary stability, and generally to operate the currency and credit system in the country. As the economy progressed, RBI's role underwent several shifts. For instance, when India followed a control model of economic governance, RBI's monetary policy was focused on allocating resources to various sectors and maintaining price stability. A novel mandate of RBI during the early stages of its existence was to finance Five-Year Plans, and to establish specialized institutions for promoting savings and meeting the credit needs of the priority sector.

The functions of RBI underwent a strategic shift post-liberalization in the 1990s, and are now more in the nature of the facilitation of efficient functioning of money and capital markets besides the strengthening of supporting institutional infrastructure. The leitmotif of change in RBI's interventions is to move from control to facilitation in all aspects—overseeing foreign exchange reserves, fixing interest rates, providing an operating framework for banks, and setting down disclosure and transparency parameters.

RBI has been largely successful in its objectives of growth with stability, in developing India's banking and financial sectors, and in ensuring the evolution of competitive markets. Inevitably, because of the liberalization process, the Indian banking sector has been subject to greater shocks from external sources; for instance, a market-based exchange rate system has integrated the Indian economy into the global economy but the exchange rate has become more volatile. To that extent, there has been a partial loss of autonomy of domestic monetary policy.

[95] A view propagated by Cukierman, Alex, 1992. Central Bank Strategy, *Credibility and Independence*, MIT Press, Cambridge, Mass.

The broad mandate of RBI currently is to:

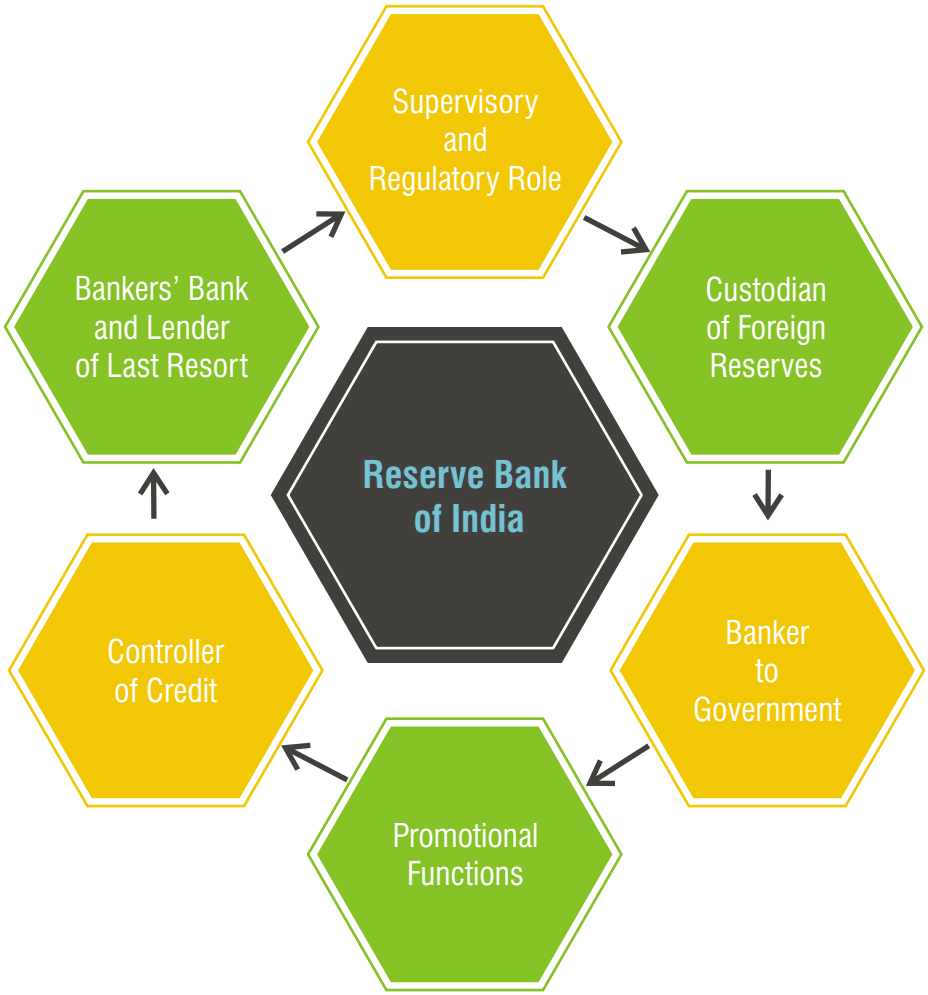
- Stimulate economic growth by controlling monetary expansion (or contraction), including making adjustments in the interest rate structure;
- Maintain internal price stability by monitoring inflationary pressures; and
- Develop the banking and financial sectors and to perform a proper oversight and regulatory role.

RBI indirectly also controls the commercial sector by regulating the lending policy of banks and financial institutions, and maintains an indirect oversight role over businesses through mandatory information submission.

The total market capitalization of the banking sector in India was Rs. 6,89,751 crore as on 31 March 2011.[96] The total flow of financial resources to the commercial sector from banks was Rs. 7,11,031 crore as on 31 March 2011.[97]

The model of governance of banks and financial institutions followed by RBI is that of prescribing prudential norms and laying down broad disclosure principles, coupled with periodic surveillance rather than direct interference, and micro-managing the banking sector of the economy, while at the same time pursuing the ultimate objective of strengthening market institutions in order to infuse greater transparency and liquidity in the financial markets.

The Main Functions of RBI



The following are the main functions of RBI:

- To act as regulator and supervisor of the financial system and to prescribe broad parameters of banking operations within which the country's banking and financial system functions.
- To formulate, implement and monitor the monetary policy.

[96] Annual Report, SEBI, for the year ending 31 March 2011.

[97] Annual Report, RBI, for the year ending 31 March 2011.

RBI's power of supervision and control over commercial and co-operative banks relates to licensing, branch expansion, asset liquidity, management, and the methods of working, amalgamation, reconstruction, and liquidation.

- To ensure an adequate flow of credit to the productive and priority sectors.
- To protect the interests of bank customers and the public at large.
- To control the monetary supply by issuing currency and regulating minimum margins for various advances received by banks (including the Cash Reserve Ratio and the Statutory Liquidity Ratio).
- To act as a banker for the entire financial sector by lending/accepting deposits at the prevalent rate of interest of banks.
- To act as a controller of credit, that is, to exercise the power to influence the volume of credit created by banks in India by changing the bank rate or through open market operationsit can, therefore, impose both quantitative and qualitative restrictions.
- To monitor economic indicators and the economic structure of the country for facilitating price stabilization and economic development.
- To control the banking system through the procedures of licensing, inspection and calling for information.
- To facilitate external trade and payment, and promote orderly development and maintenance of the foreign exchange market in India.
- To oversee payment and settlement system and promote financial stability.

RBI's ambit of supervisory and regulatory powers covers the following:

- Regional Rural Banks (RRBs);
- Public sector banks;
- Private banks;
- Foreign banks;
- Cooperative banks;
- Non-banking finance companies;
- Institutions formed under special Acts (such as the State Bank of India Act; The Industrial Development Bank Act; The Industrial Finance Corporation, National Bank for Agriculture and Rural Development Act; National Housing Bank Act; an d the Deposit Insurance and Credit Guarantee Corporation Act).
- Small Industries Development Bank of India (SIDBI).

RBI's power of supervision and control over commercial and co-operative banks relates to licensing, branch expansion, asset liquidity, management, and the methods of working, amalgamation, reconstruction, and liquidation. The RBI is authorized to carry out periodical inspections of banks, and to seek returns and necessary information. RBI also has the responsibility of maintaining the official rate of foreign exchange and acts as the custodian of India's reserve of international currencies.

RBI is mandated to promote the habit of banking, to extend banking facilities to rural and semi-urban areas, and to establish and promote new specialized financing agencies. Accordingly, RBI has helped in the setting up of the Industrial Finance Corporation of India (IFCI), State Finance Corporation, Deposit Insurance Corporation, Unit Trust of India (UTI), Industrial Development Bank of India

(IDBI), Agricultural Refinance Corporation of India, and Industrial Reconstruction Corporation of India.

RBI and Corporate Governance

Banks play a pivotal role in the financial and economic system of any country. RBI plays a leading role in formulating and implementing corporate governance norms for India's banking sector.

The ambit under which RBI operates encompasses safeguarding and maximizing the shareholders' value, upholding retail depositors' risk, and stabilizing the financial system in order to protect the larger interests of the public. This role becomes important in view of the fact that in India, bank assets often lack transparency and liquidity because most bank loans, unlike other products and services, are customized and privately negotiated.

Banks are 'special', as they not only accept and deploy a large amount of uncollateralized public funds in a fiduciary capacity, but they also leverage such funds through credit creation. They are also important for ensuring the smooth functioning of the payment system.[98]

In the case of instability in one bank owing to incompetent or unethical management, the entire financial system and the economy may be impacted adversely. As one bank becomes unstable, there may be a heightened perception of risk among depositors for the entire class of such banks, leading to early liquidation and exposing the entire financial system to chaos. In such a situation, the interest of borrowers (corporates, retail clients, etc.) may also be affected in terms of the availability of credit, the recall of credit lines, and loss in valuation of mortgaged assets.

Two main features set banks apart from other businesses—the level of opaqueness in their functioning and the relatively greater role of the government and regulatory agencies in their activities. The opaqueness in banking creates considerable information asymmetries between the 'insiders', that is, the management, and 'outsiders', that is, the owners and creditors. The very nature of the business makes it extremely easy and tempting for management to alter the risk profile of banks as well as to siphon off funds.[99] RBI performs the corporate governance function under the guidance of the Board for Financial Supervision (BFS). The primary objective of BFS is to undertake consolidated supervision of the financial sector comprising commercial banks, financial institutions, and non-banking finance companies.

BFS was constituted in November 1994 as a committee of the Central Board of Directors of RBI. The Board comprises four directors of RBI from the central board and is chaired by the Governor. The Board is required to meet normally once every month. It considers

[98] "A Comprehensive Policy Framework for Ownership and Governance in Private Sector Banks", RBI circular dated 2 July 2004.

[99] Chakrabarti, Rajesh, "Corporate Governance in IndiaEvolution and Challenges",available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=649857 last accessed on April 9, 2012

BFS

The primary objective of BFS is to undertake consolidated supervision of the financial sector comprising commercial banks, financial institutions, and non-banking finance companies.

inspection reports and other supervisory issues placed before it by the supervisory departments. The BFS oversees the functioning of the Department of Banking Supervision (DBS), Department of Non-Banking Supervision (DNBS), and the Financial Institutions Division (FID), and gives directions on the regulatory and supervisory issues.

BFS inspects and monitors banks by using the 'CAMELS' (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Systems and Controls) approach. Through the Audit Sub-committee, BFS also aims to upgrade the quality of the statutory audit and internal audit functions in banks and financial institutions.

The Corporate Governance Mechanism followed by RBI

The corporate governance mechanism followed by RBI follows a three-pronged approach, comprising:

a) Disclosure and transparency;
b) Off-site surveillance; and
c) Prompt corrective action.

These elements of RBI's corporate governance mechanism are discussed in detail below.

a) *Disclosure and transparency* constitute the main pillars of a corporate governance framework, enabling, as they do, an adequate flow of information to various stakeholders and leading to informed decisions. Accounting standards in India in all sectors including the banking sector have been enhanced to align with international best practices.

b) *The off-site surveillance mechanism* monitors the movement of assets, and its impact on capital adequacy, and the overall efficiency and adequacy of managerial practices in banks. RBI promotes self-regulation and market discipline among the banking sector participants and has issued prudential norms for income recognition, asset classification, and capital adequacy. RBI brings out periodic data on 'Peer Group Comparison' on critical ratios in order to maintain peer pressure on individual banks for facilitating better performance and governance by the latter.

c) *Prompt corrective action (PCA)* is a supervisory mechanism implemented as part of Effective Banking Supervision in terms of Basel II requirements. It is based on a pre-determined rule-based structure of early intervention, whereby the benchmark ratios for three parameters—Capital Adequacy Ratio, Non-Performing Assets Ratio, and Return on Assets—are determined. Any breach of these trigger points is considered as an early warning on the financial health of the banks, and consequently, RBI initiates appropriate mandatory or discretionary action to deal with such a breach. 'The published balance sheet, off-site returns and on-site inspection report constitute the primary

sources for identifying the banks which could be placed under the PCA framework. The 1980s and early 1990s signified a period of great stress and turmoil for banks and financial institutions all across the globe. These events led to the search for appropriate supervisory strategies in order to prevent bank failures, as they can have a destabilizing effect on the economy.

For this reason, medium or large banks are rarely closed and the governments try to keep them afloat. In both industrial and emerging market economies, bank rescues and mergers are more common than the outright closure of the banks in the event of any crisis. Thus, if banks cannot be allowed to fail, it is also essential for corrective action to be taken well in time, when the bank still has an adequate cushion of capital so as to minimize the cost to the insurance fund/public exchequer in the event of a forced liquidation of the bank.[100] Thus, triggers based on the Capital Adequacy Ratio (CAR), Net Non-performing Assets (NPAs), and Return on Assets (ROA) are linked to a bank's performance in three critical areas, which are quantifiable and which form an integral part of the supervisory oversight. These actions are designed to pre-empt any deterioration in the soundness of banks.

RBI considers capital adequacy norms, NPAs and ROA as proxies for asset quality and profitability, and undertakes effective banking supervision and timely intervention through these early warning signals. As mentioned earlier, the breach of these trigger points invites both mandatory and discretionary disciplinary action from RBI; some of these actions are listed in Annexure I.

RBI's Corporate Governance Mechanism

[100] RBI circular on 'Prompt Corrective Action' dated 30 March 2001.

Other Corporate Governance Mechanisms

a. Apart from working under the jurisdiction of RBI, as mentioned above, listed banks, NBFCs, and other financial intermediaries are governed by SEBI' s Clause 49 on corporate governance (as discussed in the section on SEBI).

b. Additionally, RBI has also issued various circulars and notifications that provide guidelines on:

- Composition, Qualification, Independence and Remuneration of Board of Directors.
- Roles, Responsibilities and Training of Executive Directors.
- Resolution of Conflict of Interest in case of related party transactions.
- Constitution of Nomination Committee, Risk Management Committee and Audit Committee.

c. Audit of banks:

One of the inspection and monitoring tools used by BFS is the quality of audit (both statutory and internal) conducted on the banking sector. Although public sector banks have operational freedom in the matter of appointment of auditors, they need to choose from a list prepared by the Comptroller and Auditor General of India (CAG) and the Institute of Chartered Accountants of India (ICAI), and such names must be approved by RBI before banks can select statutory auditors. Banks are required to allot the top twenty branches (to be selected strictly in accordance with the level of outstanding advances) in such a manner as to cover a minimum of 15 per cent of the total gross advances of the bank by the statutory auditors. Banks do not have the authority to remove audit firms during their working tenure without the prior approval of RBI.

Influence on the Corporate Sector

As a regulator of the banking sector, RBI has an immense bearing on the corporate sector (and the entire economy) in terms of rates of interest, foreign exchange, and anti-money laundering, among other things, as summarized in Table 1.

Table 1: RBI's Influence on Corporate Sector

	Policy	Impact
1	Monetary Policy determines the Repo Rate, Bank Rate, Cash Reserve Ratio, Statutory Liquidity Ratio. (Changes in the prime interest rate)	It determines the cost of borrowing of the corporate sector, affecting the profitability, capital budgeting decisions, and creation of production capacities depending upon the credit availability, among other things. Past events in the world have shown that easy liquidity has propelled the economies out of recessionary business cycles and led them to a higher growth trajectory.
2	Monetary Policy (contd.) (changes in the money available in circulation, reserve requirements of banks)	It controls the inflationary pressures on both capital assets and the price of consumable goods. Currently, the rate increase effected by RBI to cool off inflation has adversely impacted business plans by reducing disposable income in the hands of both industrial users and consumers.
3	Interventions in the Foreign Exchange Market (by buying or selling the foreign currency to ease out volatility in the forex market)	It reduces the currency risk involved in making payment of imports, repayment of loan and interest thereon. It makes exports competitive by bringing certainty in receivable collection and pricing of products/services in international markets. It also enables borrowing in foreign currency through External Commercial Borrowings, Foreign Currency Convertible Bonds, by facilitating a stable investment portfolio for international investors.
4	Export/Import Regulations (Foreign Exchange Management Act Guidelines)	Export proceeds should be realized within twelve months of the date of the export, which encourages time-bound collections. Payment of imports under the automatic route or by way of advances in the case of certain specific items is governed by RBI.
5	Regulation of investment in Indian companies by Foreign Institutional Investors (FIIs), Non- resident Indians (NRIs), and Persons of Indian Origin (PIOs) via the portfolio investment scheme. (Acquisition of shares and debentures in Indian companies through stock exchanges)	RBI has imposed sectoral cap and statutory ceiling for corporates. These approvals determine investible funds with Indian corporate sector.
6	Guidelines for Indian direct investment in joint ventures and wholly owned subsidiaries abroad.	It affects business strategic expansion decisions, foreign technology sourcing, and resource (labour/material) availability and export market development.
7	External Commercial Borrowings (ECB) (bank loan, buyers' credit, suppliers credit, securitized instruments, etc. from sources outside India)	RBI approval is mandatory subject to certain limits under the automatic route. The borrower must obtain a Loan Registration Number (LRN) from RBI before drawing down the ECB.
8	Guidelines for issuance of Foreign Currency Convertible Bonds (FCCBs)	FCCBs can be issued up to an amount of $500 million under the automatic approval route. For amounts greater than $500 million, RBI's approval is required. It impacts the debt equity ratios of companies.
9	Anti-Money Laundering, Know Your Client Norms	Corporates (as well as individuals and other entities) have to fulfil Bank Account Opening norms pertaining to mandated documentation, and adherence to anti-money laundering norms on prohibited cash deposits in bank deposits.
10	Priority sector lending norms require Indian banks and foreign banks to lend 40 per cent and 32 per cent of the net bank credit, respectively, to the priority sector.	It helps the corporates involved in following areas to avail of credit facility at a lower rate of interest. Agriculture sector, small scale industries, small road and water transporters, small businesses, retail trade, professionals and self-employed persons, education sector, housing sector, micro-credit organizations, food and agro processing sector. It also enhances the investment activity in the economy.

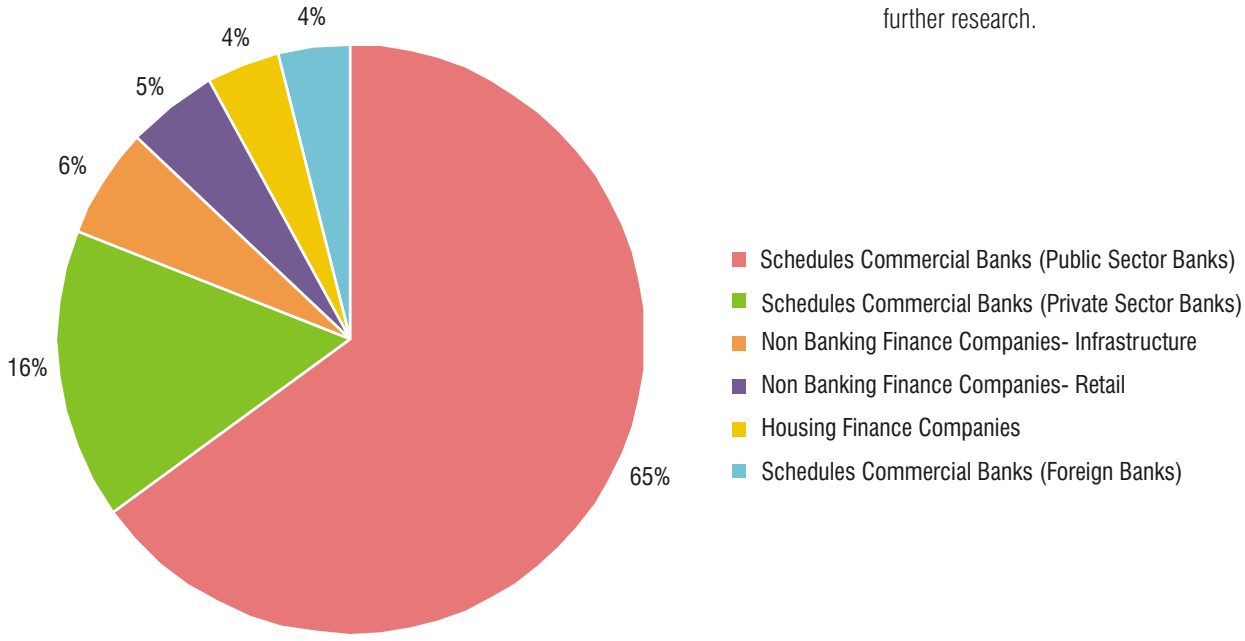
Financial Sector Entity	Percentage
Schedules Commercial Banks (Public Sector Banks)	65%
Schedules Commercial Banks (Private Sector Banks)	16%
Non Banking Finance Companies- Infrastructure	6%
Non Banking Finance Companies- Retail	5%
Schedules Commercial Banks (Foreign Banks)	4%
Housing Finance Companies	4%

As per ICRA (Rating Agency) report titled 'Indian Banking Sector, Challenges Unlikely to Derail the Progress Made'.[101]

The Indian financial sector (including banks, non-banking financial companies, and housing finance companies reported a compounded annual growth rate (CAGR) of 19% over the last three years and their credit portfolio stood at close to Rs. 49 trillion (around 62% of 2010-11 GDP) as on March 31, 2011.

Thus commercial banking sector holds 85% share in the credit portfolio, hence the current study evaluates the role of RBI in commercial banking sector and sets aside the other financial sector participants for further research.

Credit Portfolio Percentage Share



[101] Available at http://www.icra.in/Files/ticker/Banking%20note-final.pdf last accessed on March 15, 2012

Effectiveness of RBI as a Regulator of the Banking Sector

RBI regards CAR, NPAs and ROA as proxies for asset quality and profitability, and the measure of supervision of the corporate governance mechanism.

Objectives: The study seeks to achieve the following two objectives:

(i) To assess whether the banks have been able to maintain the above ratios within the trigger; and

(ii) To determine whether the movements (favourable/otherwise) get reflected in the share prices and earning per share of the banks, assuming that other variables determining the market price and earnings are constant.

Methodology: The following data were collected for 15 listed banks (including ten public and five private banks) for a period of five years beginning 31 March 2006 and ending 31 March 2010. *The sample size of the study represents 70 per cent of the total capital and reserves of the public sector banks and private sector banks in India.*

Ratios Used:

a) CAR is used as a measure to check the availability of the bank's capital to cover for its risk-weighted assets.

$$CAR = \frac{\text{Tier One Capital} + \text{Tier Two Capital}}{\text{Risk Weighted Assets}}$$

Banks are required to maintain the CAR at 9 per cent.

Banks with a higher risk assets profile are required to maintain a higher level of capital funds. Alternatively, banks which have less capital are required to reduce the assets that carry a higher risk weight.

b) NPA is used as a measure of the overall quality of the bank's loan book.

$$\text{NPA Ratio} = \frac{\text{Gross NPA*- Total Accumulated Provisions}}{\text{Total Advances}}$$

*(Assets having interest overdue for more than 90 days)

Banks are required to maintain the NPA ratio at 10 per cent.

A higher ratio reflects the rising poor quality of loans.

c) ROA is used as a measure of profitability and the earning capacity of assets.

$$\text{ROA Ratio} = \frac{\text{Net Profits}}{\text{Total Assets (including Fixed Assets)}}$$

*(Assets having interest overdue for more than 90 days)

Banks are required to maintain the ROA ratio at 0.25 per cent. The higher the proportion of average earnings assets, the better would be the resulting returns on total assets.

The figures for these ratios have been taken from RBI's Statistical Tables.

As per RBI's Annual report for the year ended 31 March 2011, the ratios (200910) for the Indian Banking sector are given in Table 2.

Table 2: Ratios for the Indian Banking Sector

Ratio	Percentage
Capital Adequacy Ratio	13.6
Non-Performing Asset	2.4 (Gross)
Return on Assets	1.05

d) Share Prices.[102]

e) Earnings per Share.[103]

[102] Source: www.bseindia.com.

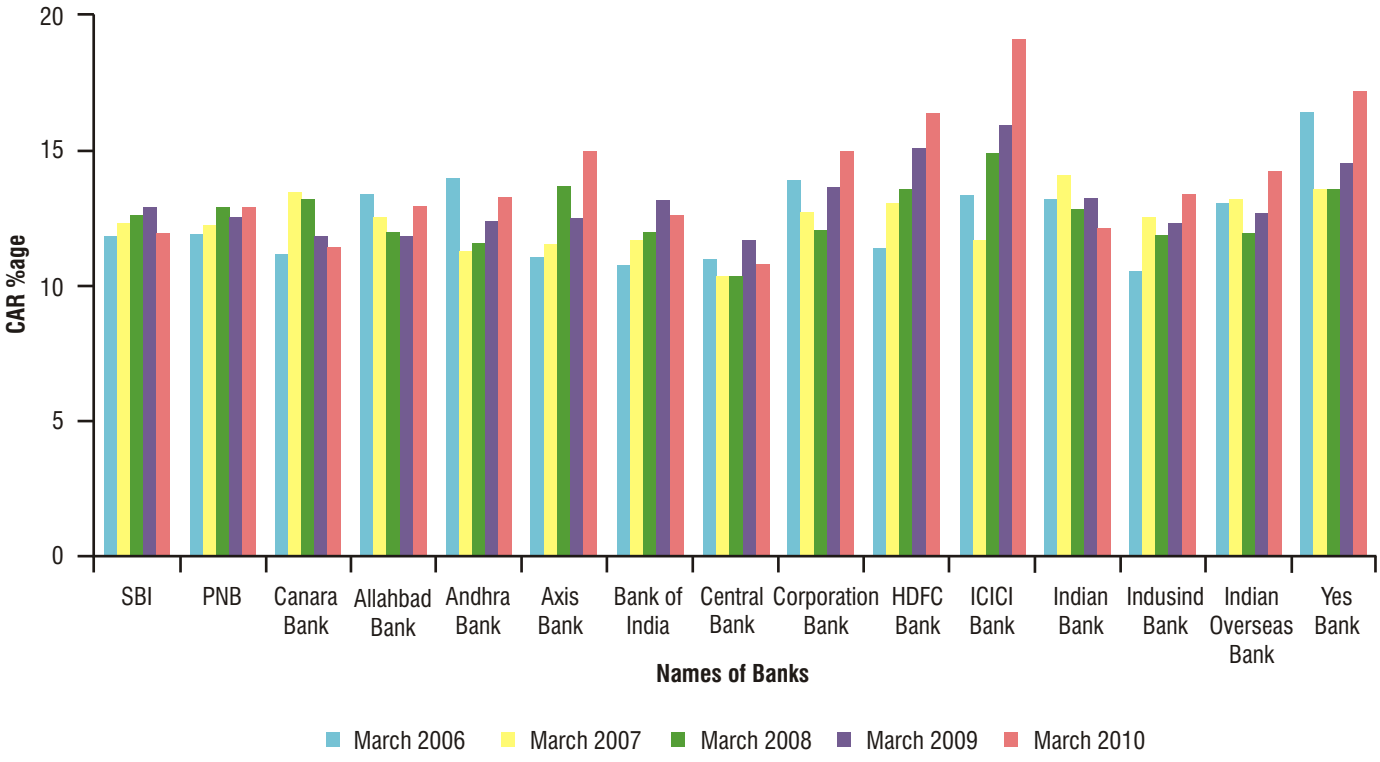
[103] Source: www.rediff.money.com) and bank's annual reports

Annual Reports

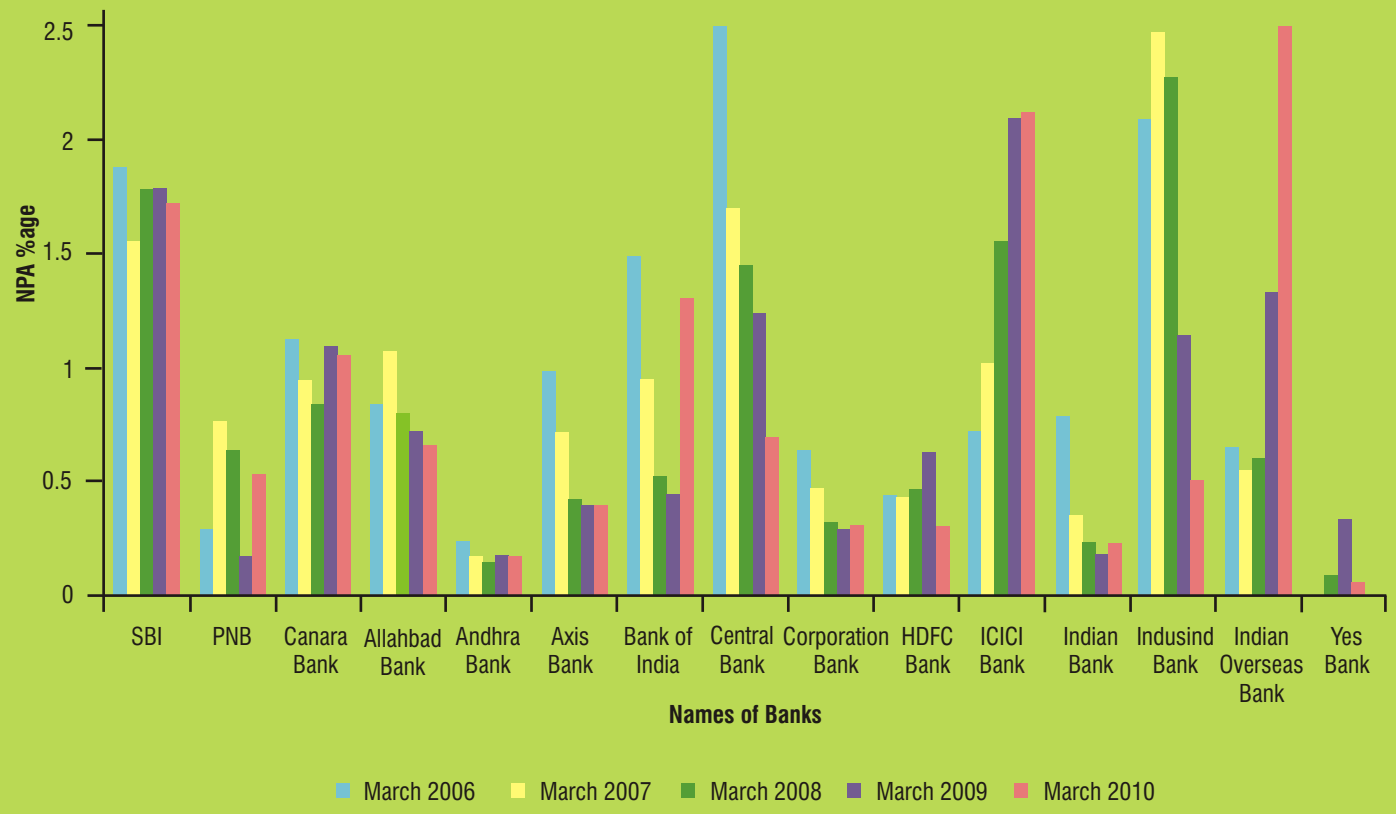
Preliminary Data Analysis:

(i) All banks were able to follow the trigger limits (CAR: 9 per cent; NPA: 10 per cent; and ROA: 0.25 per cent, during the sample period).

Capital Adequacy Ratio (CAR)



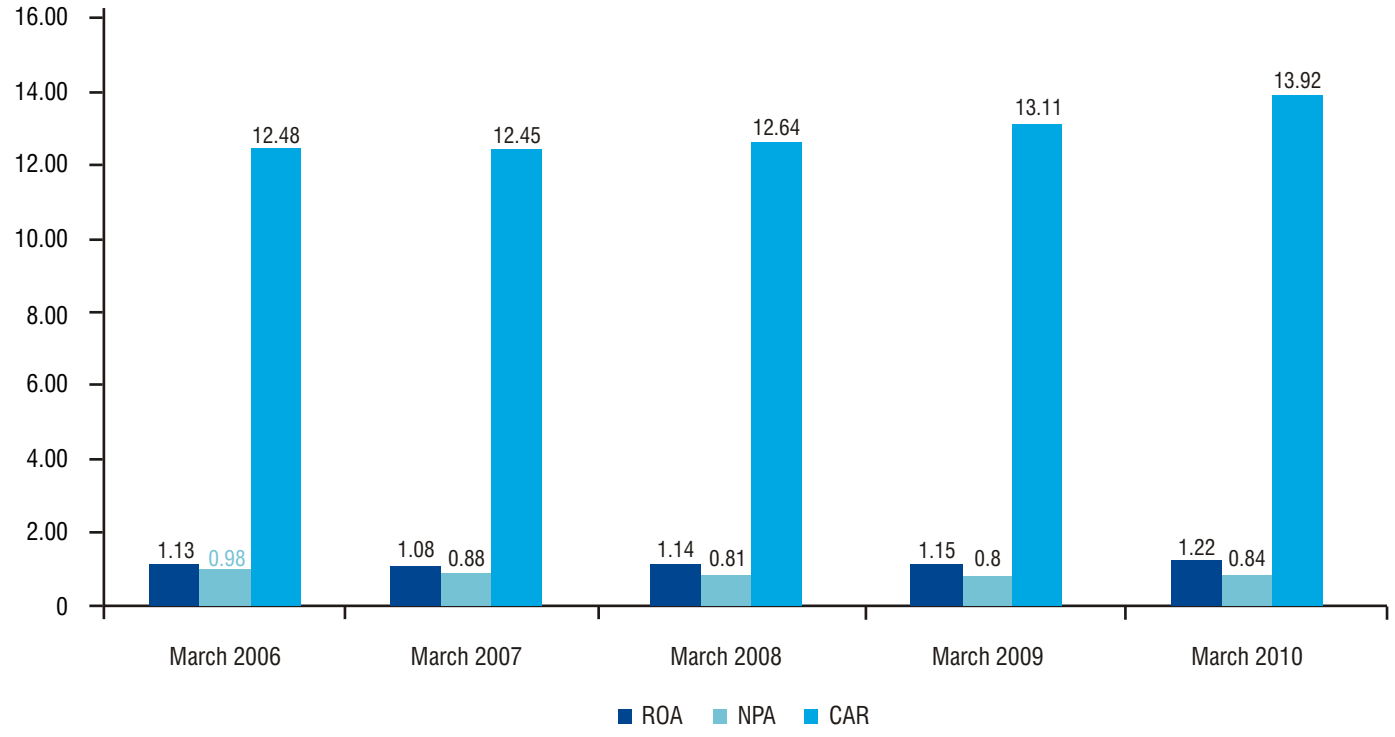
Non-Performing Assets Ratio (Net NPA)



Return On Assets (ROA)

Average Ratios	ROA	NPA	CAR
March 2006	1.13	0.98	12.48
March 2007	1.08	0.88	12.45
March 2008	1.14	0.81	12.64
March 2009	1.15	0.80	13.11
March 2010	1.22	0.84	13.92

Average Ratios



Thus, to conclude, the banks were not only able to maintain the triggers but the simple average of these ratios calculated for the sample banks showed an improvement over the period of 5 years from March 2006 to March 2010.

Prompt Corrective Action has enabled banks to improve the quality of assets and reduce Non Performing Assets.[104]

[104] Justin Nelson Michael and Vasanthi G in their paper "Prompt Corrective Action on banks in India" available at www.papers.ssrn.com) last accessed on March 14, 2012

Prompt Corrective action also led to significant reduction in portfolio risk. 'Capital Adequacy Requirements and the Behaviour of Commercial banks in India: an Analytical and Empirical study'[105]

Prompt Corrective Action might prove to be an effective framework for arresting bank deterioration and prevent systematic failure of banks.

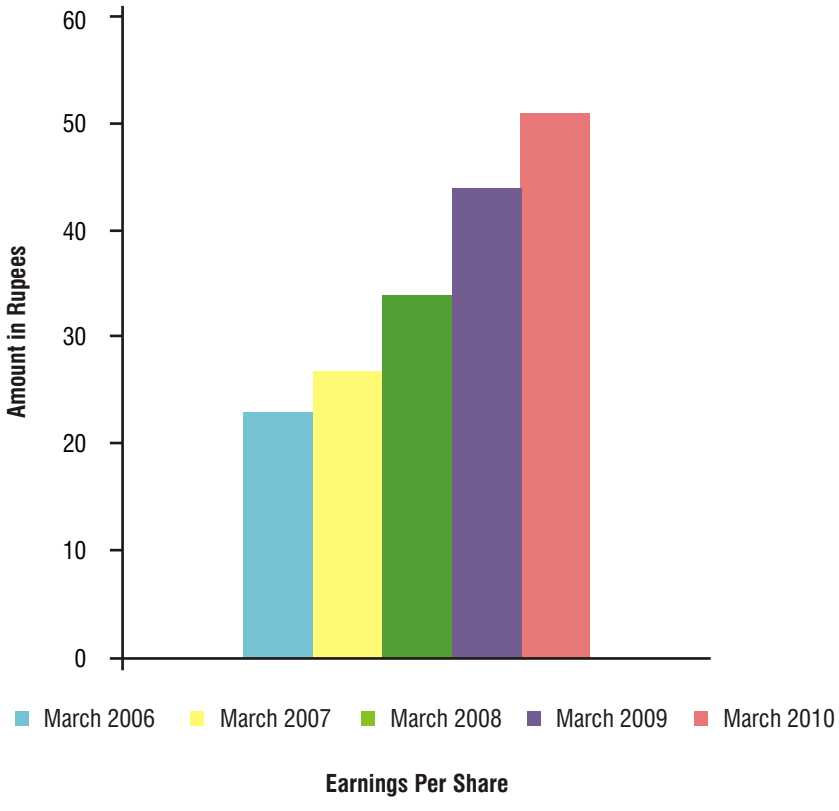
(ii) As next step in our data analysis, we looked at the profitability of the sample banks and whether improvements in the stipulated ratios over a period of 5 years had any impact on Earning Per Share and the Share Prices of these banks.[106]

Most of the sample banks (barring 2) displayed an improvement in the Earnings Per Share with average EPS increasing from Rs 23 to Rs 51 (124%) from 2006 to 2010.

Average Earnings Per Share

Earnings Per Share	Simple Average of sample banks
March 2006	23
March 2007	27
March 2008	34
March 2009	44
March 2010	51

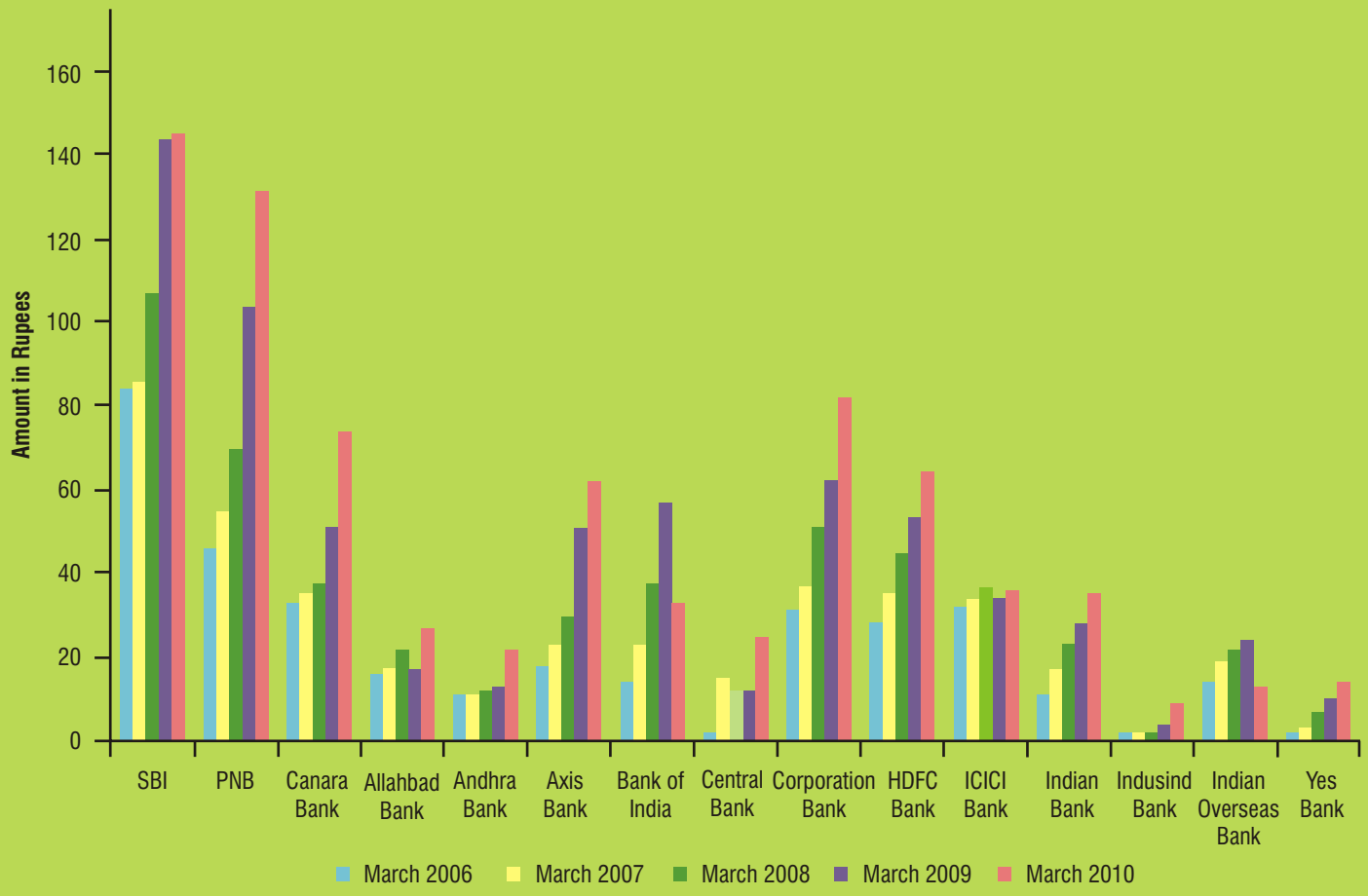
Average Earnings Per Share



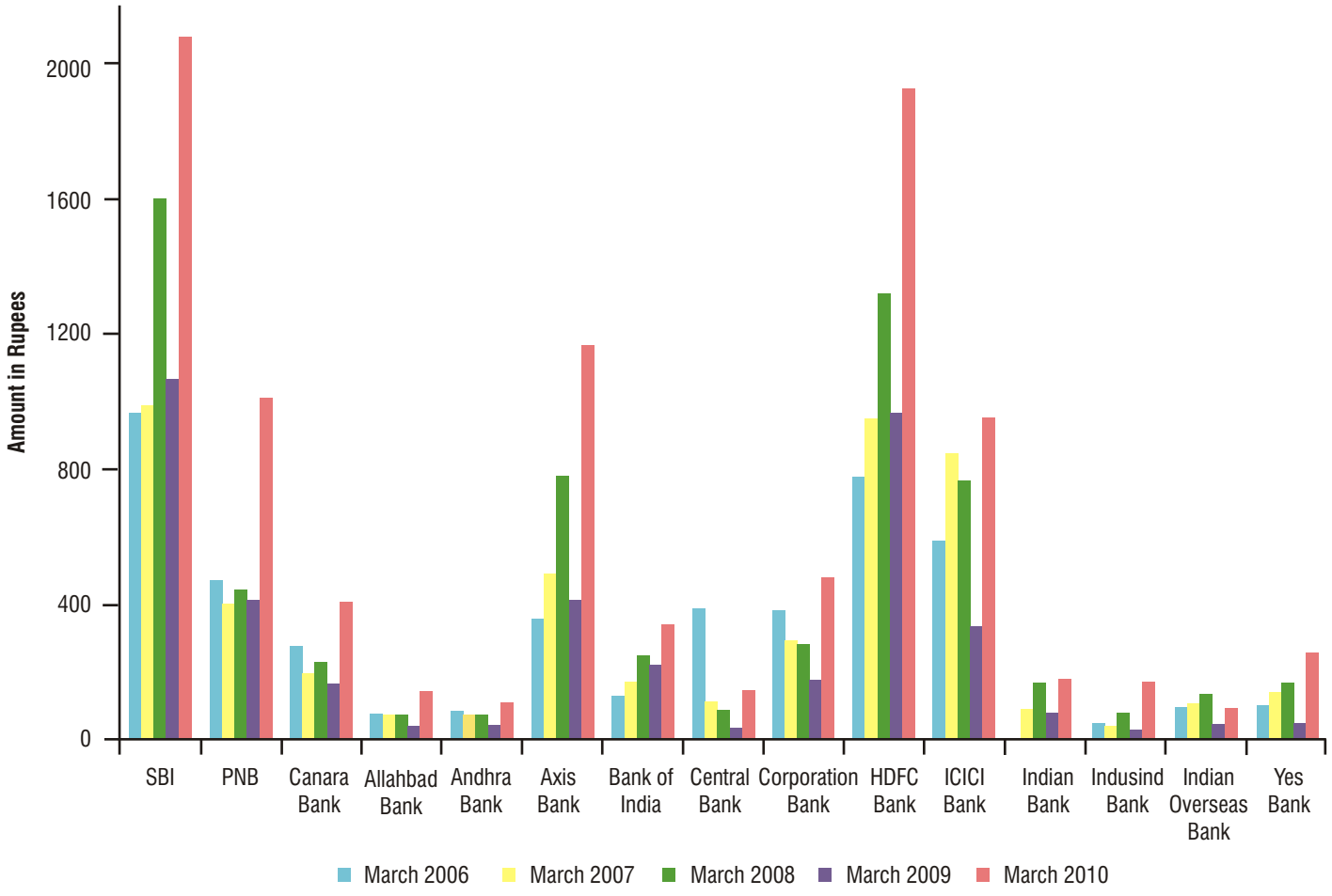
[105] D.M.Nachane, Aditya Narain, Saibal Ghosh, Satyananda Sahoo- Department of economic analysis and policy, Reserve bank of india) available at http://rbidocs.rbi.org.in/rdocs/Publications/PDFs/16016.pdf) last accessed on March 14,2012

[106] Capital Adequacy and Commercial Banks- By DM Nachane available at www. Books.google.co.in) last accessed on March 15,2012

Earnings Per Share



Share Prices of Sample Banks



The sample banks share prices at Bombay Stock Exchange have showed an increasing trend over the period of five years from March 2006 to March 2010 except one bank. The sample banks' share prices have increased in the range of 26% to 264% with an average of 103% when the Sensex has increased by 55%.

Thus sample banks show better profitability as measured by EPS and also show an increasing share prices.

(Iii) In this section we analyze the reasons for change in profitability of the sample banks by drawing a relationship between the benchmark ratios (ROA, NPA & CAR) as identified under PCA and the profitability of the banks as proxied by EPS.

For this purpose we have used the statistical tool of coefficient of determination (square of coefficient of correlation, known as r square) presuming a linear relationship between either of independent variables

(CAR/NPA/ROA) and dependent variable (EPS- profitability).

Co-efficient of determination (R square) is taken as the proportion of variance in the dependent variable that is predictable from the independent variable. R square is useful because it gives the proportion of the variance (fluctuation) of one variable that can be explained from the other variable and can also determine how certain one can be in making predictions.

The co-efficient of determination (in percentage terms) for the sample banks by squaring the coefficient of correlation between the variables for the period of 5 years are displayed in the following table.

On an average, only 38% of the change in EPS can be explained by change in the Capital Adequacy Ratio, only 37% of the change in EPS can be explained by change in the asset quality as reflected by NPA and only 44% of the change in EPS can be explained by change in ROA.

Thus, this study could not associate changes in benchmark ratios (CAR/ NPA/ ROA) as determinants of the profitability (EPS) of sample banks .

Indian banking sector is unique in its complexities and the associated challenges with profitability being influenced by various factors. Profitability could not be conclusively explained by the PCA indicators analyzed in the above section. The study recommends further research into both the quantitative and qualitative factors contributing to the profitability of Indian Banks.

Coefficient of Determnation	SBI	PNB	Canara Bank	Allah-bad Bank	Andhra Bank	Axis Bank	Bank of India	Central Bank	Corp-oration Bank	HDFC Bank	ICICI Bank	Indian Bank	Indus-ind Bank	Indian Over-seas Bank	Yes Bank	Average Mean
Coefficient of Determnation CAR & EPS	13.9666	52.2084	20.2430	0.3285	12.2599	61.2818	83.8281	4.4914	30.5075	97.2073	26.6564	43.7953	51.9055	56.9586	14.5751	38.0142
Coefficient of Determnation NPA & EPS	1.0598	4.0855	9.8083	33.3559	6.9479	62.0292	66.0772	83.8475	65.2326	1.6836	36.3790	65.9259	86.2432	16.2253	23.4510	37.4901
Coefficient of Determnation ROA & EPS	21.9549	92.7747	65.2730	0.2589	13.0400	92.9846	76.0993	62.7036	8.4020	21.0885	15.4036	70.6161	97.9956	25.5433	2.2153	44.4236

The study further examined whether any change in profitability as reflected by EPS is rewarded by the stock markets in the form of enhanced capital valuations. A similar statistical test of correlation of determination is carried out between EPS and closing share market prices for a period of 5 years on the sample banks and the results are as under:

Coefficient of Determination	SBI	PNB	Canara Bank	Allah-bad Bank	Andhra Bank	Axis Bank	Bank of India	Central Bank	Corp-oration Bank	HDFC Bank	ICICI Bank	Indian Bank	Indus-ind Bank	Indian Over-seas Bank	Yes Bank	Average Mean
Coefficient of Determination EPS & Share Price	33.5360	55.8617	47.0272	68.5164	43.8979	42.4028	20.0129	66.7664	7.9873	68.8993	24.1364	27.4136	73.8343	3.9387	22.6128	40.4562

On an average only 40% of the change in the share prices can be explained by the change in EPS. Share prices are a reflection of various factors such as future earnings potential, investors' perception, market sentiments, etc other than profitability and these factors need further research.

Limitations

The above study is subject to the limitation of possible manipulation of year-end numbers (if any) that may be carried out to improve ratios.

CAR may be influenced by revaluation of assets, conversion of assets into off-balance sheet items through Special Purpose Vehicles, and reduction in the risk weightage or transfer of risky assets within the same banking group, as some examples.

NPA ratios also depict the aggressiveness and risk appetite of banks. Higher risk may lead to higher returns during the initial phases, but the portfolio may be tarnished with delinquencies and provisions at later stages. Sticky loans may be rescheduled on the basis of early warnings of repayments and may not reach the bucket of greater than 90 days, thereby necessitating provisions. The ROA ratio may be re-worked to give higher returns by reducing the asset value at the year-end via securitization, inter-group transfers, etc.

Subject to the above limitations, the study concludes that prompt corrective action prescribed by RBI in situations where norms are not followed has helped in maintaining the financial health of the Indian banking sector.

Therefore, it is reasonable to conclude that RBI, through its policies, has insulated the Indian economy from the effects of one of the worst global financial crises, following the fall of Lehman Brothers in October 2008 and from the impact of the sub-prime crisis due to limited exposure to toxic assets, owing to the counter-cyclical prudential norms prescribed by the Reserve bank.

However, this insulation was more a result of the habitual conservatism of RBI in terms of laying down strict guidelines of products that are offered by banks than as a conscious decision to avoid potentially dangerous products. There are several instances wherein the cost of RBI's conservatism has been borne by Indian consumers in terms of the high cost of borrowings. Another aspect of the restrictive product policies of RBI in terms of derivatives, credit swaps, and securitization is the high cost of funds to the banks, which ultimately gets transferred to the regular consumer.

For instance, Credit Default Swaps are not allowed in India; these instruments help transfer the risk of credit default on an underlying credit from the lender to another market intermediary. They also help promote market liquidity, risk shifting, and accurate pricing of credit risk, and finally to reduced cost of borrowings. The risks involved in this type of instruments are also very high, as the world has witnessed, but absolutely banning all risky instruments may not be the best solution for an economy.

In October 2011, the reputed credit rating agency, Moody downgraded the State Bank of India (SBI), India's largest public sector bank to "D" on account of its low Tier I capital ratio and deteriorating asset quality. This suggests modest intrinsic financial strength, potentially requiring some outside support at times. (The corresponding rating for SBI's private sector peers, like ICICI Bank, HDFC Bank and Axis Bank, is at 'C'.)

The downgrading of the rating not only puts pressure on the government to induce fresh capital but also questions the promptness of RBI's current asset quality supervisory mechanism. SBI's Gross NPAs increased by 30 per cent from Rs. 19,535 crore in March 2010 to Rs. 25,326 crore in March 2011, and the capital adequacy ratio on Basel II norms fell from 13.39 per cent in March 2010 to 11.98 per cent in March 2011.

Performance of SBI's NPAs

State Bank of India	March 2006	March 2007	March 2008	March 2009	March 2010	March 2011
Net Non Performing Asset Ratio	1.88	1.56	1.78	1.79	1.72	1.63
Gross Non Performing Asset Ratio	3.61	2.92	3.04	2.86	3.05	3.28

The explanations for SBI's failure, as mentioned above, is beyond the scope of this paper, but it is reasonable to conclude that such slips in the asset quality of SBI over the past three years should have been more proactively inspected and dealt with by RBI, the Finance Ministry, and the Government of India without giving a foreign credit rating agency the opportunity to ring the alarm bell.

Non-Banking Finance Companies (NBFC)

Non-Banking Financial Company ('NBFC') is defined as per Section 45(I) of the Reserve bank of Indian Act to include a financial institution/ non- banking institution which is a company and which has as its principal business the receiving of deposits or lending or such other non- banking institution as may be notified by Central Government. The term 'Financial Institution' includes any non- banking institution which carries on the business of financing (making loans or advances), acquisition of shares, bonds, debentures or securities, letting or delivering of any goods to a hirer under a hire-purchase agreement, carrying on of any class of insurance business, managing, conducting or supervising of chit funds or collecting money by subscription to units or instruments. It does not include any institution whose principal business is that of agriculture activity, industrial activity, sale/purchase/construction of immovable property.

A non-banking institution which is a company and which has its principal business of receiving deposits under any scheme or arrangement or any other manner, or lending in any manner is also a non-banking financial company (Residuary non-banking company).

NBFC play a significant role in credit disbursement in the diverse Indian economy. NBFCs provide small and medium ticket size personal loans (with/ without security), microfinance facility, asset backed funding for acquisition of new/ old assets (commercial vehicles/ construction equipment) to various sections in an economy who may not have access to banks. They also cater to demands of project finance, infrastructure funding and loans to promoters against pledging of shares. However, because of lower regulation and entry barriers, the NBFC sector witnessed several crises of confidence among the investing public which lead to stricter regulation and oversight of NBFCs by RBI.

NBFCs provide small and medium ticket size personal loans (with/ without security), microfinance facility, asset backed funding for acquisition of new/ old assets (commercial vehicles/ construction equipment) to various sections in an economy who may not have access to banks.

NBFCs played a greater role as a major element of financial system till late nineties but has gradually lost its significance because of the regulations like Entry norms and Prudential norms which were introduced to ensure financial discipline among the players.

On the basis of data on number of NBFCs and the public deposits mobilised by NBFCs analysed from RBI Statistical tables, we have

observed that there has been substantial reduction in their activities in the last decade.[107]

Number of NBFCs and Public Deposits Raised

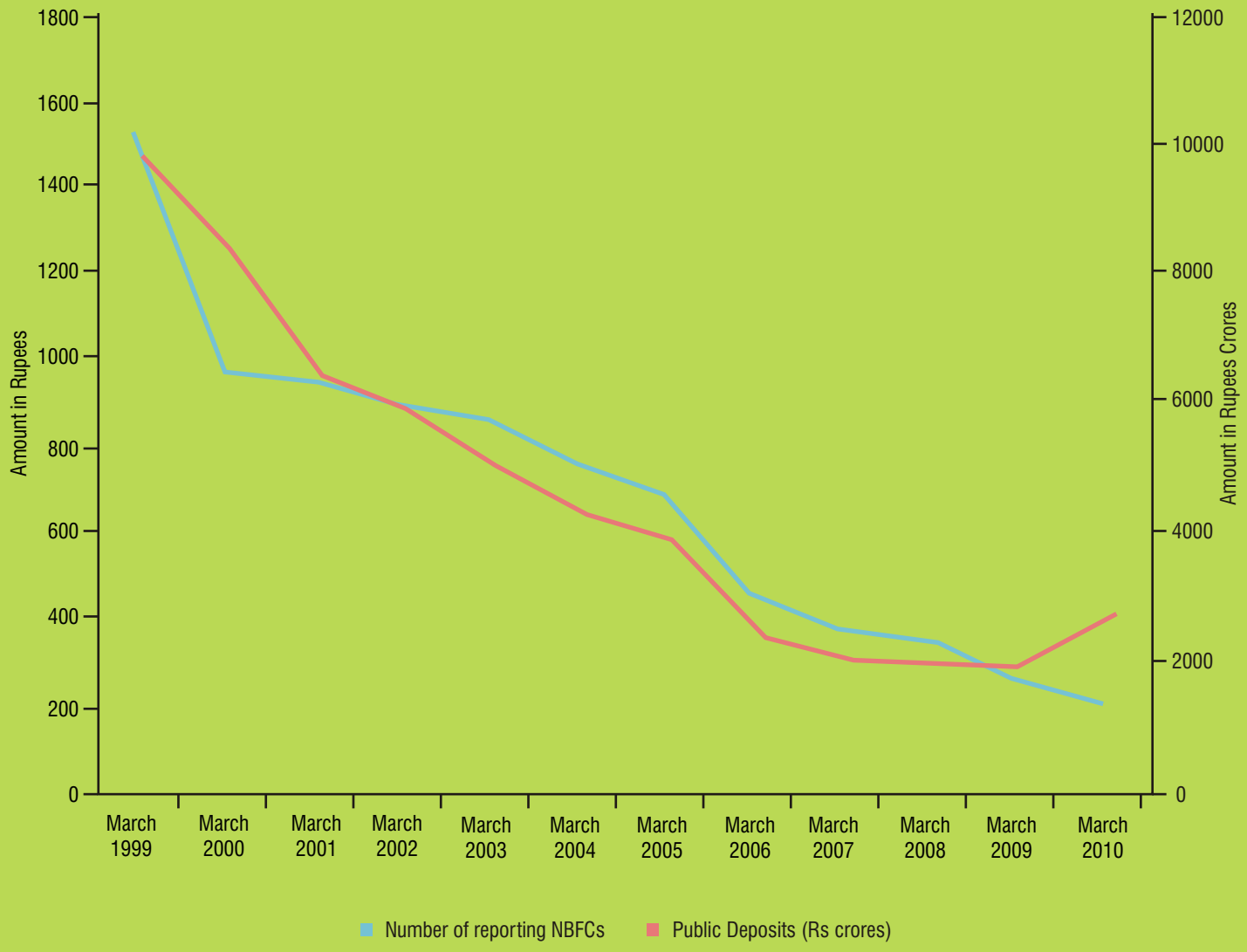
Year Ending	Number of reporting NBFCs	Public Deposits (Rs crores)
March 1999	1536	9,785
March 2000	996	8,338
March 2001	974	6,459
March 2002	905	5,933
March 2003	870	5,035
March 2004	774	4,317
March 2005	700	3,926
March 2006	432	2,447
March 2007	371	2,075
March 2008	350	2,042
March 2009	288	1,971
March 2010	228	2,727

It is mandatory that every NBFC should be registered with RBI to commence or carry on any business of non-banking financial institution and should have net owned funds of Rs 200 lacs. As per the report of RBI working group on the issues and concerns in the NBFC sector, August 2011, it has been proposed that minimum net owned funds should be increased to Rs 50 crores for new NBFC registration.

They are required to maintain liquid assets as a percentage of deposit liabilities, create reserve fund by transferring certain percentage of profits on an annual basis. RBI has also issued directions to NBFC on

[107] Martina Rani Kopala, Non-Banking Financial Companies in India: Reforms and Performance available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1674332, last accessed on March 15, 2012

Non Banking Finance Companies - Numbers and Aggregate Deposits



prudential norms, capital adequacy, deployment of funds etc.

However, to obviate dual regulation, certain categories of NBFCs which are regulated by other regulators are exempted from the requirement of registration with RBI viz. Venture Capital Fund/Merchant Banking companies/Stock broking companies registered with SEBI, Insurance Company holding a valid Certificate of Registration issued by IRDA, Nidhi companies as notified under Section 620A of the Companies Act, 1956, Chit companies as defined in clause (b) of Section 2 of the Chit Funds Act, 1982 or Housing Finance Companies regulated by National Housing Bank.

NBFCs have been mandated to constitute audit committee, nomination committee, risk management committee and advised against connected lending by RBI as per guidelines on corporate governance applicable to NBFCs with deposit size of Rs 20 crores and above and non-deposit taking NBFCs with assets size of Rs 100 crores and above.[108]

Thus, RBI has made regulation of NBFC nearly as stringent as that of commercial banks and this helps raise public confidence in the banking sector.

Conclusion

All these indicators suggest that the monitoring and oversight mechanism instituted by RBI for improving the corporate governance of banks, and by inference, of individual borrowers, is robust and effective. The mechanisms also promote efficient management of the banking sector, in general, and are rewarded by the capital market through an increase in shareholders' equity. Thus, RBI is effective as a regulator of the banking sector and a good gatekeeper of corporate governance.

This working paper restricts itself to the study of RBI's effectiveness in regulating the banking sector. There are several instances wherein RBI seeks information directly from the commercial sector and can, therefore, enforce checks and balances to instill good corporate governance. RBI's effectiveness as a direct gatekeeper of the corporate world is not covered here and is the subject of further research.

[108] RBI Circular, Guidelines on Corporate Governance, RBI/2006-2007/385

Epilogue

RBI has done some remarkable work in ensuring a clean and healthy banking system in the last couple of decades. The policy of 'Prompt Corrective Action' in particular is being increasingly seen as one of the possible reasons for the hearty performance of the Indian banking sector in the backdrop of recent worldwide meltdown. It continues to stress on growth with inclusion, urging the financial sector to focus on making their services more attractive and viable for the small customer, to continue adopting more cost-effective technology and practices that would very naturally lead to increase in its reach.

Gatekeepers of Corporate Governance

- Reserve Bank of India (RBI)
- **Securities and Exchange Board of India (SEBI)**
- Auditors

SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)

All about market intermediaries in fair trade

Kshama V. Kaushik, Rewa P. Kamboj

Capital Markets came about to help enterprising individuals/entities raise funds for long-term ventures, from those in possession of surplus resources. However, mere raising of funds is not a sufficient condition for capital formation; it needs to be productively deployed, which in turn is dependent on investors being properly protected. SEBI is committed to protecting investors by keeping the markets fair and efficient. Increasingly the small investor is turning to the markets to earn a reasonable interest on investments and secure his/her future. Sound market regulation has never been more important.

Securities and Exchange Board of India

Introduction

At the time of Independence, India had a functioning stock market (Bombay Stock Exchange is Asia's oldest stock exchange), a flourishing trading sector, a fledgling industrial sector, and a well-developed banking sector. The concept of joint stock companies was immensely popular since it was first introduced by the British rulers, and Indian businessmen took to the concept very well, as it helped disperse risk more widely and provided better access to funding resources.

However, the method of running these companies or corporate governance took on an entirely indigenous flavour—businessmen hardly altered their style of working under the sole proprietorship or partnership mode and often treated the company as their personal property. Promoters were unwilling to give up unbridled control over the business which is inevitable in a joint stock company. The concept of a managing agency house (often a partnership firm that provided specific services), wherein promoters would pass a resolution appointing their family firm as the managing agent almost in perpetuity and with unfettered powers, was a neat solution. Corporate governance, as is understood in the modern context, was an alien concept for indigenous Indian business houses for a long time. The socialist policies followed by the government after Independence also contributed to weak governance norms, which was more evident in India's huge public sector and nationalized banks where the governing ethos took on a form of its own.

Originally established in 1988 as an advisory body, SEBI was granted the authority to regulate the securities market under the Securities and Exchange Board of India Act of 1992 (SEBI Act).

Faced with a fiscal crisis in 1991, the Indian Government responded by enacting a series of reforms aimed at general economic liberalization. This opened up the Indian economy not only in terms of business opportunities and newer funding avenues but also to fresher ideas of governance models. In order to develop India's capital markets further, the Central Government established regulatory control over stock markets through the formation of the Securities and Exchange Board of India (SEBI). Originally established in 1988 as an advisory body, SEBI was granted the authority to regulate the securities market under the Securities and Exchange Board of India Act of 1992 (SEBI Act). Through the passage of this Act, the Parliament established SEBI as an independent statutory authority, but stipulated that it would have to submit annual reports to the legislature.

SEBI was designed to serve as a market-oriented independent entity in order to regulate the securities market akin to the role of the Securities and Exchange Commission (SEC) in the United States. The stated purpose of the agency is to protect the interests of investors in securities and to promote the development of, and to regulate, the securities market.

The first initiative at introducing corporate governance in a structured manner in India was by the industry through its association, the Confederation of Indian Industry (CII) in 1998. It was a purely voluntary set of recommended governance norms that companies could adopt in order to be seen as well-run companies. However, in order to ensure the more widespread adoption of corporate governance norms, it is necessary to have a certain statutory compliance value and, therefore, SEBI undertook the second initiative in corporate governance by introducing a code formed by a committee under the chairmanship of a leading industrialist, Kumarmangalam Birla, in 1999. The recommendations of this committee contained new provisions in line with global developments such as incorporating a Management Discussion and Analysis report as part of the annual report, emphasizing on the formation of Board committees, and advocating the role of independent directors. These proposals were introduced by SEBI in 2000 for companies within its jurisdiction—listed companies—by amending the Listing Agreement that companies enter into with stock exchanges.

SEBI's mandate, however, extends only to companies listed on stock exchanges and a comprehensive adoption of corporate governance norms for all companies can be brought about in India only through the legislative route. Therefore, a third set of corporate governance proposals was carried out by the Department of Company Affairs (now the Ministry of Corporate Affairs) on the basis of the recommendations of the Naresh Chandra Committee in December 2002. It made recommendations pertaining to two

key aspects of corporate governance: financial and non-financial disclosures, and independent auditing and board oversight of management, as also a series of recommendations regarding statutory auditors.

The fourth initiative on corporate governance in India was again carried out by SEBI on the basis of the recommendations of the Narayana Murthy Committee, which was set up to review Clause 49, and suggest measures to improve corporate governance standards. This was done in the wake of the Enron scandal in the United States in order to evaluate the adequacy of the existing Clause 49, and to further improve existing practices in order to enhance the transparency and integrity of India's stock markets, and to ensure compliance with corporate governance codes, in substance and not merely in form. The changes suggested reflect global norms of corporate governance developed in Anglo-Saxon countries, which operate under a different business environment than prevalent in India.

Regulatory Framework of Securities and Exchange Board of India (SEBI)

SEBI acts as a developer and regulator of the capital market in India. SEBI has delegated powers to two exchanges (the Bombay Stock Exchange and the National Stock Exchange) to ensure that their members adhere to the SEBI regulations and instructions.
The total market capitalization as on 31 March 2011 of listed companies in India at the Bombay Stock Exchange is Rs. 68,39,084 crores, as per SEBI's Annual Report for the year ending 31 March 2011.

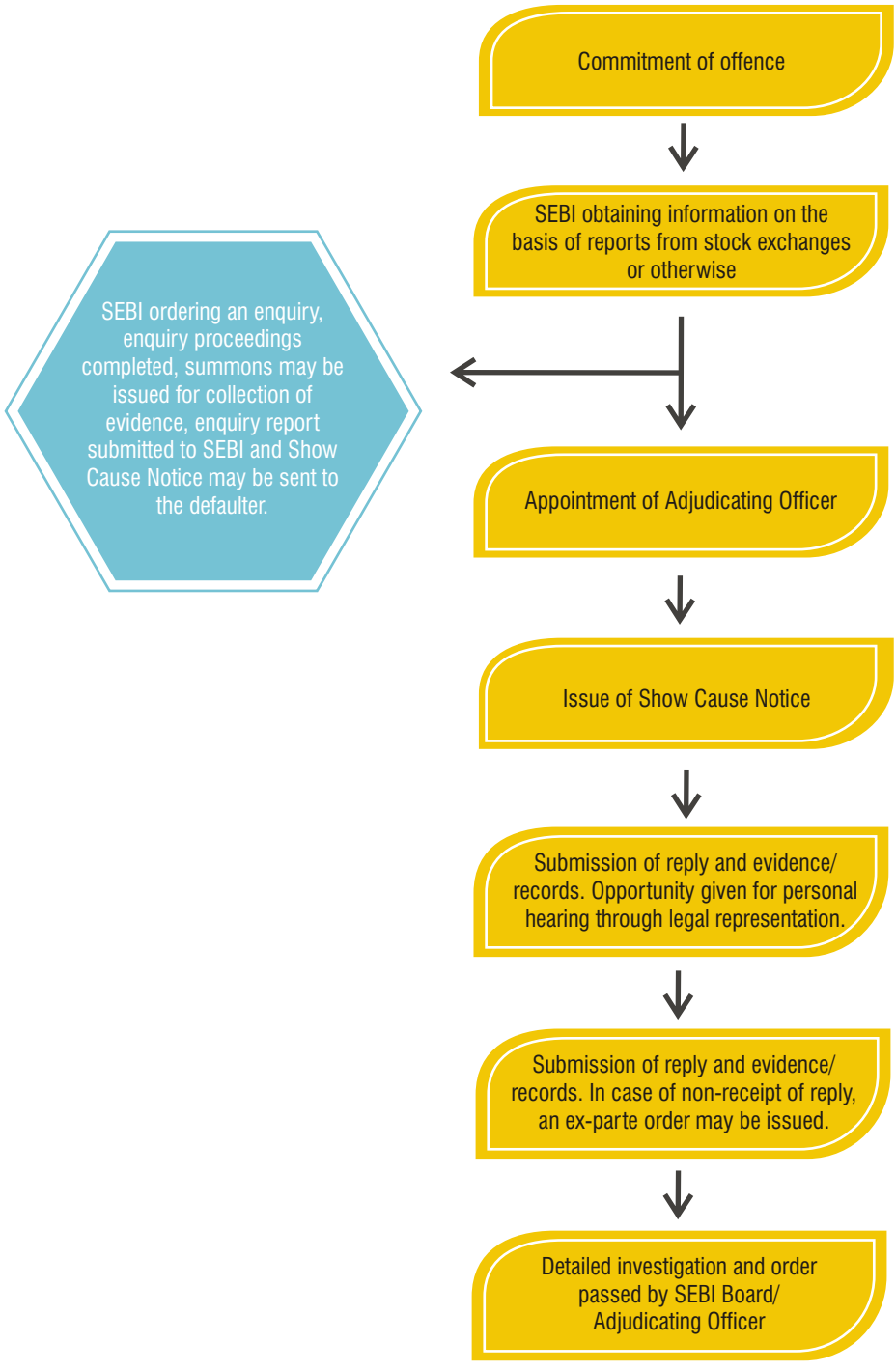
Some of the roles that SEBI performs as a market regulator are as follows:

1. Regulating the market by creating rules for functioning of various products.
2. Approving/amending the laws of stock exchanges.
3. Inspecting the books of accounts and calling for periodical returns from recognized stock exchanges.
4. Inspecting the books of accounts of financial intermediaries and levying fees/charges on them.
5. Compelling certain companies to list their shares in one or more stock exchanges.
6. Educating investors.
7. Prosecuting and judging directly the violation of certain provisions of the Companies Act.
8. Prohibiting and preventing insider trading.
9. Framing rules for the merger and takeover of companies.
10. Regulating the issue of capital and debt in the primary and secondary markets.
11. Preventing unfair trade practices and market manipulation.

Thus, SEBI drafts regulations in its legislative capacity, conducts investigations and authorizes enforcement action in its

SEBI has delegated powers to two exchanges (the Bombay Stock Exchange and the National Stock Exchange) to ensure that their members adhere to the SEBI regulations and instructions.

Figure 1: Flowchart for Adjudication Proceedings

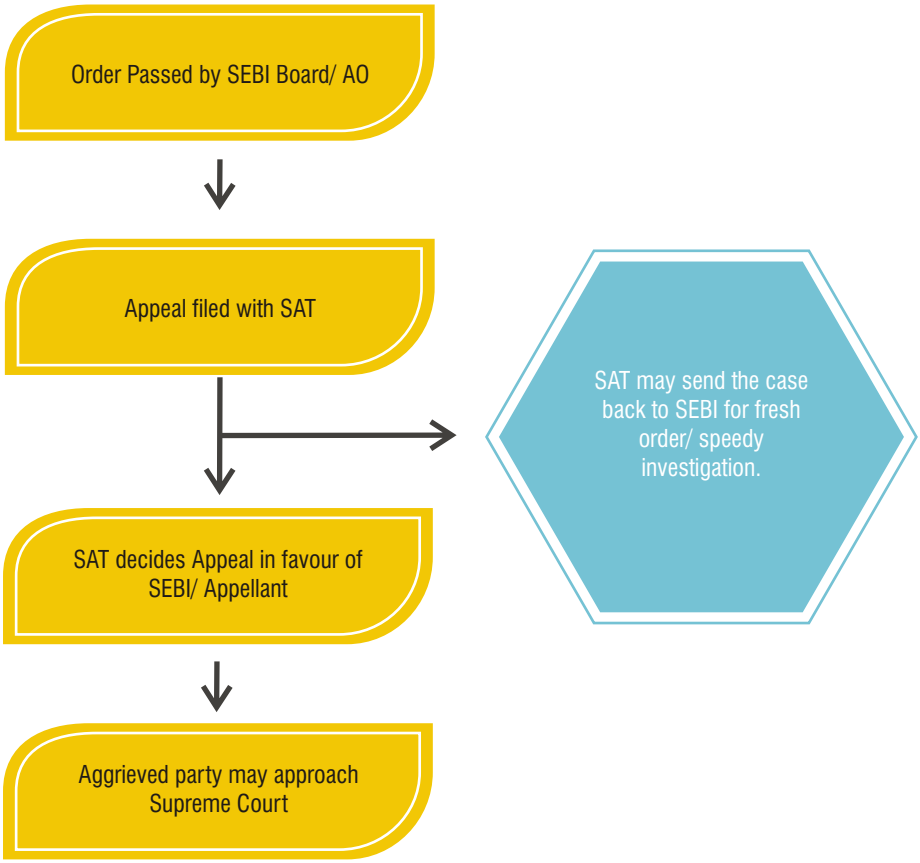


executive function; and passes rulings and orders in its judicial capacity. Although this makes it very powerful, there is an appeals process to ensure fairness and accountability through a Securities Appellate Tribunal (SAT), which was formed in 1995 to act as a forum of justice to appeal against the orders passed by the SEBI Board or the adjudicating officer (AO) appointed under the SEBI Act.

The general process flow of the adjudicating and appeals procedure is usually takes the form depicted in Figures 1 and 2 but may vary a little in some cases.

(An appeal can be filed with the Central Government of India at any stage of the adjudication proceedings.)

Figure 2: Flowchart for Appeal Process
At any stage, an appeal can be filed with the Central Government of India



SEBI and Corporate Governance

SEBI has laid out corporate governance provisions that are intended to ensure a minimum standard of corporate governance among listed companies in India. This is issued as a part of the Listing Agreement that each listed company signs with the stock exchange under the title 'Clause 49', which remains the most significant corporate governance reform and has helped establish a new corporate governance regime.

Like corporate governance standards in the United States and the United Kingdom, India's corporate governance reforms have followed a fiduciary and agency cost model. With the focus on the agency model of

corporate governance, the Clause 49 reforms included detailed rules regarding the role and structure of the corporate board and internal controls. These norms lay down the criteria for the:

1. Appointment of independent directors in the board.
2. Appointment, composition and powers of the Audit Committee.
3. Functioning of the Remuneration Committee, and the Investors Grievances Redressal Committee.
4. Compensation that can be paid to the non-executive directors.
5. Adherence to an internal control of conduct by the Board of Directors and other top executives.
6. Disclosure of Accounting Policies, Contingent Liabilities, Related Party Transactions, and IPO Proceed utilization.
7. Certification by the CEO/CFO on the adequacy of the internal control system, and the correctness of the reported financials.
8. Whistle-blower policy.

The director and auditors/ company secretary of the company are required to sign a certificate of compliance on the terms contained in Clause 49, which has to be annexed to the annual report.

The stock exchanges are mandated to ensure compliance with the above provisions at the time of listing of shares and through the quarterly compliance reports received from the listed companies. Listed companies are also required to submit a consolidated compliance report to SEBI within 30 days of the end of each quarter.

The Clause 49 reforms were phased over several years, at first applying to largerentities and eventually to smaller listed companies.

Eventually, the compliance of corporate governance must be carried out by:

- Issuer Companies;
- Stock Exchanges;
- Central Securities Depositories;
- Stock Brokers;
- Mutual Funds;
- Foreign Institutional Funds;
- Investment Banks;
- Depository Participants;
- Credit Rating Agencies;
- Venture Funds; and
- Registrars and Underwriters.

Effectiveness of SEBI as a Gatekeeper of Corporate Governance in India

SEBI is the capital market regulator in India and in recent years has been active in its efforts to usher in a standard form of corporate governance. This part of the study analyses the effectiveness of SEBI's role in implementing corporate governance mechanisms. This is done in four parts as follows:

a. Study of the extent of adoption of corporate governance norms by the listed companies of SEBI.
b. Study of the effect of such an adoption on the performance of companies.
c. Study of the effectiveness of SEBI's overall regulatory mechanism by analysing the first level of mechanism, that is, the Assessing Officer level, as well as the appeals process, that is, the Securities Appellate Tribunal (SAT).
d. Study of the mechanism of Consent Orders and analysis of its prevalence, and effectiveness as a deterrent, and an assessment of the transparency of the system.

The above steps are discussed in detail below.

a) Study of the Extent of Adoption of Corporate Governance Norms By Listed Companies

We have analysed data from the National Stock Exchange of the company-wise submissions with respect to compliance with the provisions of the corporate governance code for the quarter ended 30 June 2011.

Our analysis showed that almost all companies were following corporate governance measures. The details of the analysis are given in Table 1.

This analysis is limited to only an examination of whether companies had declared their adherence to prescribed corporate governance mechanisms and did not cover an examination of the quality of such mechanisms or the benefit of such mechanisms for individual companies.

Table 1: Analysis of Compliance of the Corporate Governance Code By Listed Companies

Particulars	Number of Companies	Percentage
Complied	1044	71
Not Complied	106	7
Cannot comment*	312	21
Total	**1462**	**100**

*Cannot Comment: Data includes fields which did not have any input, hence it cannot be determined if compliance was done or not.

A study on corporate governance in India[109] states that India has one of the best corporate governance laws but suffers from poor implementation which together with the socialistic policies of the pre-reform era has

[109] Chakrabarti, Rajesh, Corporate Governance in IndiaEvolution and Challenges, College of Management, Georgia Tech., USA, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=649857 last accessed on April 9, 2012

affected corporate governance. The legal environment plays a crucial role in determining the nature of corporate governance in any country and encompasses two important aspects—the protection offered in the laws (*de jure* protection) and the extent to which the laws are enforced in real life (*de facto* protection).

Two indices have been used for this purpose—a shareholder rights index ranging from 0 (lowest) to 6 (highest), and a *rule of law* index ranging from 0 (lowest) to 10 (highest)—in order to measure the effective protection of shareholder rights. The first index captures the extent to which the written law protected shareholders, while the latter reflects the extent to which the law is enforced in reality. India has a shareholder rights index of 5, making it the highest in the sample of 49 countries that was examined, but the rule of law index shows a score of 4.17giving India the 41st ranking out of the 49 countries studied. Thus, it appears that Indian laws provide great protection of shareholders' rights on paper, but the application and enforcement of those laws are lamentable. This difference in terms of the protection of shareholders' rights has led to completely different trajectories of financial and economic developments in the different countries.

The study concludes that the bigger challenge in India lies in the proper implementation of corporate governance rules at the ground level.

b) Study of the Effect of Adoption of Corporate Governance Norms on Listed Companies

The OECD Principles of Corporate Governance (2004) and various corporate governance indices (such as Standard and Poor's Corporate Governance Index) focus on the characteristics of corporate governance mechanisms rather than on the outcomes based on the principle that effective and robust processes result in appropriate results. However, authors like Pitabas Mohanty argue that "if a company has got a governance system then it must get reflected in certain outcome(s). (The argument is that) if the processes are in order, we must observe certain desirable outcomes. If the outcomes are not present, then the mere existence of a process does not amount to anything."[110]

Significant research in this area conducted[111] show that firms with stronger stockholder rights have higher Tobin Q's, their proxy for the measurement of corporate value, indicating that better-governed firms are more valuable.

In a study done on Corporate Governance and Firm's Performance[112] a summary index of firm-specific governance, 'Gov-Score', is created and is related to the operating performance, valuation, and cash payouts for 2,327 firms in USA. They show that poorly-governed firms (that is, those with low Gov-Scores) have lower operating performance,

[110] 'Mohanty, Pitabas, "Institutional Investors and Corporate Governance in India". Available at: www.nseindia.com/content/research/Paper42.pdf, Accessed on 20 January 2012.

[111] Gompers, et al. (2003), Bebchuk and Cohen (2004), and Bebchuk, Cohen and Ferrell (2009)

[112] Corporate Governance and Firm's Performance (2004), Brown and Caylor

lower valuations, and pay out less cash to their shareholders, while better-governed firms have higher operating performance and higher valuations, and pay out more cash to their shareholders.

Scholars also agree that there are no formalized and generally accepted criteria for determining if a particular system of corporate governance system works.[113]

Bain and Band (1996)[114] and Bhagat and Jefferies[115] believe that the following factors form the pillars of corporate governance and have a positive relationship with the value of a firm:

- Independent board of directors;
- Equal rights of minority shareholders;
- Dispersed ownership;
- Timely and transparent information system; and
- Independent auditors.

Certain other factors also affect the relationship between the value of a firm and corporate governance, which include: a) the role of judiciary, banks, government and politicians, b) macro-economic factors such as the economic growth rate, inflation, and interest rates, and c) intangibles such as goodwill, customer relations, supply chain and growth potential, among other things.

In other words, the value of a firm is a combination of its monetary value plus its social value.

Indian corporate governance systems are drawn from the Anglo-Saxon model of corporate governance wherein the focus is on shareholder value maximization, with the shareholder value being derived in terms of the market valuation of a firm.[116]
Several studies have linked different parameters of performance to corporate governance for assessing its effectiveness. Some of these parameters include share price movements, volatility of share prices, and earnings per share. Kaplan[117] and Gibson[118] suggest that the performance of a corporate governance system can be evaluated by investigating the link between corporate performance and CEO turnover. The reasoning for this premise is that an effective governance system requires poor performing managers who need to be penalized by removal.

However, Gibson also provides evidence that when a firm has a large repository of domestic private shareholders, the relationship between CEO turnover and corporate performance weakens in emerging markets. This is also indicated in India, where the agency gap between owners and managers is low, which is compounded by the fact that the owners of the top 500 companies in BSE as on 30 September 2011 hold 60 per cent of the listed companies, creating a strong entrenchment of management and, therefore, CEO turnover may not provide accurate indications of good or bad corporate governance.

[113] Macy, J., 1998. "Measuring the Effectiveness of Different Corporate Governance Systems: Towards a More Scientific Approach", *Journal of Applied Corporate Finance*, Vol. 63, No. 2.

[114] Bain, Neville and David Band, 1996. *Winning Ways through Corporate Governance*, Macmillan Business, London.

[115] Bhagat, Sanjai and Richard H. Jefferies, 2002. *The Economics of Corporate Governance Studies*, MIT Press, Cambridge.

[116] 'Kakani, Ram Kumar, Biswatosh Saha and V.N. Reddy, 2006. "Determinants of Financial Performance of Indian Corporate Sector in the Post-Liberalization Era: An Exploratory Study", available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=904983, last accessed on April 9, 2012

[117] Kaplan, S.N., 1994. "Top Executive Rewards and Firm Performance: A Comparison of Japan and the United States", Journal of Political Economy, Vol. 102, No. 3, pp. 51046; Abe, Y., 1997. "Chief Executive Turnover and Firm Performance in Japan", Journal of the Japanese and International Economies, Vol. 11, pp. 226.

[118] Gibson, M.S., 2003. "Is Corporate Governance Ineffective in Emerging Markets?", Journal of Financial and Quantitative Analysis, Vol. 38, No. 1, March, pp. 23150.

Chhaochharia and Laeven (2007)[119] have evaluated the impact of firm level corporate governance provisions on the valuation of firms in a large cross-section of countries. They have distinguished between governance provisions that are set at the country level and those adopted at the firm–level, and conclude that governance provisions adopted by firms beyond those imposed by regulations and common practices among firms in the country have a strong, positive effect on firm valuation.

Despite the costs associated with bringing about an improvement in corporate governance at the firm level, many firms choose to adopt governance provisions beyond what can be considered as the norm in the country, and these improvements in corporate governance have a positive effect on firm valuation. Indian software and other companies listed overseas, especially in the USA, followed these principles of voluntarily imbibing greater measures of corporate governance for the perceived value it created for their businesses.

The challenge is to find a broad yet accurate measurement indicator that factors in the effect of corporate governance by linking two or more appropriate parameters, which reflect the performance of a company within a certain environment. *Tobin's Quotient* is widely used by academicians as a proxy for firm performance when studying the relationship between firm performance and corporate governance.

Tobin's Quotient or Tobin's Q is a ratio that was devised by Nobel Laureate James Tobin of Yale University in 1969, who hypothesized that the combined market value of all companies on the stock market should be equal to their replacement costs. The ratio is calculated as follows:

$$\text{Tobin's Q} = \frac{\text{Total Market Value of a Firm}}{\text{Total Asset Value}}$$

(where 'Total Asset Value' refers to the replacement value of assets.)

If Tobin's Q is equal to 1.0, the market value will be perfectly reflected by the recorded assets of the company. If Tobin's Q is greater than 1.0, then the value is greater than the value of the company's recorded assets. The accepted view is that in such cases, the

[119] Chhaochharia, Vidhi and Luc Laeven, 2007. "The Invisible Hand in Corporate Governance". Available at: http://www.luclaeven.com/papers_files/CG_Provisions.pdf, last accessed on April 9, 2012.

market value reflects some unmeasured or unrecorded asset of the company. This 'extra' value is often used as a proxy for corporate governance.

In theory, firms with Tobin's Q substantially less than one are good candidates for liquidation, because their assets are worth more than the value that they are generating whereas firms with higher Tobin's Q are likely to provide greater investment opportunities. This may explain why Enron was a stock market favourite (Enron's Tobin Q at the height of its stock market valuation was 6.8) despite subsequent events that unravelled the company.[120]

In practice, Tobin q is sensitive to the swing effects of its equation's denominator, i.e. the firm's total assets of cash, receivables, inventory and plant book value. Tobin Q is used as a diagnostic tool and predictor of company success when applied to 'The Business Policy Game'. If players can be shown how to be more efficient in their use of cash, how to produce better forecasts which allows them to lower their average inventories or obtain more output given the firm's plant and equipment, its 'q' will increase.[121]

Matthew Harney and Edward Tower[122] *have summarised that Tobin q* displays superiority and beats all variants of the PE ratio for predicting real rates of return over alternative horizons. A fundamental relationship should exist between stock market valuations and underlying corporate assets; more simply, firms in the long run should be valued at their current cost of creation and thus **q** should theoretically hover around one under rational expectations.

Cheung and Pruitt[123] developed and empirically tested the robustness and usefulness of the simple formulation of Tobin's Q. They concluded that the correlation of the values obtained through the Q values is theoretically correct and can be safely applied. This conclusion, in many ways, supports the main assertions of another prior study on Tobin's Q by Perfect and Wiles, 1994, 'Alternative constructions of **Tobin's** q: An empirical comparison'.[124]

It is now widely accepted that Tobin's Q is an appropriate proxy for the underlying, true Q, which is an indicative measure to invest.

Clause 49 of the Listing Agreement of Indian Companies

The corporate governance mandate is contained in the revised Clause 49 issued by SEBI, effective from 1 April 2004 for listed companies. These provisions have been in effect for a period of seven years, and it can be reasonably expected that they would be entrenched long enough for its effect to be reflected in certain parameters. These provisions are designed to improve the way in which companies are managed. The main provisions of Clause 49 are detailed in Table 2.

[120] 'Disappearing Delaware Effect', Guhan Subramanian, Harvard Law School http://www.law.harvard.edu/programs/corp_gov/papers/Subramanian_Paper.pdf last accessed on March 17, 2012

[121] Http://sbaweb.wayne.edu/~absel/bkl/vol30/ 30at.pdf

[122] Rational Pessimism: Predicting Equity Returns using Tobin's q and Price/Earnings Ratios available at http://public.econ.duke.edu/Papers//Other/Tower/Pessimism.pdf last accessed on March 21, 2012

[123] Chung, Kee H. and Stephen W. Pruitt, 1994. "A Simple Approximation of Tobin's Q", Financial Management, Vol. 23, No. 3. Available at SSRN: http://ssrn.com/abstract=957032 last accessed on April 9, 2012

[124] Journal of Empirical Finance 1, 313-341, available at http://economics-files.pomona.edu/GarySmith/tobinsq.html last accessed on April 9, 2012

Table 2: Main Provisions of Clause 49 of SEBI

Guidelines	Impact	Objective
Board of Directors	Professionalization of directorial oversight, transparency of board remuneration & processes	Independence of Oversight
Audit Committees	Improvement in quality of financial oversight and therefore in firm performance	Risk Assurance
Subsidiary Companies	Greater oversight of unlisted companies by shareholders of holding company	Capital Protection
Disclosures	Better control mechanisms being implemented, better risk management processes	Financial Transparency
CEO/CFO certification	Greater ownership of financial affairs of the company leading to better oversight mechanism	Accountability

Methodology and Analysis

We have used Tobin's Q as a proxy to analyse the effectiveness of corporate governance practices that listed companies in India are mandated to implement.

We have analysed the movement of Tobin's Q over 100 companies comprising the BSE 100 index over a period of seven years ranging from the financial year 200405 to 201011. This involved an analysis of 800 financial statements aimed at collecting financial data to examine whether the introduction of SEBI's corporate governance mechanisms has had an impact on corporate performance.

This ratio was originally intended to be calculated on the replacement value of assets. However, it is difficult to obtain an estimate of the replacement cost of assets unless there is a defined market for used equipment. Indian laws require assets to be recorded at the historical cost adjusted for depreciation; in certain cases, mark-to-market is used but this is not the usual case. Therefore, we have used total assets as they appear in the financial statements of companies.

We have also analysed certain financial performance indicators of the 100 companies comprising the BSE 100 index over the given period of seven years in order

to study the link, if any, between corporate governance mechanisms. For instance, Return on Assets (ROA) is an indicator of how profitable a company is relative to its total assets, and may be considered as a proxy for the efficiency of management in using its assets to generate earnings; in other words, ROA may be considered as a proxy for operating performance.

Return on Equity (ROE) is an indicator of the maximization of shareholder wealth, which, in terms of the Anglo-Saxon model, is the basic purpose of corporate governance. ROE is the amount of income returned on the equity invested in the company and may be considered a proxy for the ability of the company to maximize shareholders' wealth.

Net Profit to Sales is an indicator of the level of efficiency with which a company is being operated. It may be considered as a proxy for the effectiveness of certain corporate governance mechanisms that seek to improve operational performance.

Employee Cost as a Percentage of Sales indicates whether certain human resource (HR) processes included in corporate governance mechanisms are effective in improving employee efficiency.

Cost of Debt indicates whether the company is being run effectively enough to bring down the debt component and to improve cost efficiencies, and may be considered as a proxy for financial efficiency.

Explanation of the Terms:

1. Tobin's Q is the ratio of market capitalization over the total assets of the company. Market Capitalization has been calculated by multiplying the number of shares with the issued capital. Total Assets are taken as per the Annual Financials reduced for deferred revenue expenditure to the extent not written off.

2. Return is Net Profit after Tax

Net Profit (after tax) = Earnings Before Interest and Taxes minus Interest minus Taxes

Earnings Before Interest and Taxes = Operating Revenue- Operating Expenses+ Non- Operating Income.

Operating Revenue= Sales Revenue

Operating Expenses= Cost of Goods Sold+ Selling, General and Administrative Expenses+ Depreciation and Amortization+ Other Expenses

Non-Operating Income= Dividend Income+ Profits from Investments+ Gains on account of Foreign Exchange.

3. Return on Assets is the ratio of returns for a year over the average of Total Assets during the years. Average Assets is the summation of the opening and closing assets divided by two.

4. Equity means Shareholders Funds, which is, Share Capital + Reserves and Surplus. Return on Equity is the ratio of returns for a year over the reported equity.

5. Sales are before excise duty adjustments and in case of banks, they imply the interest earned.

6. Total Debt includes both secured and unsecured long-term debt. Cost of Debt is the ratio of the interest cost over the average debt. Average Debt is the summation of the opening and closing debt divided by two.

7. Price/Earnings Ratio is the ratio of the closing market price of the shares at BSE divided by the reported Earnings per Share.

8. Mean is the simple average of the data variables over the sample size and period.

9. Median is the middle-most value of the data variables over the sample size and period.

10. Skewness is a measure of the asymmetry of the data around the average mean. If skewness is negative, the data are spread out more to the left of the mean than to the right. If skewness is positive, the data are spread out more to the right of the mean. The skewness of the normal distribution (or any perfectly symmetric distribution) is zero. In case the data skewness is more than +/- 5, the mean has been substituted by the median for analysis.

Our Discussion and Analysis:

Table 3 depicts the average Tobin's Q of the BSE 100 companies annually since the introduction of SEBI's Clause 49 in April 2005.

Table 3: Average Tobin's Q of the BSE 100 Companies since April 2005

Tobin's Q (Mean)	2011	2010	2009	2008	2007	2006	2005	Trend
Market Capitalization/Total Assets	3.47	3.5	2.2	4.04	3.85	4.24	3.27	Oscillating

We observe that there was a marked increase in Tobin's Q one year after the corporate governance regulations were introduced in 2005, and that there has been a marked improvement in the measure over the next three years, suggesting that the capital market reacted favourably and rewarded companies for implementing corporate governance mechanisms.

This observation is in line with prior empirical studies done by Jain, Kim and Rezaee in 2006, suggesting that SOX regulations in the USA created a buoyancy in the markets by reducing information asymmetry due to higher levels of disclosures, which increased the market liquidity and size.

At an average Tobin's Q of over three for all years (except one), it indicates that markets value companies far more than what they are worth as compared to the amount of investment made by them.

However, the value of assets in our sample is calculated at historical cost reduced by depreciation, that is, book value of assets. Tobin's Q as originally envisaged must be calculated on replacement cost to capture market perception of the worth of a firm including its corporate governance mechanisms.

For instance, Tobin's Q for all US public listed companies has been valued at 0.8182 for the month ending September 2011with a long term average of 0.755. Here Tobin Q has been calculated by dividing the market value of all listed companies with the replacement cost of assets.[125]

Movement of Companies toward Better Corporate Governance

We analysed the movement of the BSE 100 companies over a period of seven years in order to assess if the assimilation of corporate governance mechanisms recommended by Clause 49 has helped companies move up on the index of Tobin's Q. This was analysed with reference to the mean Tobin's Q ratio for each of the years to observe the migration of companies past the mean towards a higher benchmark.

The results, as depicted in Table 4, indicate that the number of companies that are below the mean Tobin's Q ratio for BSE 100 has only increased over this period. If corporate governance mechanisms were effective, companies could have been expected to move closer to the higher Tobin's Q benchmark. This could also mean that the market accepts a certain corporate governance standard as the basic after a period of time and does not continue to reward companies beyond a certain point.

Therefore, while the number of companies below the mean Tobin's Q has increased over time, it is not clear whether this is because of the ineffectiveness of corporate governance mechanisms or because the market expects such 'standard' behaviour from everyone and does not recognize these basic efforts.

[125] http://ycharts.com/indicators/tobins_q, last accessed on March 21, 2012

Table 4: Distribution of Companies around Mean Tobin's Q

Distribution of Companies Above & Below Mean Tobin's Q	2011	2010	2009	2008	2007	2006	2005
Number of companies more than the mean	30	30	26	33	31	28	23
Number of companies less than the mean	70	69	71	63	59	58	59
NA	-	1	3	4	10	14	18
Total	**100**	**100**	**100**	**100**	**100**	**100**	**100**

Data Skewness

We also observed that there is great data skewness in the sample of BSE 100 with Tobin's Q ranging from less than 1 up to 25 as shown in Table 5. Such a high Tobin's Q suggests that the assets of those companies may be over-utilized as compared to the amount of capital invested in them. Theoretically, a high Tobin's Q should encourage those companies to invest more in capital in order to balance market valuations.

Table 5: Tobin's Q Spread Year-wise

Distribution of Companies Above & Below Mean Tobin's Q	2011	2010	2009	2008	2007	2006	2005
Not Available	-	1	3	4	10	14	18
Up to 1	39	31	41	25	27	23	27
1 to 2	13	19	27	16	12	9	18
2 to 3	16	16	9	15	14	13	13
3 to 5	13	14	10	16	10	18	9
5 to 10	11	12	8	18	20	15	10
More than 10	8	7	2	6	7	8	5
Total	**100**	**100**	**100**	**100**	**100**	**100**	**100**

Alternatively, this high Tobin's Q indicates that there is an unexplained exuberance in capital markets regarding certain companies, which puts their market capitalization far above what the companies are actually worth. Sectors like Capital Goods, Fast Moving Consumer Goods (FMCG) and Transport Equipment show a high Tobin's Q of above 5 and up to 25, which is inexplicable. Information Technology (IT) shows Tobin's Q on an average between 2 to 5, indicating that the capital market factors in intangibles in the IT sector are not reflected in the total assets appearing in financial statements. Only the finance sector shows a consistent Tobin's Q between 0 and 1.

Therefore, the average Tobin's Q depicted in Table 3 needs to be read in the context of this skewness.

Company-specific Tobin's Q ratios vary significantly from industry to industry and, to a lesser degree, within industries. The variability across industries is also due to the fact that companies in some industries employ relatively little capital and therefore generate unusually high returns on capital. Those types of companies typically deserve higher Q ratios than companies in capital-intensive, cyclical industries.[126]

Other Financial Ratios

We have analysed the data of 100 companies[127] over a period of seven years. This translates into 800 financial statements, from which we have extracted financial ratios that could indicate the effectiveness of corporate governance mechanisms. These ratios have then been aggregated into annual figures to show the trend across BSE 100 companies[128], and the results are depicted in Table 6.

[126] http://www.tobinsq.com/about.html last accessed on March 21, 2012

[127] Forming part of BSE 100

[128] Forming part of BSE 100

Table 6: Aggregation of Financial Ratios into Annual Figures of BSE 100 Companies

Ratios	2011	2010	2009	2008	2007	2006	2005	Trend
Return on Assets	12.98	13.67	13.16	15.94	15.98	14.29	13.41	Oscillating
Return on Equity	18.59	19.28	19.17	23.08	24.77	21.53	20.75	Oscillating
Net Profit/ Sales	14.78	15.17	13.75	15.07	14.07	13.31	13.75	Oscillating
Employee Cost as a %age of Sales	6.10	5.88	5.52	5.78	5.19	5.52	5.61	Oscillating
Cost of Debt	6.34	6.50	8.39	6.98	6.63	5.97	7.07	Oscillating

Financial Ratios Over Seven Years

Return on Assets: The data shows an oscillating trend and appears to reflect general macroeconomic factors as well. The effect of corporate governance mechanisms is not very apparent.

Return on Equity: The data showed an increasing trend initially and then declined steadily, mirroring the recessionary trend during those years. This suggests the impact of macroeconomic factors rather than an improvement in corporate governance mechanisms.

Net Profit/Sales: Although the data shows an oscillating trend, after factoring in recession, the profitability shows an improvement over the years. However, it may be premature to conclude that this is the result of implementation of corporate governance mechanisms.

Employee Cost/Sales: Employee costs over sales shows a rising trend over the years pertaining to the sample period. An improvement in corporate governance should contribute to more efficient HR systems which, in turn, should help bring down employee costs as a percentage of sales, though this is not supported by data. Rising employee cost can also be explained by rising inflation (which would also have an adverse effect on sales) and, therefore, the effect of corporate governance on employee costs is not clear.

Cost of Debt: Other than during the exceptional year of 2009, the cost of debt shows a declining trend. This could indicate that greater value is created for shareholders as the cost of financing goes down.

Corporate governance is expected to bring in efficiencies in the way a business is run and must, in the final analysis, be reflected in the outcomes as represented by financial numbers. Some of these efficiencies would be reflected in a lower cost of debt, and more efficient employee costs per unit of sales, besides providing better returns on assets and to shareholders.

Our analysis of data reveals that at an aggregate level, these financial ratios do not indicate any trend that conclusively points to the effect of better governance by itself and may depict the influence of other macro-economic factors as well.

Regression Analysis

We find that these financial ratios do not independently provide conclusive proof of the effect of corporate governance on financial performance. In this section, we determine whether any relationship exists between corporate governance as measured by Tobin's Q and firm's performance measures (ROA and ROE) by using regression analysis over a period of 7 years for BSE 100 companies.

Regression analysis is a statistical term which includes the techniques for modelling and analyzing several variables, when the focus is on the relationship between a dependent variable and one or more independent variables. It depicts how the value of one variable (also called dependent variable) changes when any one of the independent variables varies. The known variable is called the independent variable and the variable we are trying to predict is called the dependent variable.

The results have been obtained by using linear regression model in SPSS at 95% confidence level. Linear Regression estimates the coefficients of the linear equation, involving one or more independent variables that best predict the value of the dependent variable.

Table 7: Linear Regression with Tobin Q as independent variable and ROA as dependent variable

Particulars	2011	2010	2009	2008	2007	2006	2005
R^2- Coefficient of determination	0.781	0.861	0.85	0.774	0.726	0.741	0.359
Beta- Unit change in independent variable brings beta change in dependent variable	0.884	0.928	0.922	0.88	0.852	0.861	0.599
Standard error of estimate	7.807	6.62	7.019	8.846	8.141	8.027	12.108
Level of Significance	0.000	0.000	0.000	0.000	0.000	0.000	0.000
F test	349.226	601.522	536.888	321.208	232.767	239.969	44.754

- There is a significant positive relationship between Tobin's Q and ROA.
- Coefficient of determination has been in the range of 0.72 to 0.86 except one year (2005). That is, on an average, 78% of change in ROA can be explained by change in Tobin Q.
- Value of *Beta* has been in the range of 0.85 to 0.92 except one year (2005). On an average if Tobin Q changes by 1 unit, the ROA shall change by 0.85 times. A positive value of beta can be construed as direct relationship of association but not necessarily of cause and effect.
- The standard error of estimate has been in the range of 6.62 to 8.84 except one year (2005). That is, on an average, the results shall hold true for 91.63% (100- average standard error of estimate) of the sample.
- The above test results show 95% confidence level with level of significance at 0.000 much lower than the stipulated 0.05.
- The statistical results pass the F test with the range of 232.77 to 601.52 except one year (2005).

Statistical Interpretations

Firms having good corporate governance measures perform well as compared to the firms having no or less corporate governance practices.[129]

A number of studies portray the relationship between good corporate governance and firm's performance by increased economic value to firms, higher productivity and lower systematic risk.[130]

A study of the 100 largest emerging market companies by Credit Lyonnais Securities Asia (CLSA)7 in 2001 showed that companies with the best corporate governance in each of a large number of emerging market countries had eight percentage points higher measures of EVA (economic value added) than firms in their country average. There is a perfect fit and correlation between corporate governance and financial performance ratios of the sample companies.[131]

A Harvard/Wharton team also found that U.S.-based firms with better governance have faster sales growth and were more profitable than their peers.[132]

Conclusions

Businesses adapting better corporate governance practices (as proxied by Tobin Q in our study) are rewarded by high profitability (as proxied by ROA in our study). It is of interest to note that there is a bipolar relationship between these variables where any of them can be treated as independent/ dependent variable.

The above proved relationship may solve business dilemma of benefits accruing out of

[129] Corporate Governance and Firm Performance, A Case study of Karachi Stock Market By Humera Khatab, Maryam Masood, Khalid Zaman, Sundas Saleem and Bilal Saeed published in International Journal of Trade, Economics and Finance, Vol.2, No.1, February, 2011

[130] Shleifer and Vishny, 1997; John and Senbet, 1998 and Hermalin and Weisbach, 2003

[131] Saints & Sinners: Who's Got Religion?" CLSA CG Watch, April 2001 available at http://webb-site.com/codocs/Saints&Sinners.pdf last accessed on March 21, 2012

[132] Gompers, Paul; Ishii, Joy; and Metrick, Andrew. "Corporate Governance and Equity Prices." Quarterly Journal of Economics 118(1), February 2003, 107-155 available at

following imposed corporate governance laws. Good corporate governance not only keeps companies complied with legal requirements but also help them to outperform their peers and make them more profitable.

Table 8: Linear Regression with Tobin Q as independent variable and ROE as dependent variable

Particulars	2011	2010	2009	2008	2007	2006	2005
R2- Coefficient of determination	0.645	0.726	0.719	0.662	0.522	0.596	0.262
Beta- Unit change in independent variable brings beta change in dependent variable	0.803	0.852	0.848	0.814	0.723	0.772	0.512
Standard error of estimate	9.446	8.945	9.848	10.241	10.519	9.0001	12.833
Level of Significance	0.000	0.000	0.000	0.000	0.000	0.000	0.000
F test	178.081	257.294	243.056	184.234	96.131	123.909	28.406

Statistical Interpretations

- There is a degree of positive relationship/ association between Tobin Q and ROE.
- However, Coefficient of determination is only in the range of 0.52 to 0.72 except one year (2005). That is, on an average 59% of change in ROE can be explained by change in Tobin Q.
- Value of Beta has been in the range of 0.72 to 0.85 except one year (2005). On an average if Tobin Q changes by 1 unit, the ROE shall change by 0.76 times.
- The standard error of estimate has been in the range of 8.94 to 10.52 except one year (2005). That is, on an average the results shall hold true for 89.88% (100- average standard error of estimate) of the sample.
- The above test results show 95% confidence level with level of significance at 0.000 much lower than the stipulated 0.05.
- The statistical results pass the F test with the range of 96.13 to 257.29 except one year (2005).

Conclusions

A relationship does exist between Tobin Q and ROE but may not be as significant as between Tobin Q and ROA. ROA and ROE in our calculations have the same numerator, that is, net profit after tax; the denominator is different in both cases, that is, Total Assets in case of ROA and Shareholders Funds (Total Assets Third Party Liabilities) in case of ROE.

On an average 92% of the sample cases had higher ROE than ROA. ROA does not differentiate between capital raised from shareholders or creditors whereas ROE only considers equity capital. ROE moves in tandem with ROA but is also impacted by other factors as leveraging decisions of the companies that is how they have funded their total assets by shareholders fund or external debt. In case of higher debt equity ratio the gap between ROA and ROE shall also widen. Hence movements in ROE in contrast to ROA cannot be comprehensively and fully explained by change in Tobin Q.

Thus, while there may be some individual trends noticed in different years for certain companies, these appear to be more because of sectoral and macroeconomic factors cannot clearly be said to be because of introduction of corporate governance mechanisms contained in Clause 49. Perhaps the most significant result is the shifting of the mean Tobin's Q over a period of seven years which would indicate whether Clause 49 has helped companies achieve better corporate governance. As indicated in table above this improvement of Tobin's Q ratio has not occurred, which, we believe, indicates that there are only a few companies which excel on corporate governance parameters while the vast majority of companies (60 to 70 per cent) have made no movement towards better corporate governance over the years, as perceived by the capital market.

The study has found some evidence that performance of the firms is affected by practicing good corporate governance policies and this may provide necessary reasoning for the management to implement such measures. However given various qualitative aspects to the corporate governance which may not be amenable to quantitative measurements and cannot be fully represented by Tobin Q, this study suggests building more holistic and robust proxy such as corporate governance index for measurement of effectiveness of corporate governance.

N. Balasubramanian, Bernard Black, and Vikramaditya Khanna[133] have built "Indian Corporate Governance Index" (ICGI) comprising 49 attributes normally identified with good governance. These attributes were grouped into five categories to provide sub-indices for:

- Board Structure (with sub-indices for board independence and board committees).

[133] Firm Level Corporate Governance in 'Emerging Markets, A Case Study of India' available at htpp://ssrn.com/abstract=995650, last accessed on March 21, 2012

- Disclosure (with sub-indices for disclosure substance and for auditor independence).
- Related Party Transactions (with sub-indices for volume of RPTs and approval procedures).
- Shareholder Rights.
- Board Procedure (with sub-indices for overall procedure and for audit committee procedure).

The study found a positive and statistically significant association between the company's India Corporate Governance Index (IGCI) ranking and its corporate performance. This association was found to be more significant for more profitable companies and those with greater growth opportunities. Post building of such an index, causality between corporate governance and corporate performance may be empirically tested and used for formulating an effective policy reforms in the field of corporate governance. The policy formulation should be based on a thorough and proper understanding of the underlying factors that impact corporate governance in turn effecting corporate performance.

Thus, we conclude that at this point of time there is no clear evidence of effectiveness of Clause 49 on performance of companies.

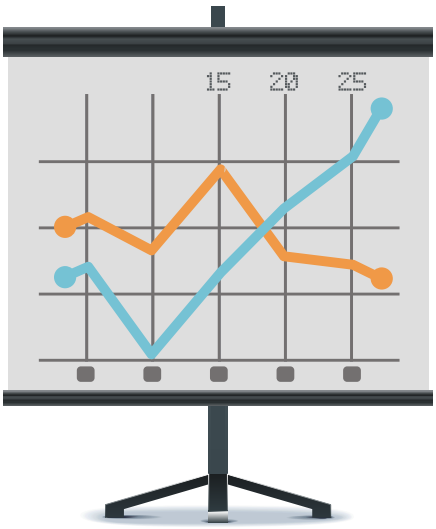
c) Study on SEBI's regulatory mechanisms at Assessing officer and Appeal Process levels

We have analysed SAT orders passed in the case of 100 appeals and the corresponding 100 Adjudicating Officer (AO)/SEBI orders passed to ascertain the effectiveness of the adjudicating and appellate process. The period of study for SAT orders ranges from 1 March 2010 to 30 September 2011, and the sample has been selected on a random basis within the constraints of data availability.[134]

The objective of the analysis is to study the nature of the offences, the time taken by SEBI to complete the adjudicating proceedings, the nature of penalties the levied, an analysis of whether the SAT orders signify independent decisions in favour of or against SEBI and reduction in penalties for appellant ensuring law of justice, the time taken to complete appeal proceedings at SAT, and finally the time taken at SEBI's end for the disposal of cases.

Methodology Followed

1. SAT orders were examined for the following parameters:
    - Date of the SAT order;
    - Name of the appellant;
    - Nature of the offence;
    - Whether the appeal was decided in favour of or against SEBI; and
    - Revised penalty.



2. The respective AO/SEBI orders were analysed to study the entire judiciary process pertaining to the following factors:

- Date of the order;
- Date of appointment of the AO;
- Date of issue of show cause notice;
- Time of offence; and
- Original penalty.

3. A detailed analysis was carried out to ascertain:

- The types of violations covered under these orders;
- The types of penalties charged by the AO/SEBI order;
- Whether the appeals were decided in favour of SEBI/appellant;
- The amount/quantum of penalties waived;
- The time lag between the date of offence and the date of appointment of the AO;
- The time lag between the date of appointment of the AO and date of the show cause notice;
- The time lag between the date of the show cause notice and the date of order passed by AO/SEBI;
- The time lag between the date of order passed by the AO/SEBI and the date of the SAT order;
- The time lag between the date of the SAT order and the date of offence; and
- The time lag between the date of the AO/SE
- BI order and the date of offence.

Assumptions of the Study/Limitations of the Data

1. The samples of 100 appellants with a maximum of two appellants in one SAT order have been considered.

2. The date of offence is the first date of violation. In cases of the offence relating to non-compliance with the summons issued by SEBI, the date of offence has been taken as the date of the first summons issued.

3. The date of appointment of the AO could not be found in case of ex-parte orders/investigations ordered by SEBI/otherwise (32 such cases). We could not ascertain the reasons as to why this date was not written in the orders. In five cases, the date of appointment of the AO follows the date of the show cause notice. Since the show causes are essentially those issued by the enquiry officer, they have been taken as enquiry cases.

4. In one case, no show cause notice has been issued, hence the date of show cause cannot be analysed.

In order to ascertain whether the outcome of the SAT order was in favour of SEBI/appellant, the following assumptions have been made:

- Appeals decided in favour of the appellant comprise cases wherein the order has been completely set aside or the monetary penalty has been reduced to zero.

- Appeals decided in favour of SEBI consist of cases wherein there is no reduction in the penalty or the order has been withheld by the appellant. Cases withdrawn unconditionally or cases settled through consent order have been also clubbed under the category of those that are favourable to SEBI.

- Appeals wherein the order has been withheld but the quantum or conditions or amount of penalty has been reduced by the appellate have been taken as 'Relief to the Appellant'. Cases wherein the order has been sent back to SEBI for further investigation or a fresh order has been issued have also been considered as 'Relief to the Appellant'.

6. In order to determine the nature of violations, data has been clubbed in the following manner:

a) Price manipulation applies to cases wherein the promoters or directors or broker of the company or the company itself has/have been involved in synchronized/circular/cross deals to create artificial volume and rig securities prices. It also applies to cases whereby false or misleading corporate public announcements have been made or insider trading has been done.

b) Takeover violation applies to cases wherein the regulations relating to the takeover code, that is, disclosures of more than 2/5 per cent of the voting rights, and the shareholding pattern of the company have not been followed.

c) Investors grievances' relate to the delays taking place in the companies in the dematerialization of shares, non-redressal of investors' grievances, huge selling in the shares with the objective of defrauding investors, delay in the refund of investors' funds, and non-implementation of the moral code of conduct to protect the investors' interest.

d) Violation of code of conduct of brokers encompasses the cases wherein the brokers have not maintained proper books of accounts, segregation of client moneys and own funds, and fund-based activities, or those pertaining to unauthorized terminals, and non-compliance of Know Your Client norms.

e) Non-responsiveness of the summons issued by SEBI applies to the cases of zero response or non-cooperation as to the quantum and timeliness of the information

submitted.f) Failure to pay stock-broker registration charges on a timely basis is also one of the violations.

g) IPO manipulation pertains to the cases wherein fraudulent financing of IPOs has been done to oversubscribe the shares and make disproportionate profits on the date of listing or to create benami shareholding. It also includes subscription undertaken to avoid under-subscription of shares.

7. This study cannot comment on the final collection of the penalty amount by SEBI.

Observations

1. Nature of the Offence

We have identified the nature of violations by categorizing them as depicted in Figure 3.

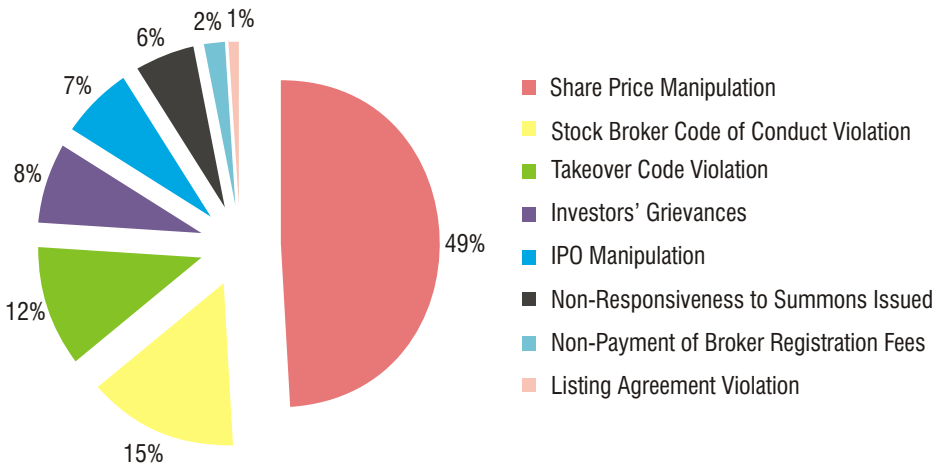
In our study, most of the cases pertain to share price manipulation or IPO manipulation (56 per cent), stock-broker code of conduct violations (15 per cent), and takeover code violation (12 per cent).

This reflects the state of the securities market wherein securities price manoeuvring is rampant either at the time of the issue of shares or later through the means of circular trades, synchronized deals and cross deals.

In such fictitious transactions, the beneficial ownership in the scrip does not change but artificial volumes are created, perhaps to lure common investors. In such cases, the price is derived not by a fair market mechanism but by creating an artificial buying pressure.

However, more research is required to comment upon SEBI's detection and disciplinarian role in such cases.

Figure 3: Nature of the Offence



2. Nature of the Penalty

The amount and nature of penalties are laid down in Section 15 of the SEBI Act. The penalties in our sample are depicted in Figure 4.

In 73 per cent of the cases, monetary penalty has been imposed. A further analysis of the penalties has been done in the following section on the disposal of cases.

3. Disposal of Appeals

The break-up of the disposal of appeals has been portrayed in Figure 5.

In 49 per cent of the cases, the appeal was decided in favour of SEBI while in the remaining 51 per cent of the cases, the appellant was given full or partial relief. In 49 cases, which were determined in favour of SEBI, a monetary penalty of Rs. 296.50 lakhs was levied.

In 51 cases, wherein the appellant received full or partial relief, a calculation was done to establish the amount of penalties waived by SAT. In order to facilitate the waiver calculation, eleven cases were excluded for the following reasons:

a) Impounding of money by SEBI, later on ordered to refund the impounded amount to the appellant.

b) Cases with monetary penalty sent back to SEBI for fresh order forming part of 'relief to the appellant', not considered.

c) Debarment from dealing in securities or cancellation of share broker certificate.

Figure 4: Nature of the Penalty

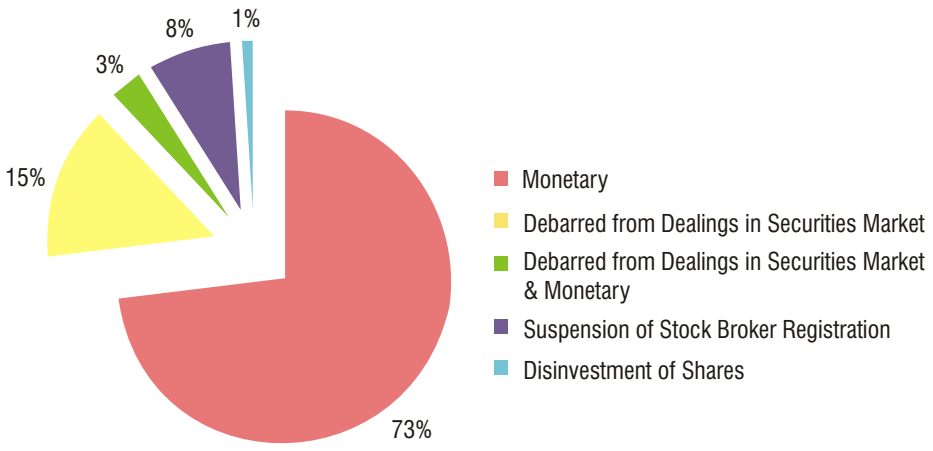
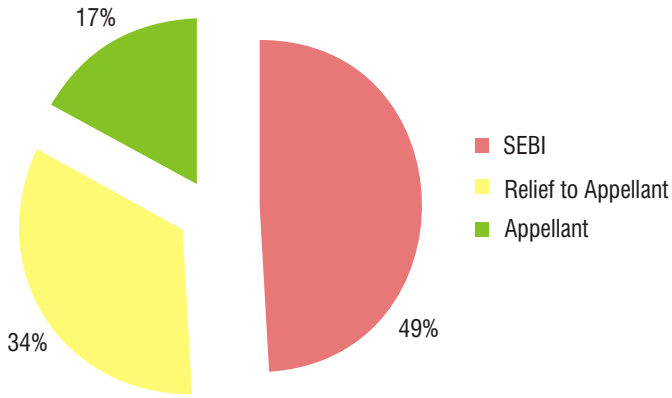


Figure 5: Break-up of Disposal of Appeals



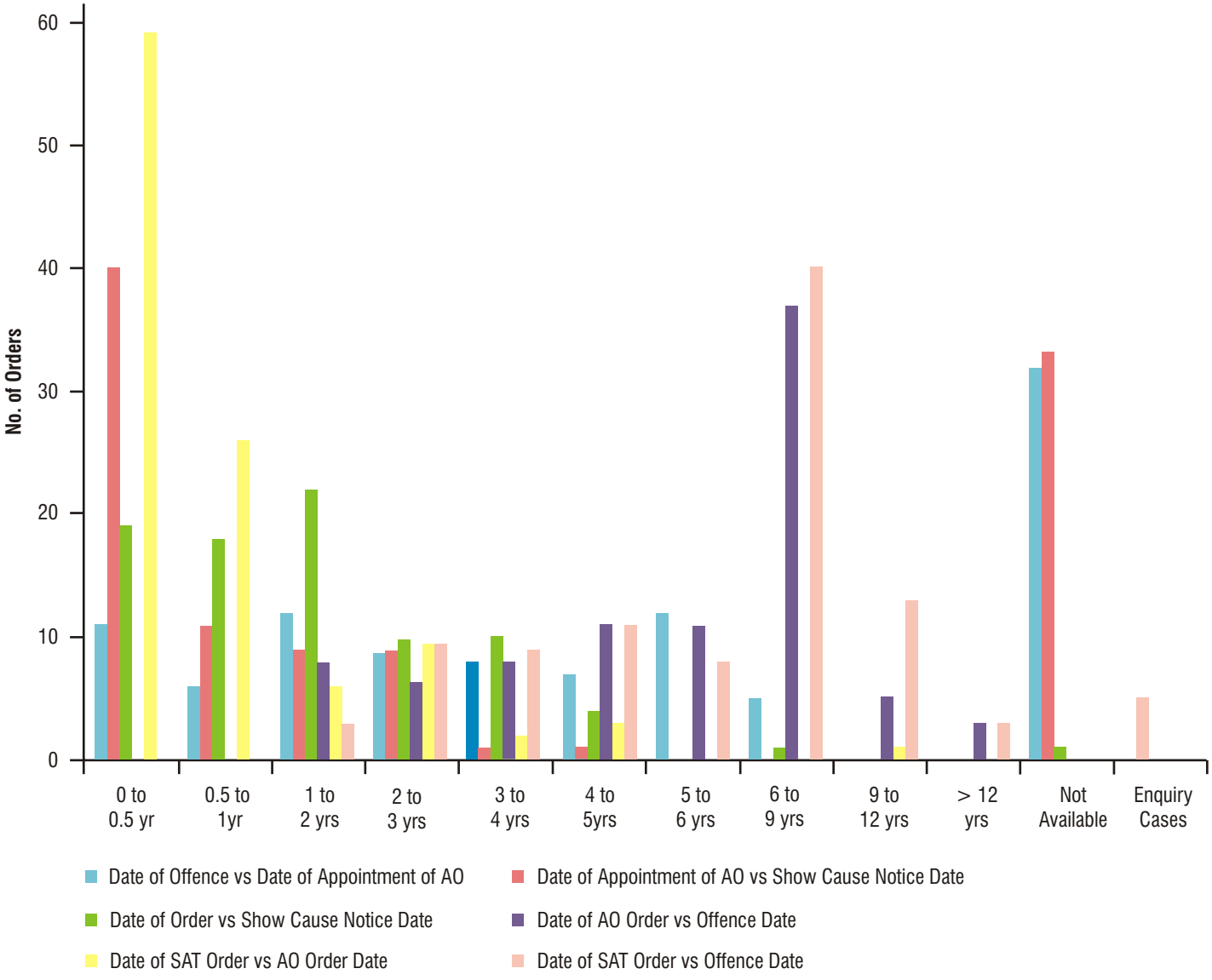
In the remaining 40 cases, the penalty was waived by 90 per cent, bringing the amount of Rs. 997.05 lakhs in the original order to Rs. 101 lakhs in the SAT orders.

These findings show a degree of ambiguity in the basis of the penalties levied by SEBI and also in the policy of reversal implemented later on.

4. Ageing Analysis of Cases

The ageing analysis of the SAT and AO orders has been depicted in Figure 6.

Figure 6: Ageing Analysis of SAT Orders and AO Orders



Interpretations

a) A comparison of the date of offence with the date of appointment of the AO to examine the time taken by SEBI to start punitive action in the case of default: In 25 per cent of the 68 cases wherein the date of appointment of the AO is available, the AO was appointed within a year. However, in 35 per cent of these 68 cases, it took SEBI more than four years to appoint an AO, that is, there was a delay of as long as four years in the appointment of an AO from the time of the violation. This may have resulted in loss of evidence and an increase in the investors' losses.

b) A comparison of the date of appointment of the AO with date of issue of the show cause notice to determine the time taken by the AO to initiate adjudicating proceedings against the violator: In 65 per cent of the 62 cases for which data was available, the AO has a show cause notice within six months, whereas in 32 per cent of these 62 cases, the AO took more than six months to issue the same. In 4 per cent of the cases, the show cause notice was issued after 36 months. In certain AO/SEBI orders, we have found instances of the transfer of the AO resulting in unwarranted delays. Further, there is no prescribed standard time within which the AO is required to issue a show cause notice, which leaves room for discretion.

c) A comparison of the date of order by the AO/SEBI with the date of issue of show cause notice to determine the time taken to complete the process of enquiry after the notice has been sent to the violator: In 37 per cent of the total cases, the proceedings were completed in one year. However, in 40 per cent of the cases, the completion of proceedings took more than two years. Such long periods of implementation of the process carry the risk of the defaulter becoming untraceable, of the destruction of circumstantial evidence, and of an increase in investor losses.

d) A comparison of the date of order by AO/SEBI with the time when the offence was committed to determine the time taken to actually punish the violation: In 25 per cent of the total cases, the order was passed within three years, whereas in 56 per cent of the cases, the AO/SEBI took more than five years to pass an order.

e) A comparison of the date of the SAT order with the date of passage of an order by the AO/SEBI to determine the time taken by SAT to complete the appellate proceedings: In 59 per cent of the total cases, the SAT proceedings were completed within six months. This shows efficiency in the disposal of cases by SAT.

   i. A comparison of the date of SAT order with date of offence to ascertain the time lag between the time of non-compliance and the final indictment

after first leg of appeal process is complete: It takes more than 5 years in 64% of the cases from the time of offence to the time of disposal of appeal at SAT with 16% in more than 9 years bracket.

The above analysis shows that the investigation and appeals process is slow, and often arbitrary and opaque. While the process framework is appropriate and in line with the best practices of justice and fair play, the problem lies in the implementation in routine everyday cases. The entire process of enquiry, adjudication, trial, decision, and appeal needs to be streamlined and the reasonable time frame strictly enforced to help SEBI perform its role as an efficient gatekeeper of corporate governance.

A consent order allows the compounding of an offence whereby an accused pays compounding charges in lieu of undergoing the consequences of prosecution.

d) Study of the Mechanism of Consent Orders and an Analysis of Its Prevalence and Effectiveness as a Deterrent, and the Transparency of the System

According to the SEBI guidelines of April 2007, a consent order means "an order settling administrative or civil proceedings between the regulator and a person (party) who may prima facie be found to have violated securities laws. It may settle all issues or reserve an issue or claim, but it must precisely state what issues or claims are being reserved. A consent order may or may not include a determination that a violation has occurred."

A consent order allows the compounding of an offence whereby an accused pays compounding charges in lieu of undergoing the consequences of prosecution. Consent orders were introduced with the objective of ensuring appropriate action, remedy and deterrence without the need for resorting to litigation, lengthy proceedings, and consequent delays. Consent orders can be passed in respect of all types of enforcement or remedial actions including administrative proceedings and civil actions. Any person who is notified that a proceeding may or will be initiated/instituted against him/her, or any party to a proceeding already initiated/instituted, may, at any time, propose in writing for settlement.

Consent orders are aimed to reduce the regulatory cost, time and effort spent on pursuing enforcement actions. We have analysed a few consent orders to determine the efficacy of the entire process. This has been done for the following periods:

- Analysis of consent orders over a period of two years from 1 September 2009 to 30 September 2011.

- Sample Study of 100 consent orders from 1 May 2009 to 30 September 2011 covering takeover regulations.

The above consent orders have been discussed for the respective periods below.

a) *Analysis of consent orders over a period of two years from 1 September 2009 to 30 September 2011:*

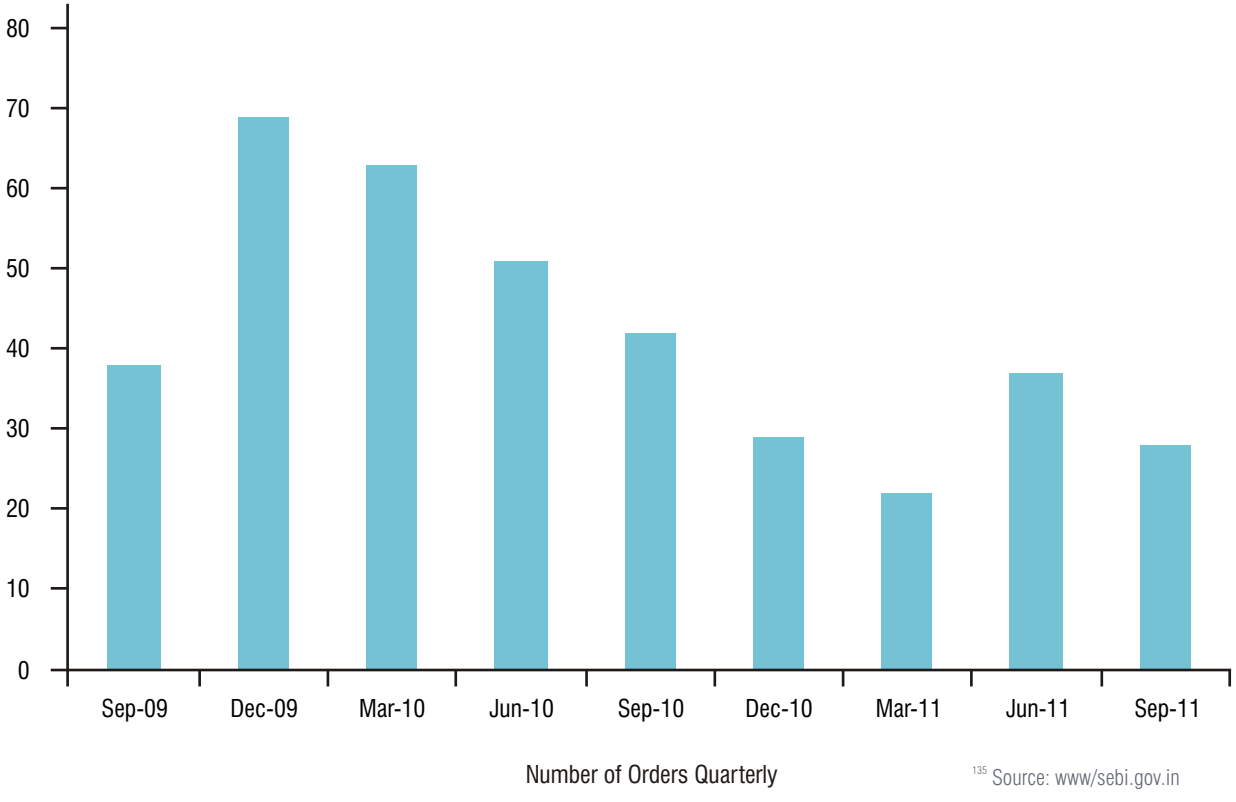
During the given period of two years beginning September 2009, a total of 379 consent orders were passed.[135]

The consent orders have been plotted quarterly and monthly in Figures 7, 8 and 9.

The data portrays a declining trend in the number of consent orders issued, from as high as 37 cases in the month of September 2009 to merely 10 cases in September 2009. The reason for this decline can be on account of a negative media opinion on the procedures followed in passing the consent orders.

The data pertaining to the given two years showed that multiple consent orders were passed for the same applicant. In the cases of 12 applicants, a repetition ranging from

Figure 7: Number of Consent Orders on a Quarterly Basis



[135] Source: www/sebi.gov.in

[136] Sources: www.takeovercode.com, www.sebi.gov.in, www.watchoutinvestors.com

two to four consent orders has been observed. However, the study cannot comment on group entities or persons acting in concert with the different applicants.

SEBI's consent order scheme aims to achieve a litigation-free alternative of achieving justice and discipline but over-enthusiasm in implementing this process may dissuade the honest law-abiders. This may also help the offenders to relieve themselves of severe regulatory action by just paying a paltry sum in the form of penalty. One of the considerations for passing the consent order and compounding charges is the applicant's past record, that is, if the latter has not been found guilty of any similar or serious violations in the past. However, allowing multiple consent orders from the same violator may encourage the tendency of violations without any fear of the law and its consequences.

b) *Sample study of 100 consent orders from 1 May 2009 to 30 September 2011 covering takeover regulations:* A sample of 100 consent orders was studied for examining the following points:

- Name of the applicant;
- Date of the consent order;
- Year/date of offence;
- Amount of penalty imposed;
- Date of application for the consent order; and
- Denial/admission of guilt.[136]

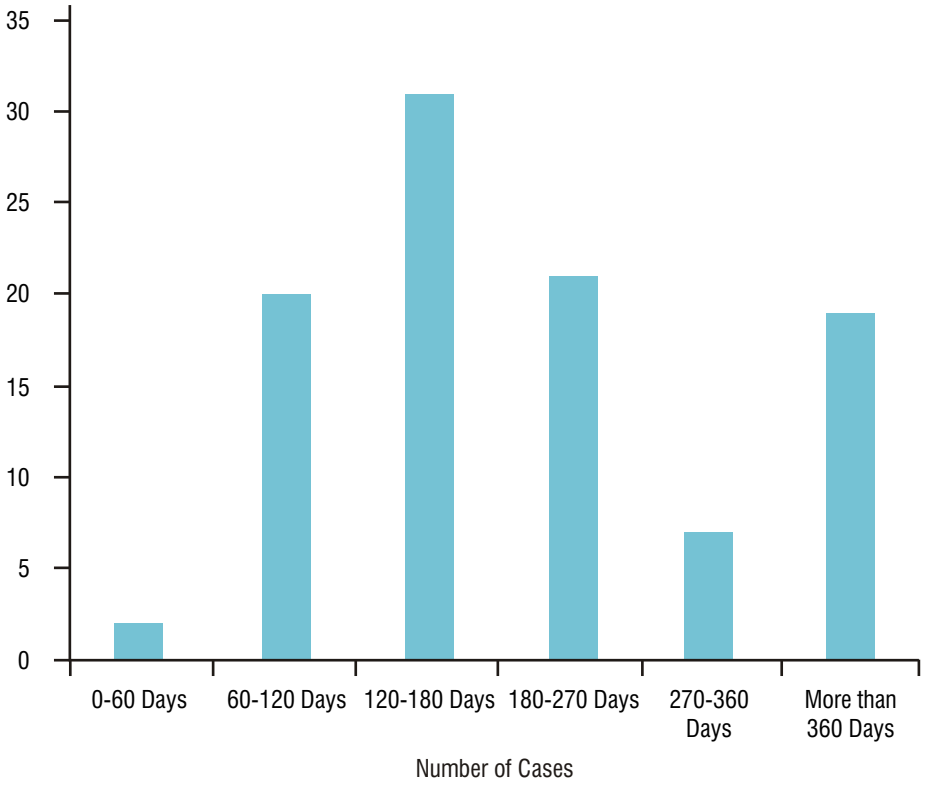
The above parameters were analysed for the following criteria:

1. Consent Order Date vs. Application Date

A comparison has been made between the date of consent order issued by SEBI and the date of application filed by the applicant requesting settlement by way of consent. In the case of filing of an application by multiple applicants, the first date has been considered as the date of application.

The time taken to complete the consent proceedings has been tabulated in Figure 8.

Figure 8: Time Taken for Completion of Consent Proceedings



It can be concluded that 53 per cent of the cases were resolved within 180 days, 28 per cent of the cases took 180360 days, while the remaining 19 per cent of the cases were resolved in more than 360 days.

Thus, SEBI's objective of avoiding lengthy legal proceedings, and delays in litigation was fulfilled through the issue of consent orders.

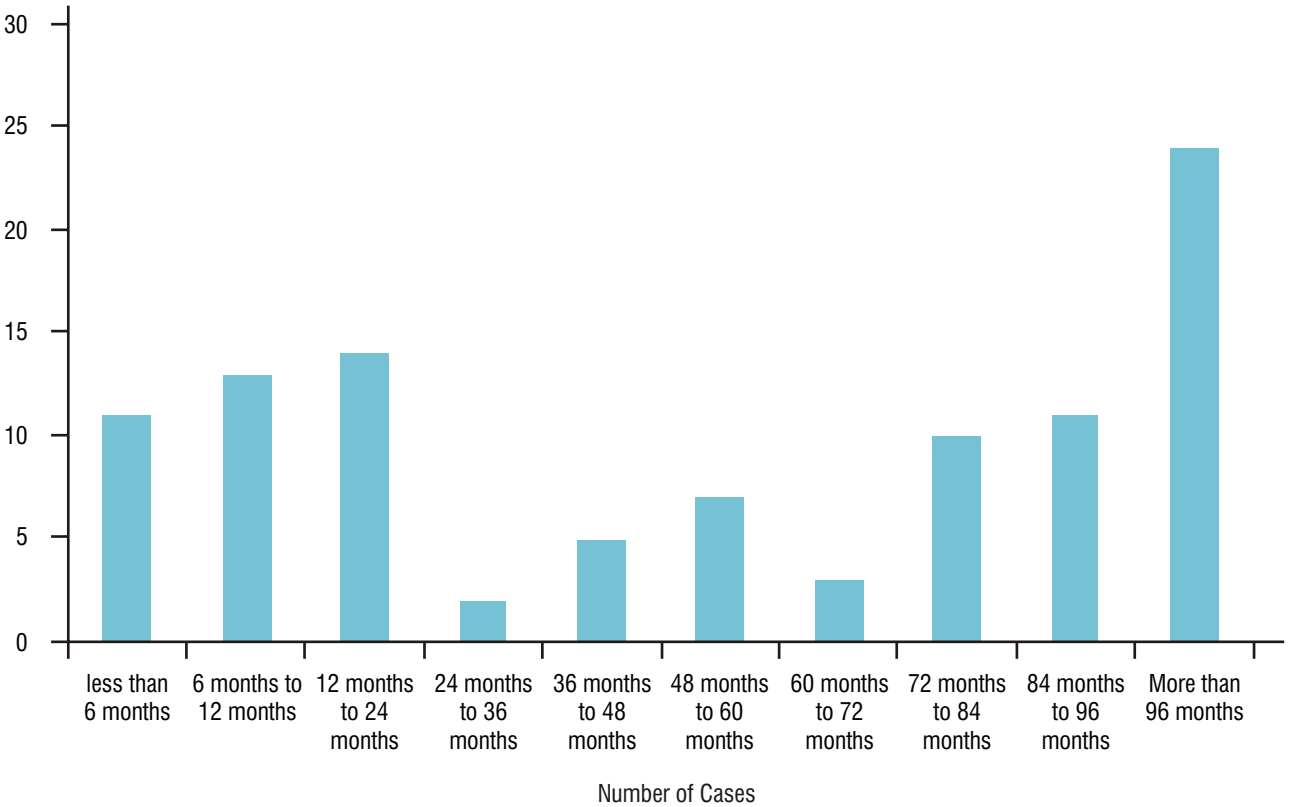
2. Date of Offence

The date of offence is defined as the date when the said regulation was not followed as per the text of the consent order. In cases where such a date is not clearly mentioned, the date of offence is taken as the middle of the year. In case only the year is mentioned or the date of adjudication is not available then the date of show cause notice issued by SEBI is taken. In the case of multiple and continuous failures over a period of time, an average date is taken, while in other cases, the first date is taken.

In the case of suo moto applications, when the date of offence could not be ascertained as above, the date of application is taken as the date of offence.

The ageing of the cases in terms of the gap between the date of passing of the consent order and the date of commitment of the offence has been captured in Figure 9.

Figure 9: Ageing of Cases



From Figure 9, it can be concluded that 35 per cent of the cases that are more than seven years old have been settled by way of consent order, which is perhaps the only way to recover dues, but 24 per cent of the cases are less than 12 months old wherein SEBI could have taken the normal route of prosecution, which could be a stronger deterrent than the consent order.

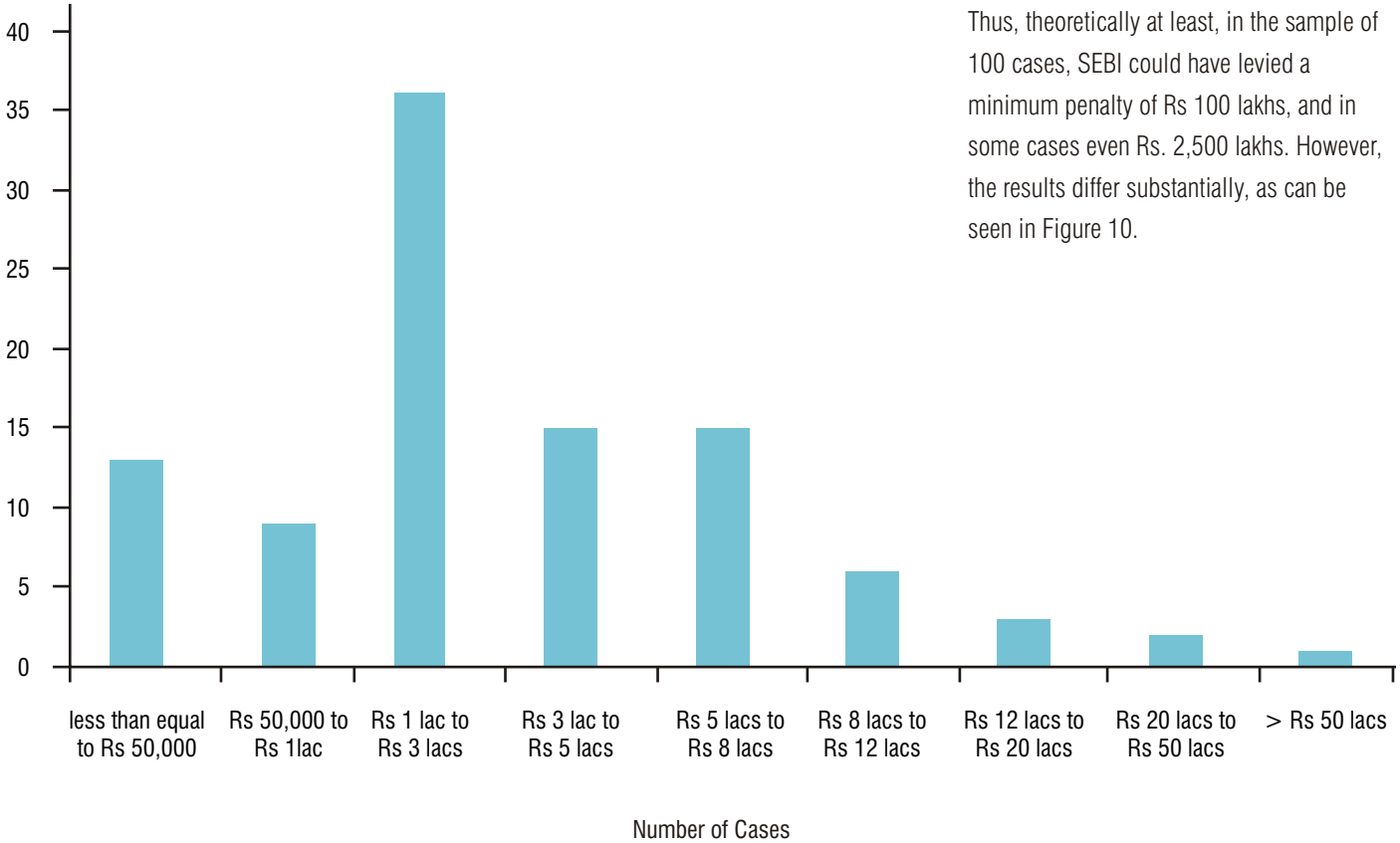
There are no clear guidelines that determine which type of cases may be settled through the consent order route, thereby leaving considerable scope for discretion.

3. Penalty Levied under the Consent Order

As per Section 15 of Chapter V of the SEBI Act, the penalty that can be levied for a delay in filling information/return, to enter into the agreement, to redress investors' grievances, etc., has to be Rs. 1,00,000 per day, subject to a maximum of Rs. 100,00,000. In the case of mutual funds, stock-brokers, and asset management companies, additional limits have been also specified. In the case of insider trading, the non-disclosure of acquisition of shares and takeovers, and indulgence in fraudulent and unfair trade practices, the penalty is three times the amount of the profit made out of such practice or Rs. 250,000,000, whichever is higher.

Thus, theoretically at least, in the sample of 100 cases, SEBI could have levied a minimum penalty of Rs 100 lakhs, and in some cases even Rs. 2,500 lakhs. However, the results differ substantially, as can be seen in Figure 10.

Figure 10: Penalties Imposed by SEBI under the Consent Orders

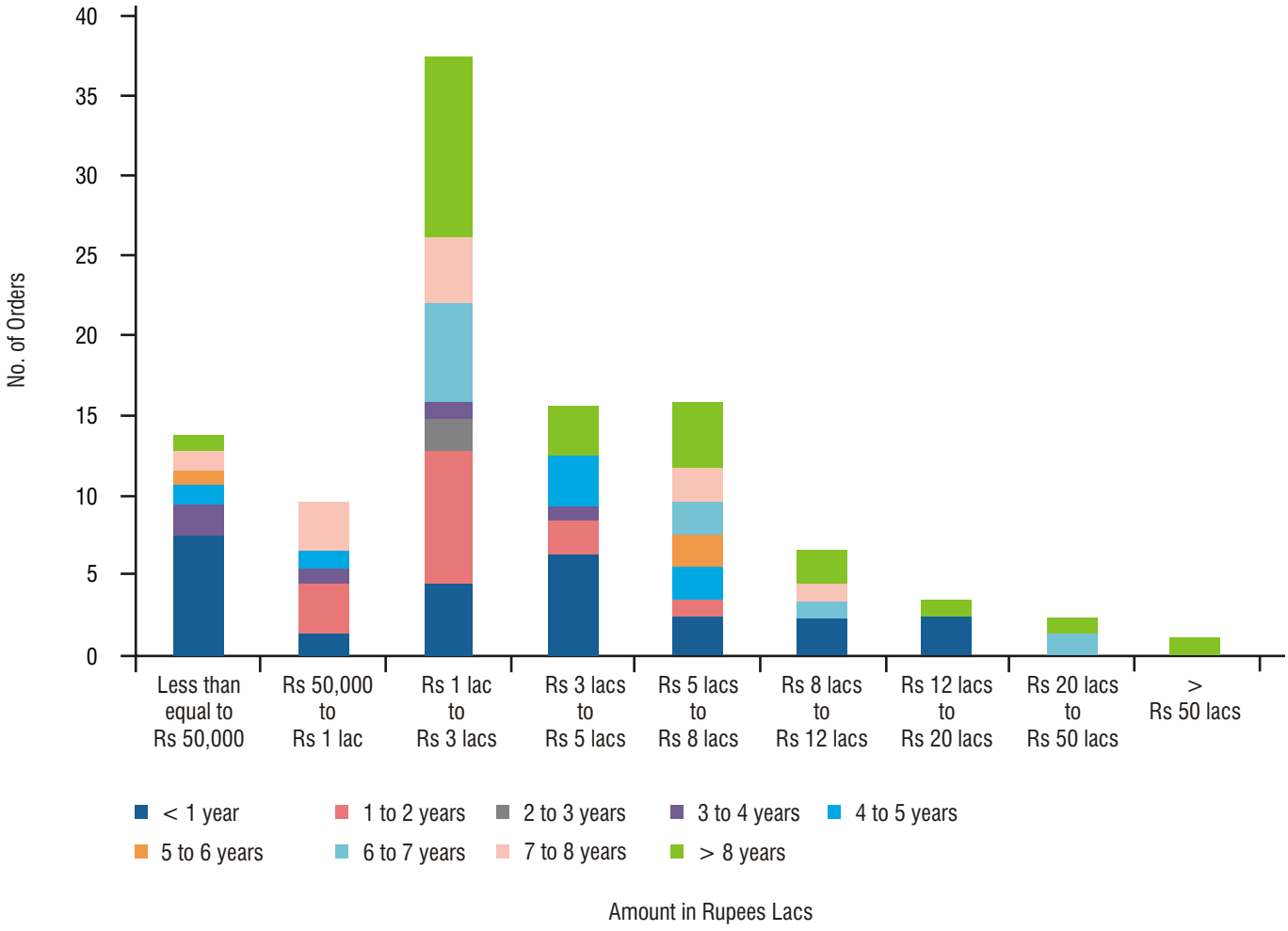


In 58 per cent of the cases, the penalty levied by SEBI was less than Rs. 3 lakhs resulting in revenue loss to SEBI and consequently, a weaker monetary deterrent for regulatory lapses.

As per Section 15J of the SEBI Act, while determining the quantum of penalty, the AO should consider the amount of disproportionate gain/unfair advantage accruing to the defaulter, the amount of loss caused to the investor group, and the repetitive nature of the default. Compounding of offences has been allowed under the SEBI Circular of Consent Order in lieu of prosecution. However, an attempt to determine the basis of the penalties levied as part of the study has remained inconclusive.

We have mapped the amount of penalty levied and the ageing of each case and the results are delineated in Figure 11.

Figure 11: Penalty Levied in Comparison with Ageing of the Case



No conclusive correlation can be drawn between the ageing of the case and the amount of penalty levied.

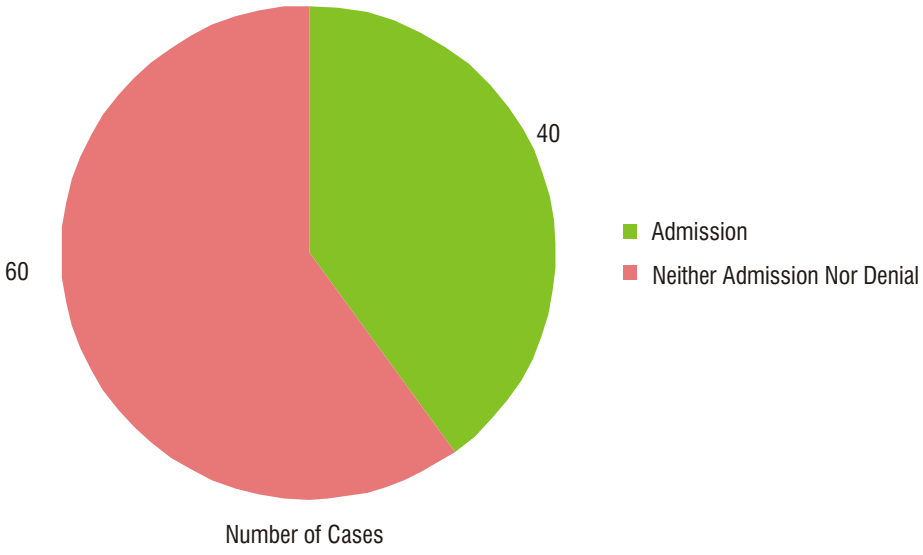
It is difficult to determine whether SEBI has truly taken into account the magnitude of the default and the loss to common investors while passing the consent orders. The results of the study show subjectivity in the amount of penalty recovered.

4. Admission/Denial of Guilt

As per the SEBI circular on consent orders, "Consent orders can be passed either a) admitting guilt or b) without admitting or denying guilt".

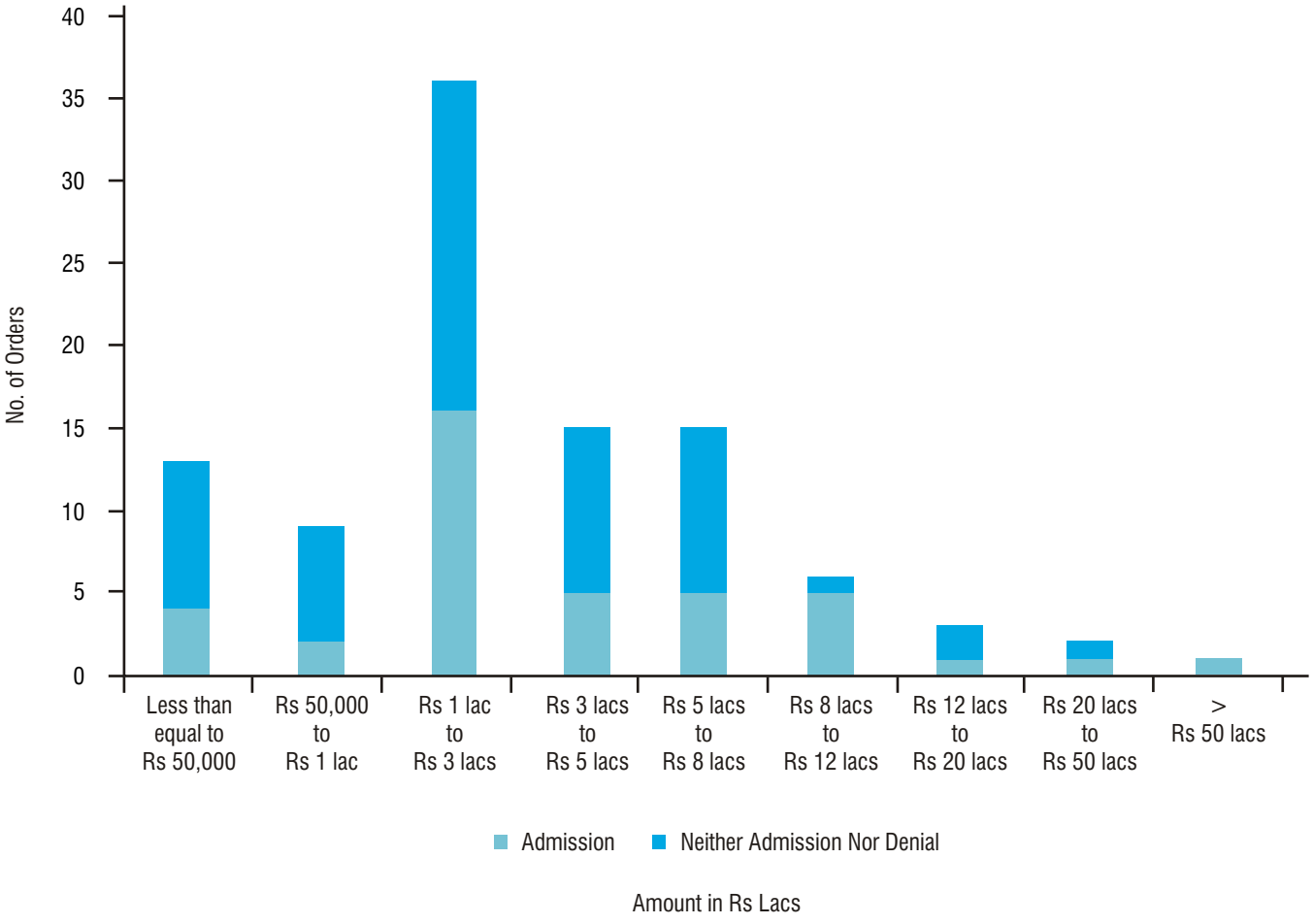
In 60 per cent of the sample cases of consent orders, settlements were reached with the applicants without admitting or denying guilt, though the latter is specifically mentioned in the consent order. However, in the remaining 40 per cent of the cases, the words 'neither admission nor denial of guilt' or similar words are not mentioned to indicate this, and, therefore, here it is assumed to be the applicant's admission of guilt. The proportion of cases showing either the denial/admission of guilt or neither is portrayed in Figure 12.

Figure 12: Proportion of Cases Showing Admission/Denial of Guilt or Neither



However, no correlation can be derived between the amount of penalty levied and denial/admission of guilt on the basis of the above assumption. The amount of penalties levied as compared with the admission/denial of guilt is delineated in Figure 13.

Figure 13: Amounts of Penalty Levied in Comparison with Admission/Denial of Guilt



5. Suo Moto Cases

In 13 out of the sample 100 cases, the applicant had suo moto filed for settlement through consent before the initiation of the adjudication proceedings by SEBI. In three out of these 13 suo moto cases, the settlement was without the admission or denial of guilt, pointing towards the opacity of the entire process.

In the rest of the 87 cases, the consent application was filed during the adjudication proceedings.

It can thus be concluded that the system of consent orders may be effective for settling cases but it lacks transparency and is marred with opacity in terms of the following factors:

- The amount of penalties to be levied;
- Non-acceptance of new cases on the parameter of time of default;
- Compounding of offences;
- Time limit for reaching settlements; and
- Criteria for accepting applications in the case of repeat offenders.

We also noticed that the AO is very powerful in the entire process and plays a significant role in the issue of show cause notices, enquiry, forwarding of the case for settlement, and acting as the approving authority in consent orders, which calls for greater transparency and clearer guidelines.

We conclude that SEBI has played a big role in instituting a basic standard of corporate governance in the country, albeit only for listed companies. However, research shows that if one sector of an economy displays certain behaviour, there is a spill-off effect on other sectors as well, and thus, corporate governance norms in listed companies may reasonably be expected to influence the adoption of such practices in unlisted companies and other businesses too.

The study could not find any conclusive evidence that the adoption of corporate governance norms as mandated by SEBI has led to any improvement in corporate performance as measured by the accepted standards of Return on Assets (RoA) or Return on Equity (RoE). While profitability per se as well as share prices have shown a consistent upward trend, there is no clear evidence that this is because of improved corporate governance alone and not due to a mix of macro- economic factors.

G. Sabarinathan[137] has conducted a review of SEBI's performance in areas such as disclosures, and corporate governance, among other things. Overall, the analysis in Sabarinathan (2010) indicates that SEBI has led the effort in improving the standards of corporate governance in India in companies that are already listed or are about to be listed. He points out, "It is hard to say whether that is the result of poor legal preparation on the part of SEBI or the leniency of the appellate systems towards the trade.

[137] Sabarinathan, G., 2010. "SEBI's Regulation of the Indian Securities Market: A Critical Review of the Major Developments" available at http://www.vikalpa.com/pdf/articles/2010/Vik354-02-ResGSabarinathan.pdf last accessed on April 10, 2012

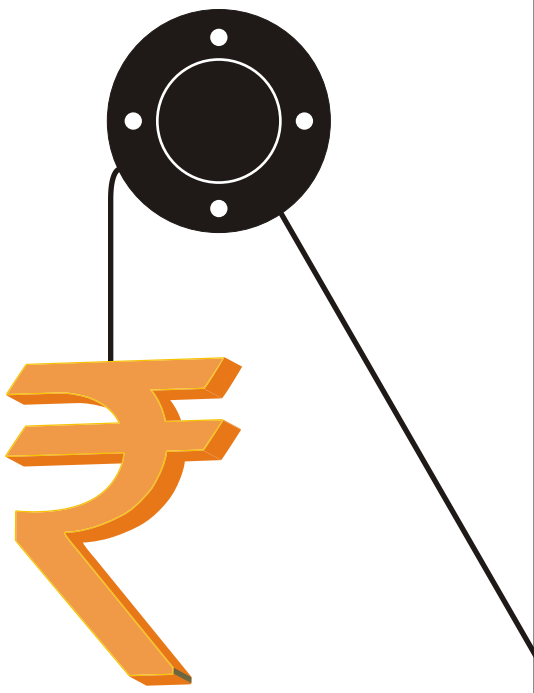
"Similarly, SEBI's record in enforcing the canons of corporate governance has not been impressive. The reason for the same may partly be the regulatory arbitrage that has been noted earlier due to the joint responsibility for oversight of companies between the MCA and SEBI. For reasons that are understandable, the two agencies approach regulatory oversight somewhat differently and are endowed with different organizational and legal capacities in the enforcement of their regulatory remit. The Indian corporate sector took advantage of this arbitrage when it successfully pushed back the initial, more demanding set of recommendations of the Committee headed by Mr. Narayana Murthy."

Black and Khanna (2007) have tried to estimate the impact of compliance with Clause 49 on the market valuation of companies in India. Their study concludes that faster growing firms gained more than the other firms, with firms that need external equity capital benefiting more from governance rules. Cross-listed firms gained more than the other firms, suggesting that local regulation can sometimes complement, rather than substitute for, the benefits of cross-listing.

The positive reaction of large Indian firms contrasts with the mixed reaction to the Sarbanes-Oxley Act (which is similar to Clause 49 in important respects), suggesting that the value of mandatory governance rules may depend on the prevalent institutional environment in a particular country.[138]

Although SEBI is a young institution, it has been fairly successful in fulfilling its mandate as the capital market regulator, ensuring the deepening of markets and the increasing participation of investors. However, the enforcement process tends to be somewhat arbitrary and rather opaque, and leaves scope for discretion in the hands of officials. The system of enforcement is also slow as the following statistics show: As per the Annual Report of SEBI for 201011, pp. 110112, there are 3493 pending cases as on 31 March 2011. An analysis of these cases reveals that as many as 32 per cent of the pending cases show an ageing of six or more than six years, while 28 per cent of the cases have been pending for 3 to 5 years (Annexure I). During the year 201011, a total of 1801 cases were disposed of by SEBI; out of these, 9 per cent of the cases pertain to the year 20042005, indicating that the cases were more than six years old, while 41 per cent of the disposed cases were 35 years old. Only 18 per cent of the cases pertain to the year 201011 (Annexure II).

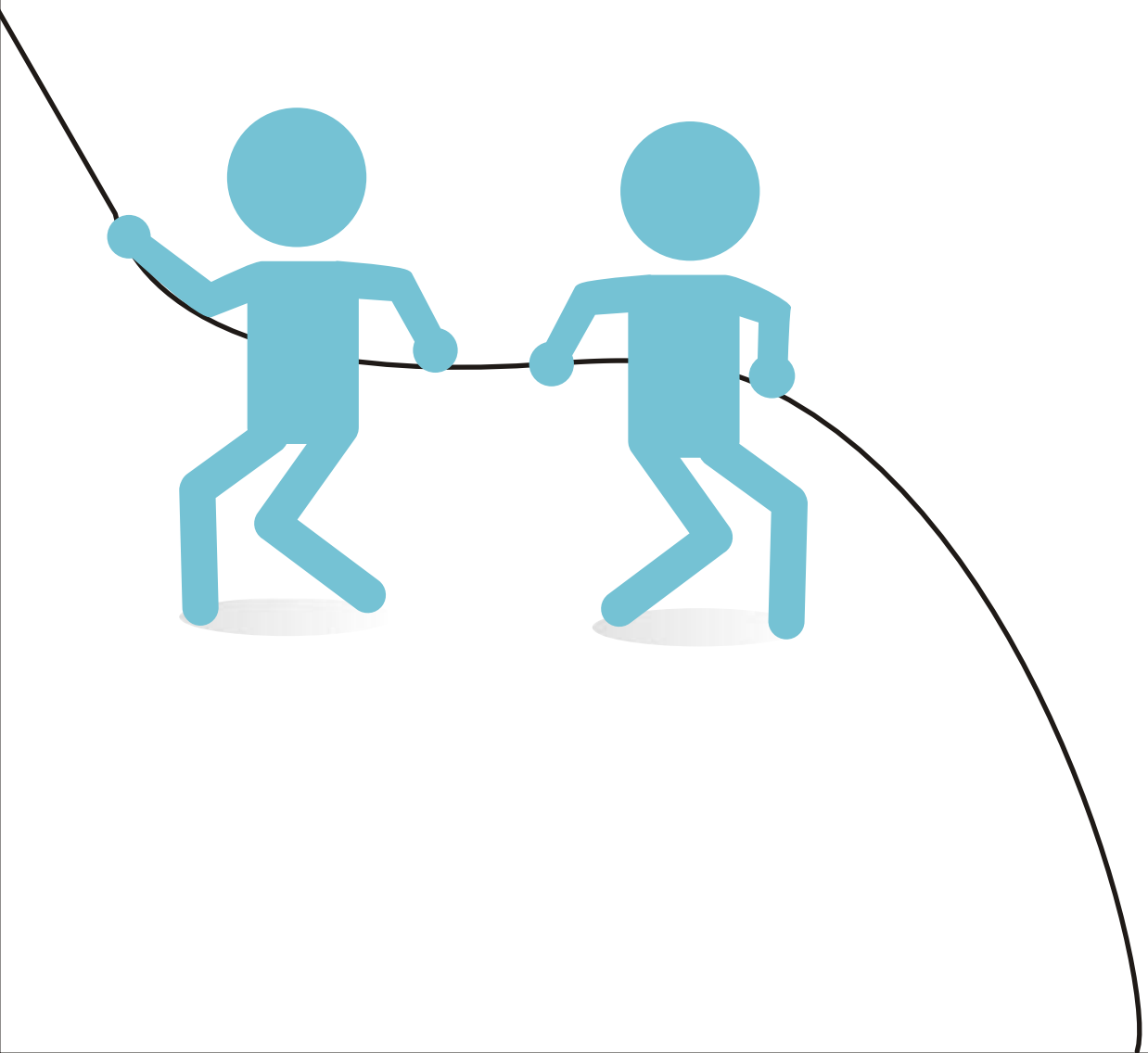
It becomes clear that even with attentive crafting of detailed governance rules by a group of elites with a deep understanding of corporate governance standards around the world, the reform process is useless if an effective infrastructure for enforcement and implementation is not in place".[139]



[138] Khanna, Vikramaditya S. and Bernard S. Black, 2007. "Can Corporate Governance Reforms Increase Firms' Market Values? Evidence from India", Journal of Empirical Legal Studies, Vol. 4; ECGIFinance Working Paper No. 159/2007; University of Michigan Law and Economics, Olin Working Paper No. 07002. Available at: http://ssrn.com/abstract=914440)

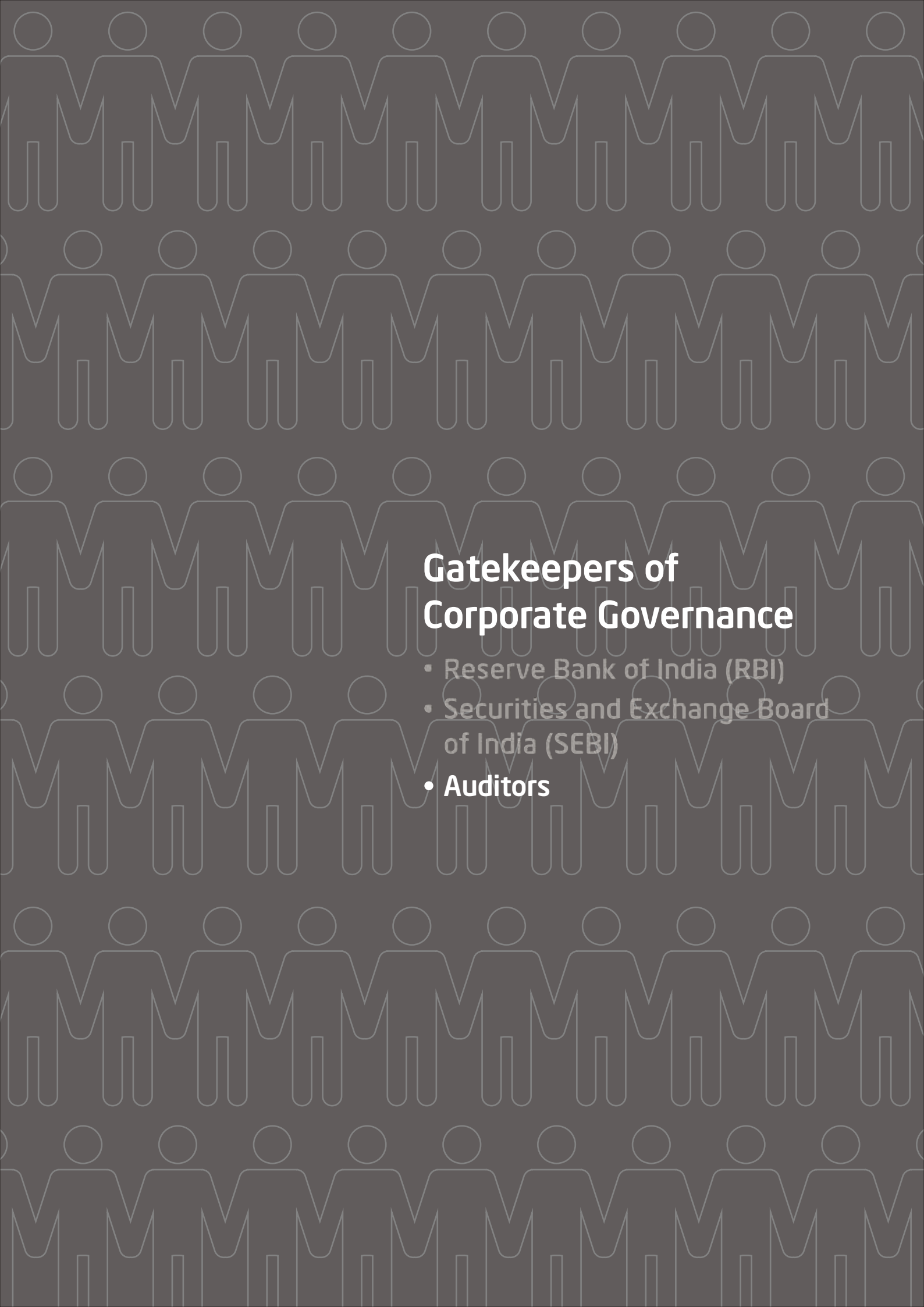
[139] Afra The Promise and Challenges Of India's Corporate Governance Reforms, Afsharipour, available at http://ssrn.com/abstract=1640249

The enforcement system, therefore, needs to be made more transparent in order to ensure greater confidence in capital markets. While the inherent spirit of framework is robust and in line with best practices of bringing timely justice and fair play, the problem lies in the implementation which needs to be more effective for capital markets to be buoyant and transparent.



Epilogue

Without doubt, ever since the inception of SEBI in 1992, there has been a comprehensive improvement in the functioning of capital markets in India. SEBI's greatest contribution has been the increase in the extent of disclosure of information in both the primary and secondary markets. It continues to move in this direction. As a result, the markets are expected to become more rational and reasonable, being based on hard data; also, more participative with increase in transparency. SEBI along with RBI could be said to be instrumental in ensuring a dynamic investment environment in India. It would be interesting to note how things evolve from this point; there are bound to be some overlaps and blind spots, which may need sorting-out.



Gatekeepers of Corporate Governance

- Reserve Bank of India (RBI)
- Securities and Exchange Board of India (SEBI)
- Auditors

AUDITORS

Judging by the Fairness of the Numbers

Kshama V Kaushik, Kaushik Dutta, Rewa P Kamboj

Accounting fraud is probably as old as commerce. No matter how many systems are designed to prevent dishonesty in management of companies, there will always be the odd case. Prevention is said to be the best cure; a proper governance mechanism may be the best way to forestall fraud. Auditors have an important role to play in protecting the integrity of financial information which is the life blood of the entire financial system; the profession has done well by evolving a professional set of standards, practices and rules to this effect. In the implementation however there seems to be some disconnect which needs to be bridged to regain confidence in the value of audited financial information.

Auditors as Gatekeepers

Auditors constitute one of the most important components of gatekeepers who are charged with maintaining corporate governance norms in companies.

Because of the centrality of the auditor's role in vouching for the integrity of such financial information, auditors are regarded as gatekeepers to the entire public securities markets and, as it were, 'keeping the faith' of investors, regulators and other stakeholders. Financial statements that go through an external audit rigor are the touchstone for all the stakeholders in a market economy. These financials form the basis of all the investment and financial decisions of the stakeholders through price determination of equity shares. The External auditors by virtue of their independence and professional competence are considered as principal gatekeepers or conscience keepers.

Regulatory Framework Governing Auditors in India

Auditing is defined as an independent examination of financial information of any entity, whether profit oriented or not, irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon. External auditor / Statutory auditor is an independent individual or firm engaged to express an opinion on whether the financial statements are free of material misstatements and whether they show a true and fair view of the financial position of the company.

Legal Status

Auditing profession is governed by The Institute of Chartered Accountants of India, a statutory body established under an act of the Indian Parliament whose mandate includes: pre-qualification education, setting

Auditors constitute one of the most important components of gatekeepers who are charged with maintaining corporate governance norms in companies.

accounting and auditing standards, code of ethics for professional conduct and continued professional development. As per the Companies Act, 1956 only a member of ICAI, holding a certificate of practice can be named as an auditor of a company and such an auditor may be an individual or a partnership firm with all the partners being practicing members of Institute of Chartered Accountants of India.

This indicates that the law holds an auditor personally responsible for conducting an audit; also such a person must be free from any constraints while conducting the audit, which is why the Companies Act specifies persons who may not be appointed as an auditor such as a body corporate, an employee of the entity, a debtor, etc., since such persons either cannot be held personally liable or cannot function without encumbrance.

Every company incorporated under the Companies Act is required to get its accounts audited by a Chartered-Accountant-in-practice to ensure true and fair view of the accounts—such an audit is called a 'statutory audit'. Statutory Audit ensures reliability of annual accounts of the company for various users of financial information of a company. To ensure that auditors spend sufficient time on each client and therefore maintain the quality of assurance, the law prescribes limits on the number of audits that a single person may carry out.

The first auditor of a company is appointed by the board of directors, while subsequent years' auditors are appointed by the shareholders in a general meeting. A casual vacancy not caused by resignation may be filled by the board of directors, but a vacancy due to resignation of an auditor has to be filled up only by the shareholders in a general meeting. The central government can step in to appoint an auditor when shareholders of a company fail to appoint one.

The board of directors has no power to remove an auditor; that power rests with the shareholders in an annual general meeting. But if the shareholders want to remove an auditor before expiry of his/her term, they have to seek prior approval of the central government for it. Even so, a special notice must be given to all shareholders for calling a meeting in which an auditor is to be removed, or if the company does not want to re-appoint the retiring auditor.

In case of companies where a public financial institution or state government holds more than 25% of the share capital, the statutory auditor must be appointed by special resolution (by 2/3rds majority of shareholders). In so-called government companies (where not less than 51% of shares is held by central or state government or jointly) and in statutory corporations (set up under a special act of Parliament), the auditor is appointed by the Comptroller and

Auditor General of India through an empanelment process of the ICAI.

The process of appointing auditors in public sector banks is also subject to stringent checks; such banks may choose auditors from a list of auditors vetted by the CAG and ICAI through a stringent empanelment process and the final selection must be approved by the RBI. Once appointed, an auditor usually works on that branch for three to four years, which is a provision to safeguard his/her independence.

An auditor may be removed by the bank only with the prior approval of the RBI. In addition to these strict provisions for appointment and removal, there are several rights of the auditor that are protected by the Companies Act in order to ensure that s/he conducts the audit fearlessly, independently and have access to all information necessary.

Some of these rights are:

a) Right to collect information to be given in Balance Sheet and Profit and Loss Account.[140]
b) Right of access to books and vouchers.[141]
c) Right to obtain information and explanations.[142]
d) Right to visit branch office and access to branch accounts.[143]
e) Right to signature for authentication.[144]
F) Auditors report to be read at the Annual General Meeting[145]
g) Right to receive notice[146]
h) Right to attend general meeting[147]

Under the Indian legal system, the office of the auditor enjoys high protection where appointment and removal must be transparent and clear with little room for arbitrariness. Apart from protecting the office of the auditor, Indian law also protects against negligence of the auditor.

An auditor is liable to make good the loss that members or investors of a company may suffer as a result of negligence on his part in the due performance of his duties. If there is fraud on his part, the auditor will be liable in tort. Claims may also arise from the auditor failing to detect defalcations or discover errors that may have put the company at loss.

However, it is necessary to prove the following before an auditor is held liable for fraud:

- The statement signed by him was untrue in fact
- That the auditor knew that it was untrue or was recklessly ignorant, whether it was true or not
- That the statement was made with the intent that the other party should act on it
- That the other party did in fact rely on it and consequently suffered damage

The shareholders can hold auditors for the losses suffered by them in case it can be established that they relied upon the auditors for making investments.

[140] Section 211 of the Companies Act, 1956

[141] Sub section (1) of Section 227 of the Companies act, 1956

[142] Sub section (1) of Section 227 of the Companies act, 1956

[143] Sub section (2) of Section 228 of the Companies Act, 1956

[144] Section 229 of the Companies Act, 1956

[145] Section 230 of the Companies Act, 1956

[146] Section 231 of the Companies Act, 1956

[147] Section 231 of the Companies Act, 1956

Role of ICAI in Maintaining Audit Standards and Quality

Institute of Chartered Accountants of India (ICAI) is the apex body in India that regulates the accounting and auditing profession. ICAI has brought out various Statements, Auditing and Assurance Standards, Accounting Standards and Guidance Notes, which are mandatory for a practicing Chartered Accountant to follow while discharging his professional duty of attestation of financial statements.

A Chartered Accountant who does not follow these standards in discharging the duty of attestation is considered guilty of professional misconduct and is liable for disciplinary action and punishment under the ICAI Act, which may include an official reprimand, removing his/her name from the register of members for a period of time, approaching the High Court for meting out punishment of a more serious nature, etc.

The Chartered Accountants Act, 1949 also contains provisions to ensure independence of the statutory auditors. It prohibits acceptance of fees, which are either linked to profits or otherwise dependent on the findings or the results of engagement.
It is an act of misconduct for a Chartered Accountant to express an opinion on the financial statements of a business in which he or his firm or a partner of his firm has a substantial interest unless disclosure of such interest is made.

A chartered accountant in practice is considered to be guilty of professional misconduct if he accepts a position as auditor previously held by another Chartered Accountant without communicating with him in writing. The objective is not to obtain a no objection certificate from the outgoing auditor, but to know the reasons for change in auditor to be able to safeguard his own interest, the legitimate interest of the public and the independence of the auditor, besides finding out if there are any professional or other reasons for not accepting the appointment.

The work of a chartered accountant involves maintaining up-to-date knowledge of professional matters and a continuous process of learning new developments and processes of auditing. ICAI has set up a Continuous Professional Enhancement Committee to help maintain highest standards of professional services. This initiative of ICIA provides inputs to members by way of seminars, lectures, background material and educating in use of electronic media.

Continuous Professional Enhancement (CPE) requirement is mandatory for members in practice, with effect from 1st January 2003 (presently set at 6 hours per annum and 25 hours in a block of 3 years).

Comptroller and Auditor General (CAG)

The CAG is responsible for oversight of financial health of Public Sector Units. The organisations subject to the audit of the Comptroller and Auditor General of India are:-

- All the Union and State Government departments and offices including the Indian Railways and Posts and Telecommunications
- About 1500 public commercial enterprises controlled by the Union and State governments, i.e. government companies and corporations
- Around 400 non-commercial autonomous bodies and authorities owned or controlled by the Union or the States
- Over 4400 authorities and bodies substantially financed from Union or State revenues
- The Central PSUs listed on Bombay Stock Exchange (excluding Public Sector Banks and State Level Public Enterprise) have a market capitalisation of Rs 15.45 trillion as on April 30,2011 constituting 22.37% of the total market capitalisation at BSE[148]

Audit of Public Sector Undertakings

Under Section 619 of the Companies Act, 1956, the statutory auditor of a government company including deemed government company, is appointed by the CAG, who also conducts a supplementary audit of the company and issues comments or supplements the audit report of the statutory auditor.

ICAI draws up a panel of firms of practicing chartered accountants to form part of a databank of firms who can conduct audits of PSUs. CAG may choose firms from this databank based on certain parameters on a suitability grid such as experience, numbers of partners/qualified personnel and years of association with the firm, past performance, etc. However, CAG does not whet the suitability of firms or check the veracity of declarations made by candidates during the empanelment process.

PSU firms form a major sector of the Indian economy and it is important to maintain a high standard of audit of its financial information. The quantity and quality of resources at the command of an audit firm determines the quality of audit of the PSU. Therefore, a more rigorous enquiry of suitability of firms must be undertaken by the CAG as the hiring entity.

CAG has also taken the following additional steps for independence of the auditor:

- Acceptance of non-audit assignments by the statutory auditors is prohibited for the year of audit and for one year after the firm ceases to be the statutory auditor
- Rotation of auditors after every 4 years

The CAG plays an oversight role by monitoring the performance of the statutory auditors and ensuring that the same is done properly and effectively.

[148] Source: (http://www.dnb.co.in/TopPSU2011/PSU_updates.asp)

The statutory auditors are required to submit the Audit Report to the CAG under Section 619(4) of the Companies Act, 1956. The certified accounts of selected government companies along with report of the statutory auditors are reviewed by CAG. Based on review through supplementary audit, significant audit observations are reported under Section 619 (4) of the Companies Act, 1956 to be placed before the Annual General Meeting.

CAG has introduced the system of three-phased audit in order to improve the total quality of engagement in their audits of public sector undertakings (79 in 2008-2009 and 114 in 2009-2010).
The objective of a three-phased audit is to:

- Establish an effective communication and a coordinated approach amongst the statutory auditors, management and the CAG audit team for removal of inconsistencies and doubts relating to the financial statements presented by the PSUs.

- Identify and highlight errors, omissions, non-compliances etc., before the approval of the financial statements by the management of the PSUs and provide an opportunity to the statutory auditors and the managements of the PSUs to examine such issues for taking timely remedial action.

- To reduce the time taken for CAG's audit after the approval of financial statements by the management of the PSUs

This approach has brought improvement in the quality of financial statements, which CAG has quantified for 2011 fiscal for 61 PSUs as:

Profitability	Rs 2,273 crores
Assets/ Liabilities	Rs 11,470 crores
Amendments to Notes to Accounts	Rs 4,041 crores
Classification Mistakes	Rs 5,070 crores

The quantum of change due to the changes made in the approach of audit makes the new process both productive and effective in safeguarding assets of public sector companies.[149]

Robustness of Legal Framework

From this overview of legal provisions and the regulatory mechanism pertaining to auditors it is evident that the Indian legal system takes protection of the office of the auditor and maintaining its independence very seriously. Auditors in India are assured of full legal support and backing while carrying out their duties as gatekeepers.

[149] CAG's oversight role, available at http://saiindia.gov.in/english/home/Our_Products/Audit_Report/Government_Wise/union_audit/recent_reports/union_compliance/2010_2011/Commercial_Audit/Report_no_2/chap2.pdf

Combined with a robust legal environment, the monitoring and regulatory functions of ICAI ensure that the country has a strong structure, which adequately supports the independent functioning of the auditor. If regulators mete out punishments or sanctions that are inadequate, it will not be for lack of statutory authority, but may point to inadequate implementation, perhaps even lack of will.

Assessing The Quality of Audit In India

Effectiveness of an Auditor

Independence is central to the effectiveness of auditors as gatekeepers. The issue of auditor-gatekeeper independence has been a constant concern for policy makers.
A factor that provides assurance of a gatekeeper's independence is the risk of loss of reputational capital. An auditor has several clients, each of whom pays it a fee for providing assurance services. Therefore, the market can reasonably assume that rather than risk reputational capital, an auditor will give up the client or at least blow the whistle on improper conduct of the firm.

Assumption of independence of auditor is a powerful signal to the market about good conduct of the company's performance. But independence can also be of various degrees.

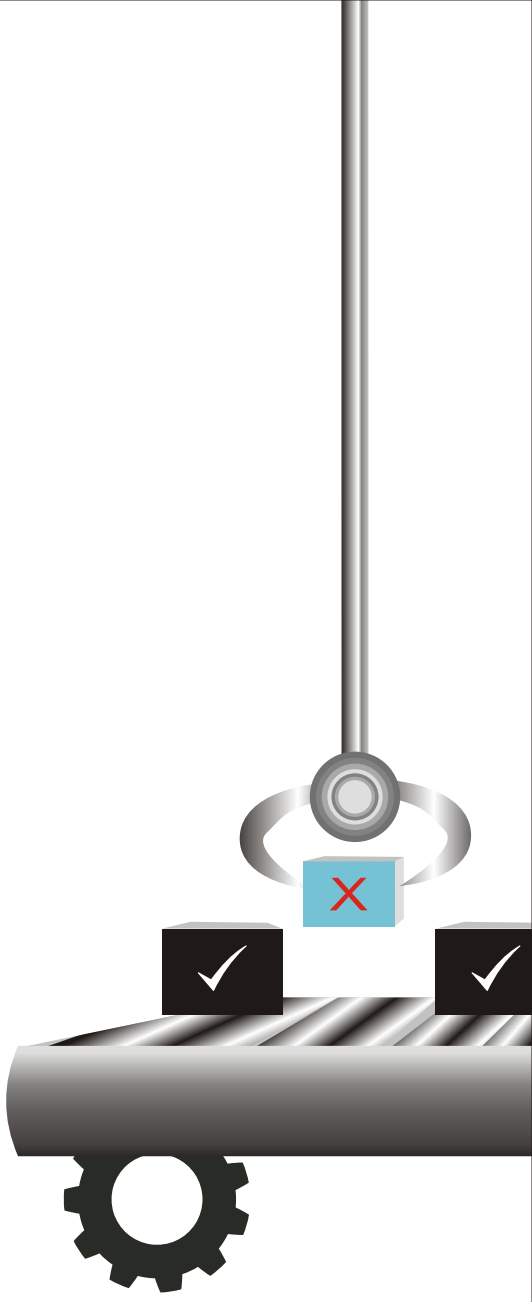
Choy et al distinguish between 'strong independence' where an auditor's compensation is completely independent of whether he/she agrees with clients in a final offer of auditor-client negotiation and 'weak independence' where the auditor would suffer some form of financial loss if he/she disagrees with the client.[150]

The authors examine how financial and non-financial incentives affect choices made by an auditor-gatekeeper, whose decisions affect the welfare of investors and concluded that:

a) Even weak independence leads to effective gatekeeper, in that the gatekeeper represents the third party (investor) as well as the third party would represent him/herself.
b) Strong independence leads to high levels of rejection (of collusion proposed by the client) even if it hurts the third party
c) Where there is absolute gatekeeper independence, the gatekeeper pays more attention to the proposed action (of collusion).

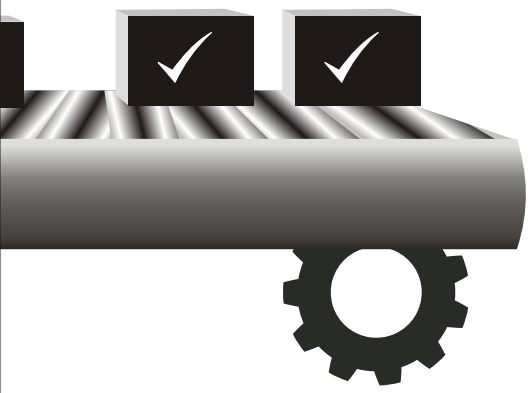
The study is useful for policy makers to weigh the costs and benefits of degree of auditor independence.

There are other scholars who assert that auditors' independence is not impaired by his/her financial interests such as provision of non-audit service, low-balling and quasi-rent. Such scholars[151] believe that in a competitive market auditors' financial interests do not impair independence.



[150] 'Social Responsibility of the Auditor as Independent Gatekeeper: An Experimental Investigation', Amy K.Choy, Thomas Fields, Ronald R.King, August 8, 2008. Available at SSRN:http://ssrn.com/abstract=1248342.

[151] DeAngelo 1981; DeFond, Raghunandan and Subramanyam, 2002; Koh, Rajgopal and Srinivasan, 2008



But is market mechanism a sufficient safeguard against collusion between auditor and client or sufficient insurance of auditor vigilance towards wrongdoing? Should there not be a certain degree of legal liability imposed on gatekeepers for negligence of their duty of care? Some scholars argue that strong reputational bonds built over the years by gatekeepers like (especially large) auditors are powerful enough to ensure the right level of gatekeeping effort on their part and are sceptical about the role that explicit and mandatory legal liability can play to provide proper incentives to such gatekeepers.[152]

Economies vary in their approaches to enforce vigilance on the part of the auditor but 'most legal systems (do not) currently adopt a strict liability regime for gatekeepers such as auditors…, but impose on them various standards of professional behaviour and liability is contingent on the violation or breach of those standards; that is, most legal systems use a negligence-like liability regime'.[153]

The public outcry following major global financial scandals appears to have one thing in commonthe investing public holds the auditor accountable for certifying truthfulness and accuracy of financial information put out by a company. In the general clamour for increased liability of an auditor, however, it is often forgotten that an auditor does not certify financial information of a company (unless it is for a designated certificate of a specific matter) but puts a stamp on the financial information giving 'a true and fair view' of the state of affairs of the company.

An audit is a complex process based on accepted standards which also involves interpretation and estimation and where the end result is an 'opinion' of the auditor. Although auditing is guided by detailed standards, guidance notes and case laws, the procedures followed are not very transparent which makes the assessment of audit quality very difficult.

For instance, an audit conducted in accordance with auditing standards can rarely uncover management fraud that involves overriding of management controls, misrepresenting information or falsifying documentation. A routine audit is not designed to spot forgeries or uncover side deals that management may have with a third party. Such frauds can be uncovered only through a forensic audit and it is not practical or feasible to conduct every audit with a forensic bent of mind.

Even in cases of misstatements subsequently found or re-statements, it requires highly specialised expertise and the considered judgement of the court to decide whether an auditor was negligent in duties or merely a victim of collusive fraud between management and third parties. There are several studies that have tried to assess audit quality using different parameters. Since

[152] Goldberg, 1988; Choi, 1998; Ribstein, 1998 & 2000; Arrunada, 1999

[153] 'Should we Trust the Gatekeepers?' Auditors' and Lawyers' Liability for Clients' Misconduct, Juan Jose Ganuze & Fernando Gomez, Universitat Pompeu Fabra, 2005, page 21-22.

2002, GAO, AICPA and PCAOB of the USA have been trying to develop quantitative or objective measures for determining audit quality . The measures are yet to be determined ,indicating such measures are difficult to develop.

Most studies are able to capture only market perceptions of audit quality rather than an auditor's actual ability to detect and report accounting misstatements. This is also because of the time lag between when audit services are offered and when (if) an audit failure becomes apparent. In the meantime the market often relies on an auditor's reputation as proxy for audit quality.

Size of an audit firm as a measure or proxy for audit quality

Some studies use size of an audit firm as proxy for audit quality. Krishnan (2003), Zhou & Elder (2001) found that the relationship between audit quality and size of the firm usually supports the hypothesis that the two are positively associated. DeAngelo (1981) found that auditor size is measured by the number of clients; she argues that since auditors earn client-specific quasi-rents, auditors with more clients have more to lose by failing to report discovered misstatements.

The attestation of a company's financial information provided by an auditor is to a large extent dependent on his/her reputation for doing a thorough audit unhampered by conflicts of interest. Reputation is often linked in various studies to size of the audit firm, the premise being that the bigger the firm, the more it has to lose and therefore the quality of audit must be superior.

Davidson & New (1993) found evidence of better quality by Big 8 (or 6 or 4, depending on when the study was conducted), Nichols and Smith (1983) found no difference attributed by market in terms of audit quality of Big 8/6/4 and non-Big 8/6/4, Lam and Chang (1994) found no difference between the two groups in terms of errors in earnings forecast, Petroni and Beasley (1996) find no systematic difference in claim loss reserve accuracy or bias between clients of either group while Tate (2001) finds that Big 5 auditors are less likely than non-Big 5 to issue qualified opinions regarding clients' deficiencies in internal control or to report significant deficiencies in internal control. However, Li Dang, Brown and McCullough (2004) found that market's ability to evaluate audit quality is not affected by auditor reputation and that the market appears to assess audit quality accurately.

In May 2010, The Sponsoring Committee of Treadway Commission (COSO), in their report on analysis of fraudulent financial reporting in USA over 10 years concluded that ‘fraud goes undetected by auditors of all types and sizes. Big 6 / Big4 firms audited 79 % of the fraud companies during the fraud period’.

This study has analysed BSE 500 companies to examine whether size can be considered a proxy for audit quality in India.

There are broadly two categories of audit firms in India:

- Big 4 Audit Firms in India (along with their affiliates)
  - PricewaterhouseCoopers, Deloitte Haskins & Sells, Ernst & Young and KPMG
- Non-Big 4 Small and Medium Sized Firm (Firms other than above category of Big 4 audit firms

BSE 500 companies for the year ended March 2011 were audited by a total of 198 registered audit firms. This includes four (4) Big 4 firms (including its affiliate firms) and approximately 196 non-Big 4 firms.

Particulars	Number of Companies	Percentage of Companies
Non Big 4	270	54
Big 4	230	46
Total	**500**	**100**

There is a relationship between proportion of auditors in the population and disclosure level and earnings opacity, suggesting that increased enforcement of accounting standards through auditing and increased disclosure may improve earnings transparency.[154]

An analysis of financial statements for the year ended 31st March 2011 companies forming part of Bombay Stock Exchange 500 shows that companies are almost evenly balanced between Big 4 and non-Big 4 auditors.

[154] The world of earnings opacity: Bhattacharya, Daouk, Welker

Particulars	2009	2010
Non Big 4	41	40
Big 4	59	60
Total Audit Done	**100**	**100**

A second analysis of auditors of Bombay Stock Exchange (BSE) top 100 companies shows similar results as BSE 500 companies. Thus Indian companies and capital markets do not create auditor concentration of Big 4 as in the USA or Western Europe. COSO Report of 2010 on Fraudulent Financial Reporting (1998-2007), concludes that both Big 4 and other audit firms are equally susceptible to mis-reporting on accounting fraud.[155]

A closer analysis of the companies audited by non-big 4 auditors reveals large public sector companies and public sector banks. This is in accordance with the policy of Comptroller and Auditor General of India (CAG) whereby auditors for PSUs and PSBs are chosen from a panel of auditors who may not necessarily be a Big 4 firm. It may be noted that Central public sector institutions consist of over 22% of market capitalisation of Bombay Stock Exchange.

Some of the private sectors of the economy particularly large companies tend to have one of the Big 4 as their auditor, if they have global operations or have raised capital in a global market. We also observe that, as a norm, multinational companies in India tend to appoint the Indian representative of their global auditor as the statutory auditor in India. We conclude that in India companies, unlike the western markets, which have a high level of concentration amongst the Big 4 firms, do not consider the size of the audit firm a measure or proxy for audit quality. There is no empirical evidence drawn that big four firms have a higher audit quality in India.

V.K Shunglu's paper on "Proposal to secure greater transparency and accountability in Financial Reporting" suggests that the sphere of oversight on auditors who audit the BSE 500 listed companies should move to SEBI, and like the SEC of the USA should monitor and review financial statements and other public filings as well as the quality of those auditors who attest the BSE 500 companies.

[155] Available at http://www.coso.org/documents/COSOFRAUDSTUDY2010.pdf last accessed on March 22, 2012

Time taken to complete the audit from the date of closing of financial year

Timeliness of financial reporting is an attribute of good corporate governance. Shareholders and other stakeholders need information while it is still fresh and the more time that passes between year end and disclosure, the more stale the information becomes and the less value it has.[156]

Timeliness of financial reporting is one of the attributes of the good corporate governance identified by OECD and World Bank. Companies that are not timely in their financial reporting practices find it more difficult to attract capital. Their corporate governance practices are also seen as less than ideal, which has a negative effect on a company's reputation within the financial community.[157]

We looked at a sample of top 100 companies listed at Bombay Stock Exchange (BSE 100) for the two financial years 2010 and 2011 to determine the time taken to complete the audit and whether this can serve as a proxy for determining the quality of audit process. We compared the date of close of financial year with the date of signing of audit report by observing 200 audit reports. The time taken by an audit firm to complete the statutory audit for sample BSE 100 companies for the two years under study is in the range of 30 to 60 days although several firms completed it within 30 days of close of financial year. The average time to complete the audit from end of financial year was at 46.20 days for the year 2010 and 48.60 days for the year 2011.

Companies in the old EU member countries take 23-354 days in old EU with a median of 85.6 days and Companies in the new EU member countries take 37-342 with a median of 84.7 days.[158]

Auditors usually perform detailed reviews at the end of each quarter and hence do not spend a lot of time to complete the final audit. However the annual audit is not a summation of various limited quarterly reviews; the books of account are not necessarily hard closed at the time of each such review and there may be several aspects that require a broader time horizon than quarter end to assess the total impact.

Additionally, the length of an audit depends on the scope of the company's operations, state and complexity of the company's records, the responsiveness of company's employees and results of prior audits. Auditor size, industry classification, presence or absence of extraordinary items and the sign of net income are some factors that influence timeliness.[159]

While there are no defined parameters about ideal time for completing the audit, a time frame of 60-90 days seems to be sufficient and where audit is completed within 30 days, there may be chances of increased errors or misstatements that go undetected. Shorter audit closures may not include rigor of

[156] The timeliness of financial reporting, a comparative study of elected EU and transition economy countries, Robert W Mc Gee and Danielle N. Igoe available at www.books.google.co.in

[157] Corporate governance and the timeliness of financial reporting: a comparative study of the People's Republic of China, the USA and the European Union, Available at http://www.emeraldinsight.com/journals.htm?articleid=17012929 last accessed on March 21, 2012

[158] The timeliness of financial reporting, a comparative study of elected EU and transition economy countries, Robert W Mc Gee and Danielle N. Igoe available at www.books.google.co.in

[159] Audit Delay and the timeliness of corporate reporting Ashton RH, PR Graul, & JD Newton, 1989, Contemporary Accounting Research 5(2): 526-552

management reviews and audits.
Certain companies in our sample took more than 90 days to complete the audit, which somewhat defeats the purpose of an audit for an investor since the data becomes too historical to be of much use. Significant delays can also be associated with lower quality of financial statements, errors and earnings management.

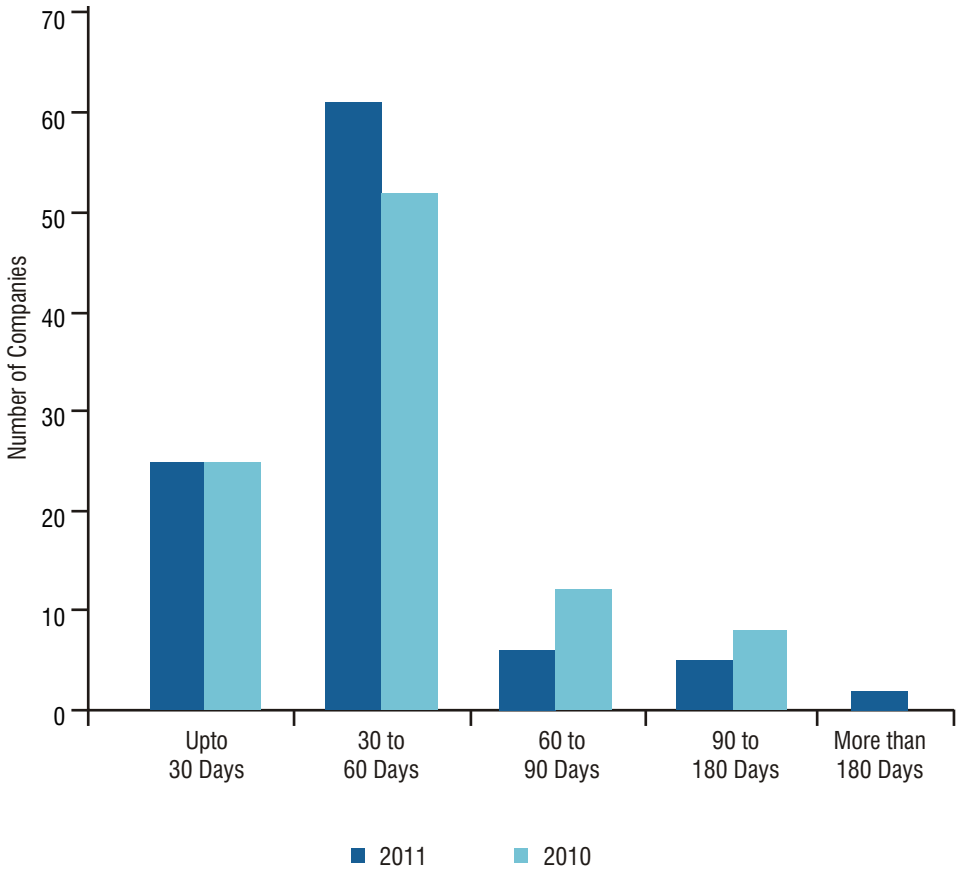
Use of Notes to Accounts in Audit Reports

We observed from our study of 100 audit reports of BSE.

100 companies that notes to accounts are used as a regular feature and often such notes are voluminous running into several pages. Some explanations are extremely technical and difficult to understand by a regular user. Other accounting policy disclosures do not portray the complete picture. Certain items having a material impact on the financials have been only explained in the notes without qualifying the auditor's report even though it ought to be qualified.

Notes to the Financial Statements are additional notes and information added to the end of the financial statements to supplement the reader with more information. Notes to Financial Statements should help the understand computation of specific items in the financial statements and provide a more comprehensive assessment of a company's financial condition.

BSE 100 Ageing of Audit Report in Comparison to End of Financial Year



However we observe that sometimes notes to financial statements are used by the auditor and management to load the statements with a lot of information that may add little to further understanding and may be construed more as a smokescreen to confuse the reader. Therefore, excessive or complex Notes to Accounts may be considered a tool of compromise between the management and the auditor and thus detract from the quality of the audit report.

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Three Pillars ensuring quality of financial information

It is difficult to arrive at any formula or a set of proxy measures that can accurately determine the quality of an audit. An audit operates within the universe of several factors, effectiveness of each of which determines the ultimate quality of financial information and their audit.

Li, et al[160] say that 'financial reporting quality may not be a critical growth factor for countries that are heavily invested in low information uncertainty industries (eg. mature industries or industries with more tangible assets than intangible assets). However, as a country moves upward along the chain of industrial evolution and focuses more on industries with greater information uncertainty, such as high-growth or high-tech industries[161], a high-quality financial reporting system can play a pivotal role in fostering faster economic growth. "India by virtue of having high growth and hi tech industries, the quality of financial systems is crucial to sustain growth and development.

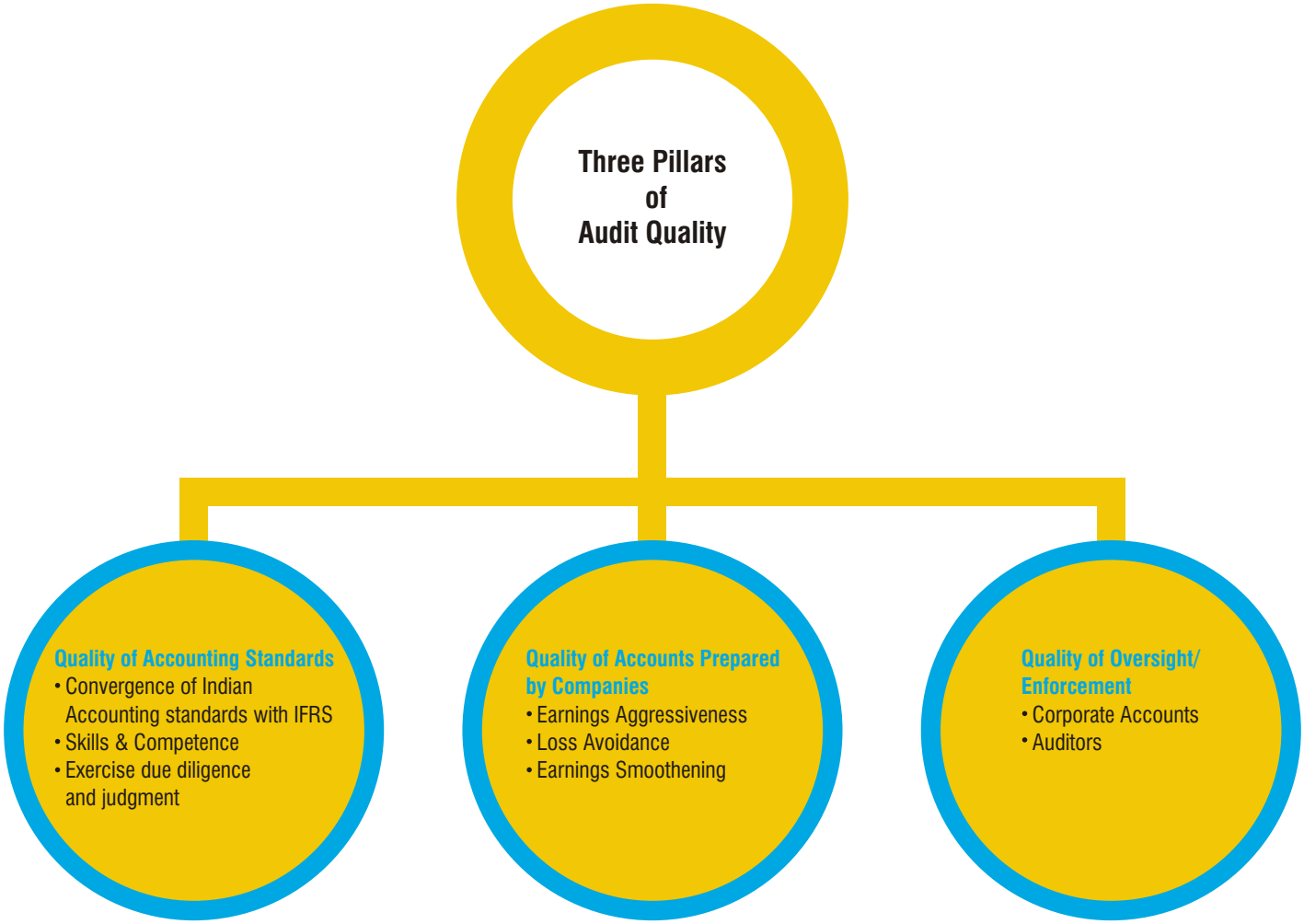
Bhattacharya, Daok and Welker (2002) put out three measures that determine the quality of financial reporting measures in an economy and in their opinion three legs upon which financial information rests are: quality of accounting standards in a country, the effectiveness of implementation of these standards through an auditing mechanism and the legal framework of the country. These determine the quality and efficacy of financial statements that form the base of capital market transactions.

Therefore, the three planks that determine efficacy of financial information and audit quality are:

- Quality of Accounting Standards
- Quality of accounts prepared by companies
- Quality of enforcement/oversight:
  a) on corporate accounts, b) on auditors

[160] Li and Shroff (2009) in 'Financial Reporting Quality and Economic Growth'

[161] See Smith and Watts 1992



Quality of Accounting Standards

Accounting standards serve as a template for how accounting information is recorded, reported and interpreted. A uniform set of accounting standards (at least in each market) is necessary to determine how financial information should be calculated and reported.

The better the quality of accounting standards, higher is the perception of good quality financial information. Such information is readily accepted by users to make informed decisions that ultimately enhance the relevance of accounting information. It goes without saying that high quality accounting standards must be clear, precise and leave little scope for interpretation.

An OECD cross-country study of 35 countries (India was not among these countries) compared the quality of

accounting standards and found that the value relevance of accounting earnings is positively associated with the quality of accounting standards.

That is, high quality accounting standards can provide better protection to investors through reliable financial reports. The study also found that high quality, acceptability and effective enforcement of accounting standards are complementary variables and put together, they better enhance the value relevance of earnings.[162] India accounting standards are prepared by the Accounting Standards Board of the Institute of Chartered Accountants of India (ICAI) and these standards are to be followed by all establishments. As the global financial market became more prevalent, there was a need for international standards that are acceptable all over the world and understood uniformly.

The International Accounting Standards Committee, although in existence since 1971, was recognised as The International Accounting Standards Board in 2001 and began developing internationally acceptable accounting standards called IFRS. IFRS allows for aspects of local culture to be embedded in the standards and therefore each country may have slightly different rules, which however, fall under the umbrella of IFRS. EU countries have already adopted these standards and the SEC of US has agreed in principle to adopt them, although the roll-out date is not fixed yet; Japan has deferred adoption till 2016.

Convergence of Indian standards with internationally accepted IFRS is a stated goal of ICAI. In the meantime, it bridges the gap between Indian standards and IFRS by issuing new standards and ensuring that existing Indian standards reflect changes in international thinking. As on 31 January 2012,, there were 35 such standards designated as 'IND AS'; however, its implementation will be in a phased manner as per the roadmap of the Ministry of Corporate Affairs, presumably, depending on resolution of issues with various government departments and agencies, such as tax authorities.

The converged IND AS rolled out so far has several carve-outs and carve-ins, which may further delay adoption of IFRS, or render it vastly different from the international version. Major points of departure from international standards are:

- Treatment of foreign exchange loss: as per IFRS: the entire loss/profit on assets and liabilities on balance sheet date must be charged to the profit and loss account. IND AS allows for either charging into profit and loss account or to capital account to be amortised over the time frame of the concerned asset or liability
- Agricultural income: IND AS dealing with this is not yet notified

[162] 'A Cross-Country Study on the Quality, Acceptability and Enforceability of Accounting Standards and the Value Relevance of Accounting Earnings', Etty R Wulandari and Asheq R.Rahman, September 2004, OECD.

- Construction industry: IFRS requires percentage completion reporting, a practice not followed under Indian standards
- Under Indian standards investments need be valued at cost; IFRS allows for measurement both at cost as well as fair value, whichever is appropriate

IFRS is a principles-based set of standards rather than rule-based that is currently followed by several domestic standards, including India. IFRS calls for professional judgement to be used on a consistent basis to comply with the intent and spirit of standards.

This is the challenge that Indian reporters will have to handle—exercising judgement and defending their stand to stakeholders. It will call for new skill sets to be developed for both account preparers and auditors to work in the changing environment. The quality of accounting standards finally adopted by India will determine the quality of financial information and also the quality of gatekeepers in the economy.

Quality of Accounts Prepared by Companies

Financial information is compiled and statements prepared by companies and then submitted for audit to an external agency. An auditor is expected to give an opinion on whether such financial information gives a true and fair view of the state of affairs of the company and ***only after*** such information has been prepared. Therefore, the quality of an audit depends to a large extent on the quality of financial information prepared by the company. Accounting standards have a degree of inherent flexibility built in and the quality of accounting standards depends on how aggressively this flexibility is used.

Bhattacharya, et al say[163] 'Reported earnings in a country could be opaque because of a complex interaction among, at least, three factors: managerial motivation, accounting standards, and the enforcement of accounting standards (e.g., audit quality). It could be that earnings are opaque because managers are motivated to manipulate earnings, and they can do this either because accounting standards allow substantial flexibility, or accounting standards do not exist to specify accounting principles related to some areas of business activity, or accounting standards, though rigorous, are weakly enforced.

It could also be that earnings are opaque, not because managers manipulate earnings, but simply because accounting standards do not call for accounting treatments that transparently reflect underlying business activity, and management is not willing or able to overcome these deficiencies by voluntarily providing more informative earnings reports.'

[164] Leuz, Nanda and Wyocki titled 'Earnings management and Investor Protection'

They have analysed the financial statements from 34 countries to determine the earnings opacity based on:

- Earnings aggressiveness (against conservatism)
- Loss avoidance (avoid negative earnings)
- Earnings smoothing (managing earnings)

The summary statistics for some of the sample countries are:

Interpretations

- Earning Aggressiveness is the average accruals divided by lagged total assets which is on expected lines negative across all the countries except Greece, Turkey and India.

- Loss avoidance measure portraying avoidance of small negative bottom line earnings is positive in 32 out of 34 countries implying that this is a global phenomemon.

- Earnings Smoothing measure, the average cross sectional correlation between change in cash flows and the change in accruals is strongly negative in all the sample countries.

Countries	Earnings Aggressiveness	Loss Avoidance	Earnings Smoothing	Disclosure Level
India	0.001681	0.735644	-0.86787	61
Indonesia	-0.00098	0.733766	-0.85613	NA
Hong Kong	-0.01194	0.17013	-0.85786	73
Malaysia	-0.01226	0.469553	-0.87234	79
United States	-0.03833	0.350638	-0.77688	76
United Kingdom	-0.02924	0.372985	-0.8683	85
Australia	-0.0213	-0.04615	-0.82374	80
Brazil	-0.0068	0.035416	-0.77614	NA
Japan	-0.01247	0.642863	-0.92135	10

On the basis of above analysis, India is ranked among the top three countries in earnings aggressiveness, top two countries in loss avoidance and top four countries in the final overall earnings opacity parameter. Thus India is only ahead of Greece, South Korea and Indonesia in the ranking for overall earnings opacity.

A study by Leuz, et al[164] puts India in the lowest cluster of countries, at a scale of three, based on earnings management score, which is based on level of disclosures, discretionary accruals and lower enforcement regime. Though the authors assign highest scores for quality of minority rights but for legal enforcement for deviations and quality of disclosures, they assign only average scores to the country, bringing down the overall score for the quality and efficacy of financial information.

Managers have to take several accounting decisions during the ordinary course of business that are permitted by recognised accounting standards; however, some of which are subject to discretion. There are over 10 accounting standards, where discretion of management in interpretation is allowed and hence the scope of discretionary earnings gets accentuated.

The problems in India associated with financial information as they relate to :

- earnings aggressiveness i.e. accrual of earnings when they do not exist
- loss avoidance i.e. postponing recording of transactions that are losses
- earnings smoothening i.e. Avoiding spokes to meet expected results are well above the global average and given the low level of enforcement by regulators, including lack of rigorous periodic review of financial statements for application of GAAP and auditing standards, such opacity will persist.

In 2011, the average holdings of promoters in Indian companies across various sectors was over 50%, whereas institutions held below 15% and individuals even lower. (National Stock Exchange) When a large proportion of listed companies are controlled by a dominant shareholder group, the presumption of influence on discretionary use of managerial power on decisions is inevitable, which impacts the perception of quality of financial information.

Bhattacharya et al[165] conclude that an increase in measure of overall earnings opacity from the 25th percentile rank to the 75th percentile rank is associated with a 2.8 percent increase in the cost of equity measured using dividend yields. India being in the lowest quartile in study can improve its cost of capital by improving financial transparency and reporting quality.

Similar conclusion on cost of capital's association with discretionary accruals has been found by FLOS (2004) and Wong (2008) using between 7 and 10 earnings attributes.

[164] Leuz, Nanda and Wyocki titled 'Earnings management and Investor Protection'

[165] Ibid see footnote 23

FLOS (2004) identifies seven earnings attributes (accrual quality, persistence, predictability, smoothness, value relevance, timeliness and conservatism) and finds that the firms with least favorable values of each attribute experience a larger cost of equity capital, implying that cost of capital is associated with discretionary accruals.[166]

Wong (2008) in a similar study as FLOS (2004) has examined ten different concepts/ dimensions of earnings quality (total accruals, unexpected accruals, cash to profit, accruals quality, persistence, predictability, smoothness, relevance, conservatism and timeliness) and concluded that the strongest association of cost of equity capital is with discretionary accruals.[167]

This for India means that if financial opacity is a regular feature—especially considering the prevalence of promoter-driven companies—the cost of equity capital is expected to be unreasonably high.

Quality of Enforcement/ Oversight

a) Corporate Accounts
b) Auditors

Corporate Accounts

Companies are required to file their annual financial statements with the Registrar of Companies (ROC) and listed companies have to additionally file these with stock exchanges where the scrip is listed. The Registrar of Companies is empowered by the Companies Act to call for information or explanation in relation to financial statements besides imposing penalties for non-compliance; however, we found very few cases of prosecution under these provisions.[168] This could of course indicate that there are no major issues that require investigation and further explanation from companies; or it could indicate that the ROC does not scrutinise the financial statements that are routinely filed by companies.

Ministry of Corporate Affairs has recently (April 2011) made electronic filing of financial statements compulsory for all companies, using XBRL software. This should make scrutiny of statements easier for the ROC because financial information submitted online is computer readable and easily comparable against a dashboard. However, the system is still very recent and till date there is no information in public domain about such scrutiny by ROC.

Another initiative by the Ministry of Corporate Affairs is the Early Warning System (EWS). EWS is a software-based fraud-detecting system that scans financial information of companies based on a few financial and non-financial parameters to pick up any red flags that require further investigation. The software scrutinises quarterly results, public announcements, filings with stock exchanges, tax returns, etc. over parameters such as: more than 5% sales with related parties, any discrepancy in EPS ratio of more than 25%, resignation of more than half the

[166] Francis J, R Lafond, P Olssson and K Schipper, 2004 Cost of Equity and Earnings Attributes, The Accounting Review 79(4), 967-1010

[167] Wong L, 2008 Earnings Quality and Firm value in Australia

[168] Source: aggregate of cases under www.watchoutinvestors.com

board of directors, changing auditors more than once in three years, and several companies having the same address and common directors, etc.

The software is expected to pick up companies that raise such concerns and are then referred to Comptroller & Auditor General of India in case of public sector companies and to Registrar of Companies in case of others for further investigations. Since its inception in 2009, in the aftermath of the Satyam accounting fraud, the EWS has referred around 160 companies to CAG & ROC in 2010; however, the outcome of such investigation is not available in public domain and we were unable to verify its efficacy.

A study on Corporate Governance in India Evolution and Challenges by Rajesh Chakrabarti, College of Management, Georgia Tech, USA states that 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. Two indices are used for this purpose: a shareholder rights index reflecting the extent to which written law protected shareholders ranging from 0 (lowest) to 6 (highest) and a rule of law index reflecting enforcement of law ranging 0 (lowest) to 10 (highest) to measure the effective protection of shareholder rights. India has a shareholder rights index of 5, being one highest in the sample examined of 49 countries but the rule of law index a score of 4.17 on this index ranking 41st out of 49 countries studied. Thus it appears that Indian laws provide great protection of shareholders' rights on paper while the application and enforcement of those laws are lamentable leading to differences in financial and economic developments in the different countries.

The study concludes that the bigger challenge in India, lies in the proper implementation of corporate governance 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.

Auditors

Peer Review Mechanism

Peer Review is a quality control procedure designed to ensure that overall quality of audit is maintained throughout the auditing profession. Under this system, audit working papers of a firm are reviewed either by a panel of experts set up by the professional institute or by another independent audit firm.

The main objective of Peer Review is to ensure that members of the Institute (a)

comply with the Technical Standards laid down by the Institute and (b) have in place proper systems (including documentation systems) for maintaining the quality of the attestation services they perform.

The review begins with the assumption that professionals discharge their responsibilities properly and the aim of review is to enhance attributes of professionalism in the audit process.

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It is mandatory for all listed companies to be audited by only peer review certified firms from April 1, 2009; additionally financial statements of companies coming out with initial public offerings (IPOs) need to be certified by firms which have been peer reviewed.

However, the findings of peer review board and action taken on such audit reports are not available in the public domain. Therefore, we are unable to analyse data to comment on the efficacy and efficiency of the system.
A few overall suggestions that may help to improve the system are:

a) Publishing the findings of the Peer Audit, at least for use by other members of ICAI, which may act as a deterrent for professional misconduct
b) At present, costs of the Peer Review Audit are borne by the auditee. Costs notified by ICAI are minimal and the audit is expected to be completed in approximately two days; however, the time and costs may not be adequate in all cases of peer reviews and the system must make provisions for this
c) ICAI may consider setting up a fund to pay for costs of peer reviews so that independence and objectivity is maintained
d) ICAI may mandate a certain number of peer reviews to be conducted by all practicing members as part of their professional duties.

Disciplinary Proceedings (section 21B of the Chartered Accountants Act)
The Disciplinary Directorate, the Board of Discipline, and the Disciplinary Committee form the foundation of the disciplinary process of ICAI. These entities are quasi-judicial and have substantial powers akin to that of a Civil Court to summon and enforce attendance or require discovery or production of documents on affidavit or otherwise. If the Board of Discipline finds a member guilty of professional or other misconduct, it may reprimand the member, remove the name of the member from the register of members for up to three months or impose a fine up to 1,00,000/- (in some cases up to Rs.5,00,000).

ICAI under its current regulations has the power to proceed only against individual members and not the firm under which practising chartered accountants may be operating. To that extent, its role and power as a regulator is diminished. If punitive action is not taken against a firm, there is little

incentive for the firm to improve its processes and ensure institutional remedies since it may be easier to simply remove the affected partners from the partnership. This possibility has been seen in recent years in the case of Price Waterhouse (Global Trust Bank), again Price Waterhouse (Satyam Computer Services Limited) and Ernst and Young (Maytas). Compounding the dilemma for ICAI is that several recent financial frauds and scams relate to organizations that had multinational accounting firms as their auditors. These multinational firms cannot legally set up a practice in India and therefore practise in the country by different means usually operating through tie-ups with local firms.

ICAI in order to strengthen its regulatory powers has asked the Ministry of Corporate Affairs, Government of India to grant additional powers so that it may proceed against firms whose partners or employees are found guilty of professional misconduct. ICAI also has sent a proposal to the Government of India to amend the Chartered Accountants Act, 1949 in order to enable it to impose a fine up to Rupees Ten Million on audit firms, if they are found guilty of colluding with companies to commit a fraud.

Quality Review Board (QRB)

Quality Review Board was constituted by Ministry of Corporate Affairs in 2007 under the Chartered Accountants Act, 1949. The Board performs the following functions:-

A) To review the quality of work and services provided by the members of the ICAI

b) To lay down the evaluation criteria and select the reviewer.

c) To ask for information from ICAI, the Council or its Committees, Members, Clients of members or other persons or organizations

d) To invite experts to provide expert/technical advice or opinion for the purpose of assessing the quality of work

e) To make recommendations to the Council to guide members of the Institute to improve their professional competence and qualifications, quality of work and services offered and adherence to various statutory and other regulatory requirements.

The Quality Review Board can also enter into consultations with the regulators like Comptroller and Auditor General of India, Reserve Bank of India, Ministry of Corporate Affairs, Insurance Regulatory and Development Authority, Securities and Exchange Board of India apart from the Institute of Chartered Accountants of India for improving the quality of audit services.

The Quality Review involves inspection and assessment of the work of auditors while carrying out the audit function (excluding internal audit) so that the QRB is able to assess:

a) The quality of audit and reporting by the auditors; and
b) The quality control framework adopted by the auditors/ audit firms in conducting audit.

Such a review may be done on a reference made to the QRB or it may suo moto select audit firms for review. ICAI has issued detailed guidelines on the declarations to be obtained from the audit firm, content of report, testing parameters, instances of qualification, treatment of recommendations etc. The QRB may take any action (as recommended by the reviewer/ otherwise) on the audit firm basing its opinion on the report.

The Review Team generally comprises of chairman (mandatorily a chartered accountant with at least 15 years of experience) and members (mainly experts or persons with industry specific experience, academicians and other experts as required by the respective case). No firm of Chartered Accountants can be included as a member of the review team.

Financial Reporting Review Board (FRRB)
Under ICAI, Financial Reporting Review Board (FRRB) was formed in July 2002 to review the financial statements and auditors reports to determine compliance with accounting principles, disclosure requirements and reporting obligations of the auditor. Such review may be done suo motto or on a reference made by regulatory body or in case of reported accounting irregularities.

In case of any non-compliance a reference may be made by FRRB to the disciplinary committee. FRRBs can review the accounts of all listed entities, banks, financial institutions, businesses with turnover greater than Rs 50 crores etc. Investigations are, however, restricted to financial statements that are filed with ROC or stock exchanges; ICAI does not have access to books of accounts of such companies.

As per the data available at www.icai.org.in, during 2010-2011, FRRB has undertaken review of 100 cases on suo motto basis, 18 as special cases and 60 cases pertaining to 2009-2010. Considering that there are 5092 listed companies at Bombay Stock Exchange as on September 2011, total number of listed companies may be more since there are 22 stock exchanges in India, a review of 118 accounts seems too small to have an impact.

Recommendations

Based on the above study on status of auditors in India, we propose following recommendations to enhance audit quality and their independence for playing a valuable role as principal gatekeepers of corporate governance.

a) Independent regulator
The current system of self-regulation (even if it is through the apex body, ICAI) appears to leave room for laxity. Although the regulator is entrusted with several powers, there is a gap in using such powers for maintaining high professional standards. This may be because members of the disciplinary committee, peer review board, etc. are elected by members of ICAI and there may be a conflict of interest in disciplining what may be considered as 'voting constituency'. Perhaps disciplinary bodies should have greater independence akin to a separate audit regulator and act as a watchdog on the functioning of the auditors. The regulator should work on time-bound targets to achieve effectiveness and must be able to issue penal action against erring auditors. Such an organisation can be made on the lines of America's Public Company Accounting Oversight Board established under Sarbanes Oxley Act.

b) There should be a stronger division between audit and non-audit services rendered by audit firms, thereby eliminating a clear conflict of interest. Audit firms often cross-sell their consulting services. The cross selling may provide auditor with an incentive to please their audit clients and it allowed clients to put pressure on their auditors by threatening to dismiss their consulting services. The regulator may provide a specific list of prohibited services so that there is no ambiguity. Where the firm undertakes any service other than audit, or and the prohibited services listed above, it should be done only with the approval of the audit committee.

c) Audit committees of PSUs must have greater power over appointment of statutory auditor. The CAG's role should be to recommend firms empanelled on the basis of agreed criteria. The audit committee of PSUs should also have greater powers and accountability in monitoring audit quality and ensuring that audit fees are commensurate with the level of audit risk and effort levels involved in undertaking the PSU audits.

d) There should be a minimum threshold of size and experience that an audit firm must have to qualify them for auditing any company that is a public-interest entity. These may be listed companies, banks and financial institutions, government owned companies, utilities etc., where any member of public has an interest. These firms also need to be reviewed for quality and enforcement by the regulator at least once in three years.

e) In case of auditors appointed for PSUs and Banks, the auditors' declarations in the empanelment application must be verified before the audit is awarded to them by either the concerned regulator or ICAI.

f) The regulator i.e. CAG and RBI should have access to the client files and auditors working paper to keep a tab on the quality of audit reports. They should also have

also the right to censure erring auditors.

g) There is multiplicity of regulators in India creating both overlaps and significant gaps. Detailed analysis of this overlap/gap is done in another section of this report.

h) The Institute of Chartered Accountants of India should publish names of banned CAs from time to time to act as a deterrent to professional misconduct.

i) Improving the quality of audit report:

- To standardise the language of disclaimers or qualifications in the report.
- Uniform treatment for non-compliances with accounting standards
- Provision for losses in subsidiaries
- Related party disclosure format.

j) There should be a cooling off period where any partner or member of the engagement team of an audit firm would be allowed to employment at an audit client after a period of two years from the year they were involved in audit of that client.

k) As per current rules, an audit firm's revenue from a single client cannot be more than 10% of the total revenue and revenue from consultancy charges cannot be more than 100% of the audit fees. However these rules may be circumvented by operating through various affiliate firms. This limit may be increased to a more reasonable level, say 25% of audit to non-audit revenue.

Firms with common partners must be asked to disclose aggregate earnings and names of clients to have greater transparency of independence. This requirement may be extended to both companies and firms with common members/partners so that absolute transparency is ensured.

Conclusion

The Indian regulatory and legal system is well-designed to provide robust auditing services to investors, capital markets and other stakeholders. However, implementation of checks and balances often becomes lax, defeating the strength of the structure.

The attestation of a company's financial information by an auditor is only as good as his/her reputation backed by training and knowledge for doing a thorough audit unhampered by conflicts of interest. Reputational risk is found to be the strongest insurance against auditor complicity and therefore assurance of audit quality. Whenever there is a financial crisis, there are strident cries of greater accountability and increased liability for auditors. However, litigation or threat of litigation as a means of promoting audit quality has several limitations.

It also raises the cost of auditing across board since the law does not distinguish between one set of auditors and another. Costs may include costs of extra checking, payment of insurance premium, costs of defending litigation, etc. There are facts and

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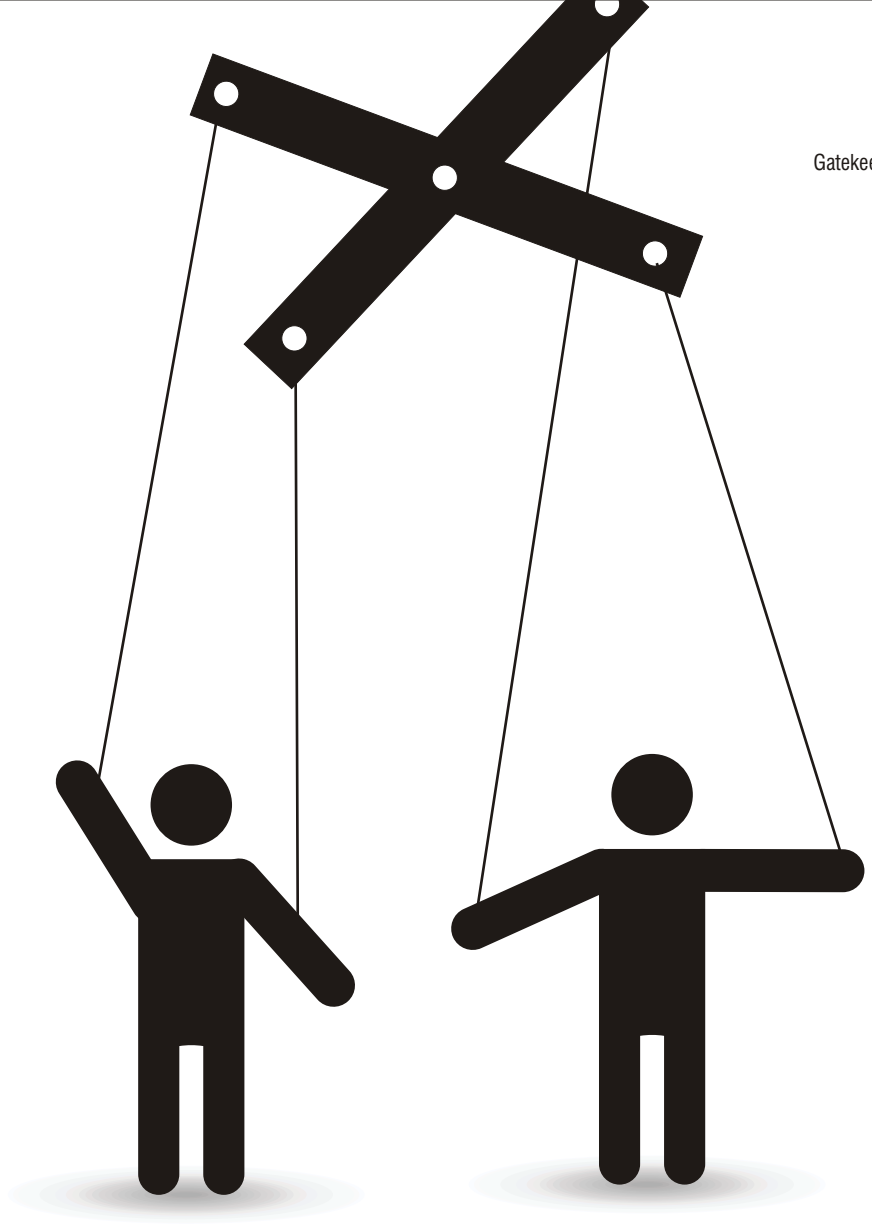

there are perceptions. When faced with the prospect of a lawsuit, an audit firm may choose to settle rather than go through the long drawn process of a trial even if it has strong defences and put its business fate to hang in balance till the conclusion of the trial. This may, therefore, cause considerable reputational damage to the firm if the investing public considers the settlement as an admission of guilt.

Business reversals often are just that—business reversals and nothing more insidious like collusion of auditors is usually proven. (Enron would probably have failed anyway, regardless of who the auditor was, because its business model was faulty). The overall rate of fraud conviction globally is low—and frauds in which auditors participate are lower still (Arthur Anderson was exonerated by the US Supreme Court but too late in the day). Populist sentiments often force regulators to be seen taking action but that may really not help improve the overall system in the long term.

What is needed is constant attention to the regulatory mechanism and ensuring that it works efficiently rather than more laws and regulations.

Epilogue

Currently, the process of oversight by auditor and audit committee is being seen as the most urgent step forward for the profession. Independence of the auditor in India is presently a matter of self-regulation. Various Committees have discussed these issues against international practices. Many of these recommendations await conversion into law in the form of the new Companies Act. However, the bill has not addressed certain important issues of audit partner or firm rotation and possible conflict of interest in auditor-client relationships. SEBI could help in this case by incorporating this requirement in its listing agreement with companies. There are several information asymmetries between insiders and outsiders, which creates opportunities for enhancing self-interest by principal shareholders. The three gatekeepers—RBI , SEBI and Auditors—would do well to synergise their efforts to bring about high quality financial disclosures and governance in India.

Exploring the Relation Between Earnings Management and Corporate Governance Characteristics in the Indian Context

Exploring the Relation Between Earnings Management and Corporate Governance Characteristics in the Indian Context

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Research Assistance: Debarati Basu and Neerav Nagar (FP students at IIM Calcutta)

Executive Summary

Earnings is the single most important signal to the market regarding the value creating/adding activities undertaken by a company. It helps the markets to allocate resources efficiently. The stock price is a summary of discounted value of expected future earnings. Therefore the management has a keen interest in its measurement and projection. The management also has several accounting tools/choices at its disposal to ensure that the results of company's activities are presented in the best and the most reasonable manner. Some discretion may be presumed in their application, but it may not always be a misrepresentation of facts.

Earnings Management (EM) and Corporate Governance (CG)

The dividing line between earnings adjustment and fraud is one of intention and is often a matter of differing opinions. Provision of a true and fair view of the financial statements is one of the primary objectives of good financial information system leading to better corporate governance. Better CG can lower the conflict between principal and agent. India is characterized by concentrated corporate ownership, majority government ownership and family control of firms. In this context we conducted a study to analyse the relationship between various CG characteristics and earnings management in the Indian context.

A Study in the Indian Context

The study analysed a sample of 2315 firms (from the CMIE Prowess database) on various factors identified on the basis of several hypotheses, which in turn have been developed on the basis of extant literature on CG. Three variables (based on Jones model) were employed as proxies for earnings management. These are total absolute accruals; total absolute accruals adjusted for size (measured by average total assets) and discretionary accruals; for the purpose of the study the total accruals were divided into discretionary and non-discretionary (categories) the discretionary accruals constitute the part which cannot be explained by change in revenue. Correlations were worked out and the following are the results derived from the correlation matrix:

Observations

Significant negative association (inverse relationship) between CG and EM: The

Earnings is the single most important signal to the market regarding the value creating/adding activities undertaken by a company.

The size of the board has a negative and significant coefficient, indicating that larger boards are able to do justice to their roles of monitoring earnings management.

correlation matrix reveals significant negative correlations between absolute discretionary accruals and some corporate governance variables like :board size (-ive), the number of independent directors (-ive), the number of meetings held (-ive), the number of other directorships held (-ive), promoter shareholding (-ive), institutional shareholding (-ive), and audit quality (-ive), thereby revealing the importance of good corporate governance in controlling earnings management.

Percentage of independent directors: It is significantly negatively associated / inversely related with EM, a finding consistent with studies by Beasley (1996), Klein (2002), and Davidson, et al. (2005). This suggests that if a board has a greater number of external directors, it would be effective in restraining the management of earnings. Studies have also found that larger boards are more likely to induct a higher number of competent independent directors as compared to smaller boards.[169]

Board Size: The size of the board has a negative and significant coefficient, indicating that larger boards are able to do justice to their roles of monitoring earnings management. Possibly, boards of larger sizes appoint various sub-committees, delegating their responsibilities to achieve greater efficiency than smaller boards. Since the responsibilities are divided among these sub-committees, they perform better monitoring as compared to smaller boards.[170]

Number of Board Meetings: The results indicate that the higher the numbers of board meetings, the lower are the discretionary accruals, suggesting that active board members are more vigilant monitors.

Promoter's Shareholding: It was found to have a strong negative association with all the three proxies of discretionary accruals, showing that the Indian context of shareholding being concentrated with the promoter acts as an incentive to restrain EM.

Institutional Shareholding: Both institutional shareholding (Indian) and foreign shareholding have significant positive association (direct relationship) with discretionary accruals; this is counter-intuitive, but a study by Lang and McNichols (1999) sets forth 'the short horizon 'problem indicating that institutional investors with insignificant exposure fail to exercise an effective disciplining role. Perhaps, with increasing exposure to the firms and a bit of training they might be able to align their interests with the long term interest of the firm.

Big 3 (auditing firms): A significant negative association with discretionary accruals has been observed. The presence of the top three reputed audit firms as auditors signals the use of a better monitoring mechanism as far as the financial disclosures are concerned, thereby curbing earnings management behaviour. However,

[169] Xie Davidson & Dalt, 2003

[170] Klein, 2002

the same has not been observed for the bigger firms (based on analysis of the highest quartile). This might imply that bigger firms are more prone to earnings management, irrespective of the presence of top auditors or institutional investors. Greater powers may be accorded to internal auditing committees to reduce reliance on external auditors to perform the whistle blower task, to check this tendency.

Conclusion

The findings of the study have thrown up significant pointers towards improving the quality of financial reporting. The objective of this study was to analyse the relationship between corporate governance characteristics and earnings management in the Indian context. A significant negative association has been found to exist between discretionary accruals and most of the corporate governance attributes, implying that the board of directors, at the helm of the internal control systems in corporate organizations, plays a very significant monitoring role. Thus, it can be said that boards are effective in discharging their duties and able to act independent of management.

However, the study also revealed some fresh insights, indicating initiatives that might be needed in these areas. The relationship between institutional investors and EM indicated existence of 'a short horizon' problem: of focus on higher current returns, which may be acting as one of the incentives for the managers to excessively manage earnings to meet the benchmarks. Perhaps, increasing their stakes/exposure to Indian firms and some training in fulfilling their monitoring role might lead the institutional investors to align their interests with the long term objectives of the firm (Institutional Advisory Services India Ltd. has already taken the first stride in this direction). Also, the results of the study were more robust in the case of the larger firms (the upper quartile) as compared to the smaller firms. Possibly because smaller firms are not subject the scrutiny of professional analysts and observers to the same extent as the larger ones, leading to lower external expectations and pressures to conform. This reaffirms the hypothesis that CG in India needs to be tweaked to respond to the peculiar needs of the Indian environment.

Introduction

Earnings management, in general, should be undesirable as the trade-offs are expensive for the owners in the long run. Indian companies characterized by relatively higher promoter shareholding and the dominance of family-owned businesses should essentially be subscribing to the view that the process of discretionary earnings management would be detrimental to the owners. However, depending upon market efficiency, the role of managerial discretionary accounting choices to signal better information may be argued for as the reason why a certain amount of

earnings management passes through the board's scanner in Indian firms, as shown by the results in this study.

Corporate governance constitutes a combination of systems and procedures aimed at controlling the functions of an organization by setting up rules, procedures and formats for managing decisions within an organization. It outlines the allocation of privileges and accountabilities among a firm's stakeholders and lays out the directives and processes for managing corporate organizations. As can be observed in several other facets of corporate affairs, norms for corporate governance should not subscribe to the herd mentality assuming similar norms across firms.

Corporate governance constitutes a combination of systems and procedures aimed at controlling the functions of an organization by setting up rules, procedures and formats for managing decisions within an organization.

Practical examples in real life scenarios are sufficient to indicate the need for customizing these corporate governance norms at least for a country, if not for an industry or a firm as a whole. The manner in which Maruti Suzuki recently handled the dissenting employee union members by doling out considerable severance packages to them did not go down too well with its institutional investors[171], nor was it readily acceptable from the point of view of good corporate governance disclosure norms. Few companies, if any at all, have to face the brunt of their shareholders' disapproval for taking such perceptibly inappropriate corporate board decisions in India, with the exception, of course, being the director's resolution against the acquisition of Maytas by Satyam[172]. In the latter's case, the implications from shareholder's wealth point of view were severe, prompting a near-collapse of the value of Satyam's ADRs. The creation of a corporate organizational form carries its own complications, as diverse stakeholder groups need to be taken care of. Although the multiplicity of such forms may be an indicator of their efficiency, corporate governance norms are required to ensure harmony between disparate groups with conflicting interests. The relative importance attributed to a particular stakeholder group at times influences the governance systems within firms and countries, because as per the widely accepted definition of corporate governance, it constitutes a set of control mechanisms to ensure that the investors get their required return on investment (Shleifer and Vishny[173], 1997). There are people who disagree with the emphasis on 'providers of capital' and their 'interests', because even though the corporate form was purportedly organizationally efficient, the issue of the governance of a company gained attention only after the spate of corporate frauds. Thus, the issue of corporate governance, which has been widely debated in the developed market economies, needs to be discussed in a different vein in the Indian context. For example, India did not share the set of factors responsible for the Asian crisis, which were largely macroeconomic and related to bank failure due to unprecedented and unchecked growth in the countries that were affected by the crisis. Similarly, the

structural characteristics of the Indian corporate sector are quite different from those prevailing in the US and UK, leading to a different set of corporate governance issues here.

One traditional method for classifying governance patterns has been the 'insider' versus the 'outsider' regime, with the outsider system being characterized by dispersed shareholding and a high emphasis on the protection of minority shareholder interests. This is similar to the 'market-based system' with its increasing reliance on the capital market for funds. Companies operating under the latter system have greater disclosure and transparency norms for the benefit of the minority shareholders, with more pronounced and comprehensive regulatory frameworks for these 'market-based' corporate systems. However, the dispersed shareholding creates lesser incentives for the owners to monitor the management except perhaps as an effective capital market tool for offloading these shares in case they [the owners] are not satisfied and want to discipline the errant management.

The 'insider-based regime' is closely related to the primarily bank-financed systems, which have a smaller number of dominant shareholders, who closely monitor the management and have greater incentives to monitor and discipline the latter. In such a system, the regulatory norms are generally more tolerant towards the concerted group of owners. The problem pertaining to the principal agent, which characterizes the 'outsider' or 'market-based' systems is thus not so dominant in the 'insider' or 'bank-based' system. Thus, while the Anglo-Saxon countries like the US and the UK have the 'outsider' or 'market-based' system, Germany and Japan follow the 'insider' or the 'bank-based' system. India typically has implemented a combination of the two systems with considerable concentrated stock ownership as compared to the 'market-based' or 'outsider' system and the dominance of family owned and managed firms.

However, banks do not constitute the only source of finance with a significant number of them being government-owned and controlled, and a proliferation of institutional investors gaining importance as a class. Rather than comparing the two models for establishing the superiority of one over the other, emphasis should be laid the incorporation of context-specific attributes, which would help companies to adapt to one system over the other. Moreover, the classic agency problem, which arises between the diversified owner and manager (and is referred to as 'Agency Problem Type—IBillalonga and Raphel, 2006[174]) is kind of overshadowed by the conflict of interests between the controlling dominant shareholder and the minority shareholders (which, in turn is referred to as Agency Problem Type II), as the dominant shareholder has incentive(s)[175] to monitor the manager.

With time, the share of promoter shareholding has not really come down. The average promoter shareholding in most of the firms in India was as high as 48.1 per cent in 2002 (Topalova, 2004[176]), while in this study, it was found to be averaging at about 50.31 per cent in the sample Indian firms. The primary reason as to why dominant promoter shareholding and control are concentrated among a select few is the existence of weak shareholder and creditor rights protection. Further, weak property rights constitute the main reason for concentrated shareholding and family control over businesses, thereby reducing transaction costs and asymmetric information problems in firms. Corporate governance norms in India have evolved well over the years since the advent of economic liberalization, with SEBI constituting a number of committees to suggest codes of conduct for facilitating good governance in corporate organizations.

The constitution of committees by SEBI was followed by the Listing Agreement under Clause 49 and by the Voluntary Guidelines of Corporate Governance in 2009, which were laid down by the Ministry of Corporate Affairs. These norms are inherently related to the legal and institutional environment in the country. India has had the legal framework for regulating the corporate form of organizations since the formulation of the Companies Act in 1956 along with fairly functional stock exchanges and their detailed listing requirements, ensuring the existence of 'de jure' protection. However, despite the proliferation of norms, minority shareholders and creditors were largely insecure because of the absence of 'de facto' protection (Chakrabarti, 2005[177]). With a decline in cross-country inhibitions regarding the raising of funds globally, it has become imperative to improve corporate governance standards. This signals the advent of greater information symmetry and transparency.

The concept of 'Earnings Management' has been defined as purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain (Schipper, 1989).

It is a convenient measure for evaluating a firm's performance during a period and for allocating limited resources among competing needs. Other things remaining same, present value of a firm's future earnings is a popular proxy for its market value. Thus earnings is a significant metric and managers are interested in it. Managers need to make informed accounting choices to add value to the firm. Thus they should know how to manage earnings. One of the earliest definitions of earnings management by Schipper (1989) had a negative connotation attached 'purposeful intervention in the external financial reporting process with the intent of obtaining some private gain'. This was reinforced by Healy & Wahlen (1999) 'Earnings management occurs when managers use judgement in financial reporting and in structuring transactions to

alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reporting accounting numbers.'

However we had positive viewpoints about earnings management focusing on this avenue as a means for signalling managerial private information which reduces the information asymmetry between the management and the stakeholders.[179] The presence of 'intent' is a prerequisite for managing earnings but the same may be channelled for either maximizing value of the firm or for opportunistic manipulation of earnings. 'Earnings management occurs when managers exercise their discretion over accounting numbers with or without restrictions. Such discretion can be either firm value maximizing or opportunistic'[180] Use of earnings management to arrive at stable and predictable information to improve persistence and predictability is another viewpoint for the managerial intent.[181]

It signifies the planning and control of the financial reporting system in order to meet the management objectives of fulfilling the expectations of analysts, maintaining the economic growth trajectory, or arriving at the predetermined target income for their incentive pay (Giroux, 2004[182]). The issue of Earnings Management has been a matter of concern for academicians, regulators and practitioners alike. However, the manner in which the issue has been dealt by each of them varies.

Academicians look for patterns and trends among large samples by using mathematical analysis, whereas managers and regulators look for the same on a case-to-case basis (Dechow and Skinner, 2000[183]). Would a change in accounting policies by eliminating managerial discretion to arrest earnings management opportunities prove to be an optimal solution from the point of view of good corporate governance? This would rather restrict an avenue for the managers to differentiate themselves for better incentives linked to the earnings of the firm. Earnings constitute one of the several signals that managers liberally use while taking their decisions in the organization.

Since it can be categorized as 'self-interested behaviour' Earnings Management ranges from manipulation to opportunism, wherein opportunism can be termed as 'self-interest with guile' (Giroux, 2004). This is perpetrated through the four popular avenues undertaken by management, laid out by Healy and Wahlen (1999)[184] as follows: avoiding debt covenants; enhancing managerial incentives; managing financial statements just before going to the capital market; or, managing the costs of regulatory and corporate governance compliance. These essentially revolve around the financial reporting disclosures of a firm. The provision of a true and fair view of the financial statements is the primary

[179] Dechow & Shkinner 2000, Scott 2003

[180] Fields et al. 2001

[181] Subramanyam 1996

[182] Giroux, Gary, 2004. *Detecting Earnings Management*, John Wiley & Sons Inc. Publications, United States.

[183] Dechow, P. and D. Skinner, 2000. *"Earnings Management: Reconciling the Views of Accounting Academics,* Practitioners, and Regulators", *Accounting Horizons*, Vol. 14, pp. 23550.

[184] Healy, P. and J. Wahlen, 1999. "A Review of the Earnings Management Literature and Its Implications for Standard Setting", Accounting Horizons, Vol. 13, pp. 36583.

objective of good corporate governance, as it helps in disseminating the necessary information among the stakeholders for protecting their interests in the firm (OECD, 1999).[185]

The very basic premise of Earnings Management, however, is the adjustment of the financial reporting numbers for managerial self-interest, which strikes at the very base of good corporate governance conduct and compromises the interests of the stakeholders. Among the list of motivations for Earnings Management as given above, in this study, we are concerned with the degree to which certain characteristics of good corporate governance arrest the self-interested behaviours of the management, which is concerned with managing the firm's reported earnings for personal gain.

As a mechanism, Earnings Management or adjustment is increasingly being resorted to by management for portraying the earnings of the firm at a desired level or for reporting the achievement of an expected income pattern through the exercise of discretionary financial reporting choices, which are offered by some of our flexible accounting standards. The dividing line between earnings adjustment and fraud is merely one of intention and is quite subjective. Among the list of incentives for managing earnings to drive management, as given above, 'signalling or concealing private information' (Demski, 1998)[186], seems a lot more convincing, as also does the benefit of making the Chief Executive Officer (CEO) look good to the stakeholders for meeting the expectations of analysts (Evans and Sridhar, 1996)[187]. This argument is in line with the age-old agency problem of managerial compensation contracts and performance-linked bonuses, leading to opportunistic earnings management by the managers at the expense of the owners (Jensen and Meckling, 1976)[188].

However, as pointed out earlier, the Indian corporate sector, consisting as it does of a majority of family-owned and controlled firms, presents a case for the Type II Agency problem, and hence would make an interesting context for exploring the possibility of matching the cash flow rights of the dominant shareholder with the voting rights. This is more so because of late, corporate governance discussions have started gaining prominence in India again, with the confessions made post the unearthing of under the Satyam fraud necessitating a review of our corporate governance standards and policies.

Fortunately, the Satyam scandal did not have a cascading impact on the Indian corporate sector. However, the Maruti Suzuki episode, and the Wipro employee embezzlement case[189], along with recent cases such as that of Kingfisher Airlines[190], have led to debates as to whether a major regulatory overhauling

[185] OECD Principles of Corporate Governance, 1999. ISBN: 9789264173705, 48 pages France.

[186] Demski, J.S., 1998. "Performance Measure Manipulation", Contemporary Accounting Research, Vol. 15, pp. 26185.

[187] Evans, J.H. and S.S. Sridhar, 1996. "Multiple Control Systems, Accrual Accounting, and Earning Management", Journal of Accounting Research, Vol. 34, pp. 45-65.

[188] Jensen, M. and W. Meckling, 1976. "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure", Journal of Financial Economics, Vol. 3, No. 4, pp. 30560.

is required for facilitating a more principle-based approach to corporate governance norms. A fine balance has always been maintained between the process of formulation of standards and policies, on one hand, and the promotion and protection of an India-specific corporate culture, on the other hand. There are enough norms in India to enable it to be compared favourably with most of its other Asian counterparts, as far as corporate governance regulations are concerned. However, compliance with those norms needs to be ensured.

The objective of this study is to present a more comprehensive study of the association between corporate governance variables and earnings management with firm level data, in the emerging market context of India, which is characterized by concentrated corporate ownership and family control of firms. The corporate governance structures existing in the past have paved the way for dominant equity holdings by families, who unilaterally take important decisions in the firm, including that pertaining to the appointment of its majority board members. This has often severely compromised the interests of the minority shareholders by leading to a mismatch between the cash flow and the control rights in the firm (Classens, et al., 2000)[191]. The interests of the minority shareholders can be protected through the incorporation of better corporate governance features, and the appointment of Big Four audit firms as external auditors or boards with a greater percentage of independent directors, in order to ensure checks against the expropriation of the interests of the minority shareholders by the dominant ones (Klapper and Love, 2004).[192]

The rationale for this study is provided by the observation of considerable earnings management across a cross-section of

[189] Allegations were made by two former employees of Wipro in 2010 that the fact that the earnings in the company were being managed could not be substantiated by Wipro's audit committee.

[190] This is a reference to the owner's equity in Kingfisher Airlines being depleted with extensive reliance being sought on bailout options.

[191] Classens, S., S. Djannklov and L.H.P. Lang, 2000. The Separation of Ownership and Control in East Asian Corporations", Journal of Financial Economics, Vol. 58, pp. 81112.

[192] Klapper, L.F. and I. Love, 2004. "Corporate Governance, Investor Protection, and Performance in Emerging Markets", Journal of Corporate Finance, 10, Vol. 5, No. 1, pp. 70328.

[193] Benford, F., 1938. "The Law of Anomalous Numbers", Proceedings of the American Philosophical Society, March, pp. 55172.

Indian firms during the period 2006-2011 by using Benford's Law (1938).[193] The results are statistically significant, suggesting the need for analysing the association between various corporate governance characteristics and earnings management more closely. Thus, we have reasons to believe that firms exhibiting better corporate governance would have relatively fewer incentives for implementing earnings management due to the existence of lower agency problems of conflict of interest between the agent and the principal, that is, primarily the dominant and the minority shareholders, in the Indian context (Agency Problem Type II).

Earnings Management in Indian Firms

A study based on the modelling of the managerowner relationship over time comes up with an interesting finding. The rationale is built on the relation of earnings management to the desire for meeting earnings expectations but the concomitant failure to see the complete picture.[194] This myopic behaviour, termed as 'bounded rationality', is the reason for the occurrence of several corporate governance scandals wherein the managers manage their earnings while being oblivious to the long-term implications of their actions on the firm. The constant pressure to meet analyst forecasts is a definite causal factor[195], and if a firm's earnings consistently meet the analysts' benchmarks, it should raise eyebrows in the corporate governance committees comprising auditors and other stakeholders. However, giving up on guidances pertaining to earnings is not the solution, as the extant literature shows that firms which have done so have indeed missed the benchmarks in more quarters than one (Chen, et al., 2010).[196]

As a precursor to building up a rationale for the need to examine the earnings management behaviour of Indian firms, we have applied Benford's Law to test for unusual patterns in earnings numbers in our sample of 2315 firms taken from the CMIE Prowess database over the period 20062011 (Carslaw, 1988[197]; Thomas, 1989[198]). The test basically looks for a greater number of zeroes and a fewer number of nines[199] than those predicted by probability for the second most frequently occurring digit in the reported earnings number. The motivations for the said managerial behaviours can essentially be mapped with the same earnings management incentives as discussed above (Healy and Wahlen, 1999; McNichols, 2000[200]).

The observed frequencies of the second digit need to be compared with the predicted frequency by using Benford's Law (1938), as each of the ten digits is not equally likely to occur in the second place. The digits that are most likely to occur are the zeroes, while those least likely to occur are the nines, with the other numbers falling in between. The variable tested for is positive profit after tax (pospat)[201], totalling some 8026 firm observations over the sample period.

[200] McNichols, M., 2000. "Research Design Issues in Earnings Management Studies", Journal of Accounting and Public Policy, Vol. 19, pp. 31345.

[201] We also tested for revenue/sales, but with POSPAT being a derived number, it finds better acceptance for validity the results for sales are attached in the Appendix.

The null hypothesis for the same is as follows:
H0: The observed distribution of the digits occurring in the second place for the variable (pospat) under study is in synchronization with the predicted distribution.

The alternate (HA) for the same is that there are significant deviations between the observed and the predicted distribution for the second digit, with greater frequencies of zeros and lesser frequencies of nines, and the deviations being statistically significant.

Table 1

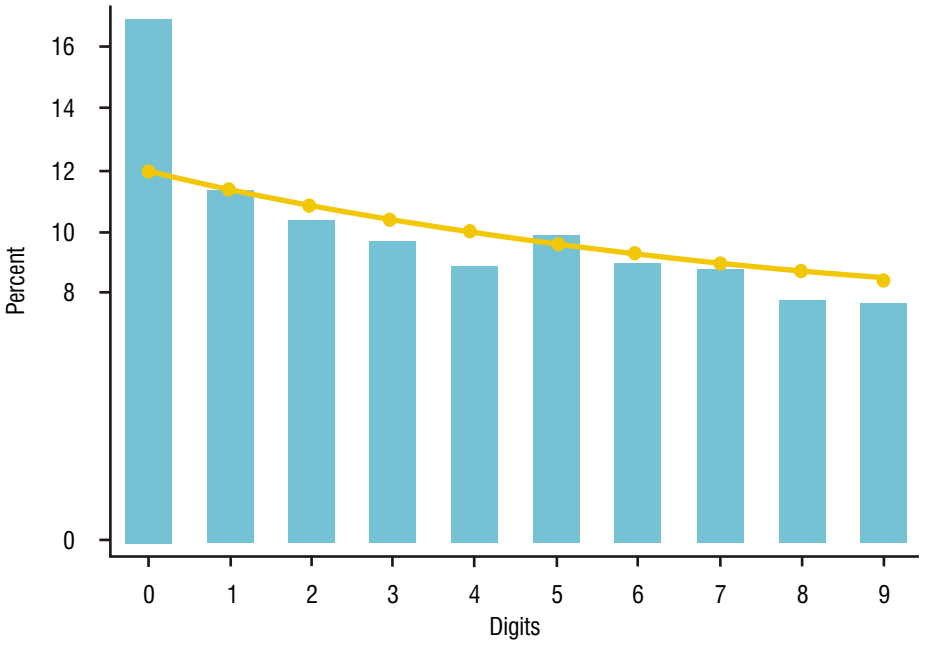
Variable	Obs	Mean	Std. Dev.	Min	Max
Pat	9921	1095.177	7537.104	-26109.7	202863
Pospat	8026	1411.705	8332.301	0.1	202863
Negpat	1839	-252.908	1085.999	-26109.7	-0.1
Npnl	56	0	0	0	0

*Pat—Profit after tax.
**Pospat—Positive profit after tax.
*** negpat—Negative profit after tax.
**** npnl—No profit no loss cases. All figures are in Rs. Crores.

The basic descriptives for the variable (PAT) for 9921 observations studied for applying the Benford test are as given above. We test for the profit-reporting firms (pospat) having 8026 observations.

Table 2

	Digit distribution for pospat (2nd digit)				
Value	**Count**	**Percent**	**Percent**	**Diff.**	**P-Value**
		Observed	**Expected**	**(MAD)**	
0	1350	16.82	11.98	4.852	0
1	906	11.288	11.389	-0.101	0.7921
2	831	10.354	10.882	-0.528	0.1322
3	779	9.706	10.433	-0.727	0.0327
4	713	8.884	10.031	-1.147	0.0005
5	791	9.855	9.668	0.188	0.571
6	717	8.933	9.337	-0.404	0.2196
7	699	8.709	9.035	-0.326	0.3207
8	621	7.737	8.757	-1.02	0.0011
9	619	7.712	8.5	-0.787	0.011
Total	**8026**	**100**	**100**	**1.008**	



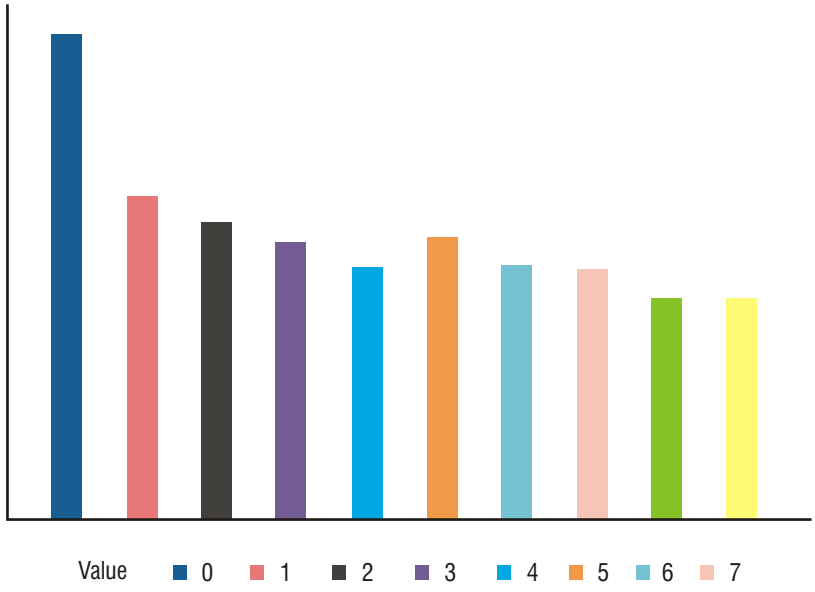


Table 2 shows the distribution of the digits 09 for Positive Profit after tax (pospat) for 8026 firm observations over the period 20062011 from the Prowess database of CMIE. The distribution shows that the digit '0' is over-represented, while the digit '9' is under-represented, and the difference between the predicted (as per Benford's Law) and the observed percentages for both are statistically significant.

In order to check for overall bias in the variable pospat, a chi square test was conducted for all the nine digits together, which is significant.

Table 3

Number of obs	8026	Percentage of Companies
N of outcomes	10	54
Chi2 df	9	46
Goodness-of-fit	**Coef.**	**P-value**
Pearson's X2	192.6522	0
Log likelihood ratio	175.9777	0

The result, in general, implies some adjustment and rounding up of the earnings numbers by the concerned management, thus laying down the groundwork for a more detailed study that is required in the wake of increasing positive sentiments for good corporate governance firms in India.[202]

Literature Review and Hypothesis Development

Earnings Management

Earnings Management as a managerial incentive has been amply discussed in literature. Different authors have discussed various motives such as '…to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend upon reported accounting income numbers' (Healy and Wahlen, 1999), managing performance bonuses (Matsunga and Park, 2001)[203] to capital market expectations (Bartov, et al., 2002)[204]. Irrespective of the motive, the main issue concerning earnings management is that it is not directly measurable. Thus, the proxies used are aggregate abnormal or discretionary accruals.

The accruals are primarily supposed to help overcome problems in measuring firm performance by bridging the gap between earnings and cash flows (Dechow, 1994).[205] However, the discretionary accounting choices with managers[206] might be geared towards opportunistic earnings management

[202] FIIs.

[203] Matsunga, S.R. and C.W. Park, 2001. "The Effect of Missing a Quarterly Earnings Benchmark on the CEO's Annual Bonus", The Accounting Review, Vol. 76, pp. 31332.

[204] Bartov, E., D. Givoly and C. Hayn, 2002. "The Rewards for Meeting-or-Beating Earnings Expectations", Journal of Accounting and Economics, Vol. 33, June, pp. 173204.

[205] Dechow, P. 1994. "Accounting Earnings and Cash Flows as Measures of Firm Performance: The Role of Accounting Accruals", Journal of Accounting and Economics, July, pp. 342.

[206] For example, Depreciation, R&D expenses, provisions and reserves.

rather than decreasing information asymmetry for facilitating better signalling of the financial performance of firms. The market efficiency, in general, is assumed to take care of these anomalies with the adequate discounting of firms indulging in the said behaviour. However, the fact remains that earnings manipulations do exist, and they, in turn, influence the markets. The Jones (1991)[207] model and the modified Jones model are widely used for measuring discretionary accounting accruals despite its limitations.

Corporate Governance

The role of corporate governance in curbing earnings management, especially in the developing economy context of India, has been justifiably argued for. The corporate governance norms for the various board sub-committees, delegated with the task of monitoring the management as shareholder representatives, ensure adequate compliance with the disclosure and financial reporting standards and practices (Zahra and Pearce, 1989)[208]. Apart from ensuring the alignment of the interests of the agents with the principal, adequate corporate governance practices increase the credibility of the reported financial statements in compliance with the accounting standards and regulations (Watts and Zimmerman, 1986)[209]. Thus, we have a set of corporate governance attributes related to the sub-committees of the board, which need to be explored for their association with earnings management in reducing the perennial agency problem in India through a safeguarding of the interests of the minority shareholders.

In general, we hypothesize that our sample firms with relatively higher degrees of corporate governance structures have lower earnings management.

H1: Lower earnings management proxies (discretionary accruals) are associated with higher/better levels of corporate governance attributes.

Independence of the Board of Directors

The role of the Board of Directors in terms of their functioning as an effective monitoring mechanism for management is dependent upon their being non-executive and independent in character (Beasley, 1996)[210]. The existence of boards dominated by outsider-members in a firm in terms of the percentage of independent directors enhances the reputation of the firm as one following good corporate governance, and thereby improving the reliability of its financial disclosures. However, there also exist studies that argue on the contrary, and point towards the evils of excess policing (Baysinger and Butler, 1985)[211] and the lack of relevant expertise (Patton and Baker, 1987)[212]. These shortcomings can be addressed by choosing efficient board members. There are conflicting results on the

[207] Jones, J., 1991. "Earnings Management during Import Relief Restrictions", *Journal of Accounting* Research, Vol. 29, Autumn, pp. 193228.

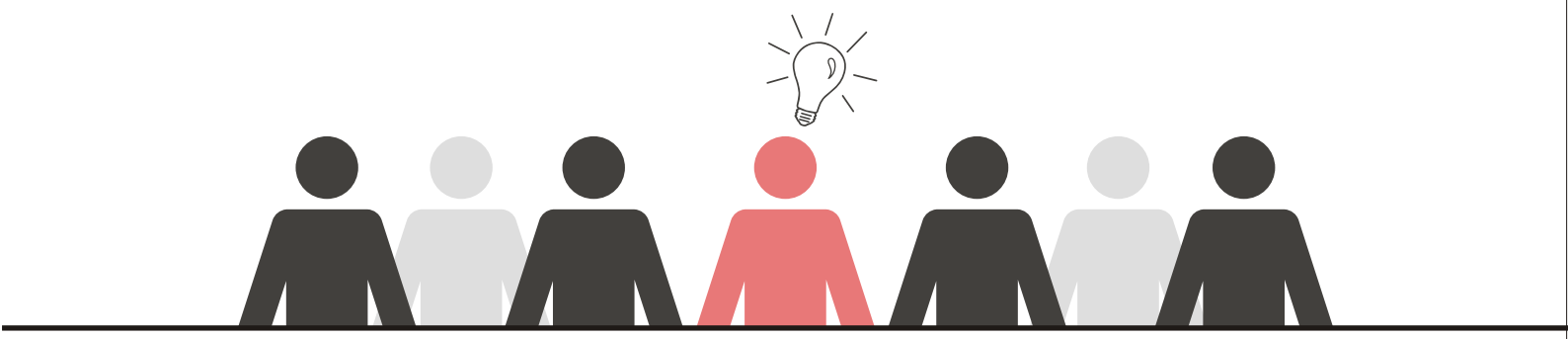
[208] Zahra, S.A. and J.A. Pearce, 1989. "Board of Directors and Corporate Financial Performance: A Review and Integrative Model", *Journal of Management*, Vol. 15, pp. 291334.

[209] Watts, R.L. and J.L. *Zimmerman*, 1986. *Positive Accounting Theory*, Prentice Hall, New York.

[210] Beasley, M., 1996. "An Empirical Analysis of the Relation between the Board of Director Composition and Financial Statement Fraud", *The Accounting Review*, Vol. 71, pp. 44365.

[211] Baysinger, Barry D. and Henry N. Butler, 1985. "Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition", The Journal of Law Economics and Organization, Vol. 1, No. 1, pp. 101-24.

[212] Patton, A. and J.C. Baker, 1987. "Why Don't Directors Rock The Boat?", *Harvard Business Review*, Vol. 65, No. 1, pp. 1018



implied association between board independence and management of earnings, with studies by Beasley (1996), Klein (2002)[213], and Davidson, et al., (2005)[214] finding a significant negative association between the two. On the other hand, Park and Shin (2004)[215], Peasnall, et al. (2005)[216], and Bradbury, et al. (2006)[217] have failed to report any association between earnings management and the independence of the board.

Thus we hypothesize that,
H2: There is a significant negative association between earnings management proxies and the independence of the board of directors.

Board Size

The number of directors on the board is another important variable, though there is no consensus in literature on the influence that the board size may have in increasing its effectiveness in curbing earnings management. Some studies report a positive association between earnings management and size of the board due to a lag in decision-making resulting from a lack of consensus (Goodstein, et al., 1994[218]; Chin, et al., (2006)[219], Zahra and Pearce (1989), Xie, et al. (2003)[220], and Peasnall, et al. (2005) argue that a larger board would be better able to monitor the management and reduce incentives for managing earnings, thereby positing a negative relation with bigger boards being associated with lower earnings management. Bradbury, et al. (2006), however, report no association between the two. Thus, we observe the association without predicting its direction and hypothesize as follows:

H3: There is association between earnings management and size of the board of directors.

213 Klein, A. 2002. "Audit Committee, Board Of Directors' Characteristics, and Earnings Management", Journal of Accounting and Economics, Vol. 33, pp. 375400.

214 Davidson, R., J. Goodwin-Stewart and P. Kent, 2005. "Internal Governance Structures and Earnings Management", Accounting and Finance, Vol. 45, pp. 24167.

215 Park, Y.W. and H.H. Shin, 2004. "Board Composition and Earnings Management in Canada", Journal of Corporate Finance, Vol. 10, Pp. 43157.

216 Peasnell, K.V., P.F. Pope and S. Young, 2005. "Board Monitoring and Earnings Management: Do Outside Directors Influence Abnormal Accruals?", Journal of Business, Finance and Accounting, Vol. 32, pp. 131146.

217 Bradbury, M., Y. Mak and S. Tan, 2006. Board Characteristics, Audit Committee Characteristics, and Abnormal Accruals", Pacific Accounting Review, Vol. 18, pp. 4768.

218 Goodstein, J., K. Gautam and W. Boeker, 1994. "The Effect of Board Size and Diversity on Strategic Change", Strategic Management Journal, Vol. 15, pp. 24150.

219 Chin, K., Firth, M., & Rui, O. 2006. Earnings management, corporate governance, and the market performance of seasoned equity offerings. Journal of Contemporary Accounting and Economics, 73a pg 98.

220 Xie, B., N.W. Davidson and P. Dalt, 2003. "Earnings Management and Corporate Governance: The Roles of the Board and the Audit Committee", Journal of Corporate Finance, Vol. 9, No. 3, pp. 295316.

Attendance in Board Meetings

It is argued that holding a greater number of board meetings would facilitate more vigilant monitoring by the board in the company affairs and would thus be associated with better firm performance and consequently reduced earnings management (Vafeas, 1999).[221]

H4: There is a significant negative association between the attendance of directors in board meetings and earnings management.

CEO Chairman

The position of the Chief Executive Officer (CEO) should be independent of the chairperson of the board in order to facilitate a balance and check on the misuse of power by either of the two. Agency theory too supports this argument in order to avoid conflict of interest and allow for the board chairman to formulate the requisite strategies and be responsible for implementing the same (Jensen,1993[222]; Blackburn, 1994[223]). This, in turn, would help check earnings management through better monitoring. Contrary to this view, Rechnar and Dalton (1991)[224] argue for the duality of roles as that would provide better incentives by linking the CEO's pay with firm performance. Klein (2002) shows that the duality of roles leads to unchecked powers and finds a significant positive association with earnings management. A number of studies, on the other hand, report no significant relationship between duality of roles and earnings management (Davidson, et al., 2005; Cornett, et al., 2006[225]). During the course of factor analysis in our sample firms, it was found that the variable CEO chair was not loaded significantly enough (which is less of a positive coefficient) to be chosen as the significant explanatory variable. This suggests that in our sample of firms, segregating the role of the Chairman from the CEO does not significantly contribute towards more effective monitoring and, hence, lesser earnings management.

Promoter Shareholding/Block Shareholding

The average promoter shareholding in our sample of Indian companies is a little above 50 per cent, contrary to that observed in the US and UK firms with widely dispersed shareholding. To add to the same, a majority of them are family firms having vested interests in maximizing shareholder's interests. Literature shows that high promoter shareholding, in consonance with resolving the agency problem (Jensen and Meckling, 1976) constrains opportunistic earnings management (Warfield, et al., 1995[226]; Chtourou, et al., 2001[227]; Yeo, et al., 2002[228]). A high level of promoter shareholding implies higher vested interests and better incentives for effective monitoring to ensure curbing of earnings management (Shleifer and Vishny, 1997). On the other hand, a significantly higher level of shareholding

A high level of promoter shareholding implies higher vested interests and better incentives for effective monitoring to ensure curbing of earnings management
(Shleifer and Vishny, 1997)

[221] Vafeas, N., 1999. "Board Meeting Frequency and Firm Performance", *Journal of Financial Economics*, Vol. 53, pp. 11342.

[222] Jensen, M.C., 1993. "The Modern Industrial Revolution, Exit and the Failure of Internal Control Systems", *The Journal of Finance*, Vol. 48, pp. 83180.

[223] Blackburn, V., 1994. "The Effectiveness of Corporate Control in the US Corporation", *Corporate Governance–An International Review*, Vol. 2, p. 196.

[224] Rechner, P.L. and D.R. Dalton, 1991. "CEO Duality and Organisational Performance: A Longitudinal Analysis", *Strategic Management Journal*, Vol. 12, pp. 15560.

[225] Cornett, M., A. Marcus, A. Saunders and H. Tehranian, 2006. "Earnings Management, Corporate Governance, and True Financial Performance", *Working Paper*, Southern Illinois University, Carbondale, IL.

[226] Warfield, T., J. Wild, and K. Wild, 1995. "Managerial Ownership, Accounting Choices, and Informativeness of Earnings", *Journal of Accounting and Economics*, Vol. 20, pp. 6191.

[227] Chtourou, S.M., J. Bedard and L. Courteau, 2001. "Corporate Governance and Earnings Management", *Working Paper*, University of Laval, Canada.

[228] Yeo, G.H.H., P. Tan, K.W. Ho and S.S. Chen, 2002. "Corporate Ownership Structure and the Informativeness of Earnings", *Journal of Business, Finance and Accounting*, Vol. 29, pp. 102346.

may lead to diminishing returns due to entrenchment, leading to an increase in earnings management (Cornett, et al., 2008).

Thus it is hypothesized that,
H5: There is a significant negative association between promoter shareholding and earnings management.

Institutional Shareholding—Domestic/ Foreign

The role of the shareholding of institutional investors in a firm and its impact on reducing the misuse of the manager's discretion gained sufficient attention in the context of Satyam's failed attempt to acquire Maytas. Institutional investors can play an effective role in monitoring and checking the managerial decisions in a firm (Bushee, 1998[229]; Rajgopal, et al., 2002[230]). There is a conflicting view on the issue of institutional investors having a short horizon problem (Lang and McNichols, 1999[231]) and their percentage exposure being the determinant factor of the importance of the disciplining role they play in the firm. Thus, it can be hypothesized that an effective oversight of institutional investors (both domestic and foreign) would have a negative impact on the earnings management activities of the agents (Chung, et al. 2002[232]; Bhojraj and Sengupta, 2003[233]). Probably, significant institutional shareholding may create the necessary monitoring incentives to dissuade the managers from focusing on the expectations of quarterly analysts rather than on long-term growth.

H6: There is a significant negative association between earnings management and the percentage of institutional shareholding in a firm.

Big Three/Four as Auditors

The existence of an audit committee facilitates the board's job of ensuring the credibility of financial reporting by delegating it to a sub-committee of directors with a certain minimum level of financial expertise. However, the presence of one of the top three/four reputed audit firms as an auditor signals the operation of a better monitoring mechanism as far as financial disclosures are concerned, thereby curbing earnings management behaviour (Xie, et al. 2003; Bedard, et al., 2004[234]; Jaggi and Leung, 2007[235]). There have also been studies reporting no significant to an unusual positive relationship between the two. Thus it can be hypothesized as follows:

H7: There is a significant negative association between earnings management and the presence of Big Three/Four as auditors in the firm.

[229] Bushee, B., 1998. "The Influence of Institutional Investors on Myopic R&D Investment Behaviour", *The Accounting Review*, Vol. 73, No. 3, pp. 30533.

[230] Rajgopal, S., M. Venkatachalam and J. Jiambalvo, 2002. "Is Institutional Ownership Associated with Earnings Management and the Extent to Which Stock Prices Reflect Future Earnings?" *Working Paper*, Stanford University, United States.

[231] Lang, M. and M. McNichols, 1999. "Institutional Trading and Corporate Performance", Working Paper, Stanford University, United States.

[232] Chung, R., M. Firth and J.B. Kim, 2002. "Institutional Monitoring and Opportunistic Earnings Management", *Journal of Corporate Finance*, Vol. 8, pp. 2948.

[233] Bhojraj, S. and P. Sengupta, 2003. "Effect of Corporate Governance on Bond Ratings and Yields: The Role of Institutional Investors and Outside Directors", *Journal of Business*, Vol. 76, No. 3, pp. 45575.

[234] Bedard, J., S.M. Chtourou and L. Courteau, 2004. "The Effect of Audit Committee Expertise, Independence, and Activity on Aggressive Earnings Management, Auditing", *A Journal of Practice and Theory*, Vol. 23, pp. 1335.

[235] Jaggi, B. and S. Leung, 2007. "Impact of Family Dominance on Monitoring of Earnings Management by Audit Committees: Evidence from Hong Kong", *Journal of international Accounting, Auditing and Taxation*, Vol. 16, No. 1, pp. 2750.

Research Design

Sample and Data

Our initial sample is drawn from the population of 2697 listed firms in the BSE A and B groups as given in the CMIE Prowess database. From this, we deleted the Banking and Financial services firms[236] (NIC code 64), thereby reducing the sample to 2351 firms. It is difficult to compute discretionary accruals measures for these firms. We further removed 36 firms from the list due to the non-availability of market capitalization data for the year 2011. This gave us the benefit of ensuring that the sample firms had traded during the last financial year, which increases the probability of data availability for the financial and the corporate governance variables. This gave us a final sample of 2315 firms, though the number of observations (firm years) used in the regressions is 9920, as the firms which do not provide complete information on some of the variables have also been removed. Thus, our interpretation of the results are limited to the given period of time and the chosen sample.

Data related to the board of directors characteristics are picked up from the corporate governance report disclosed as a part of the annual report by the companies concerned. All other financial and corporate governance variables are collected from Prowess, including the earnings, working capital, and cash flow data for computing the abnormal accruals. The final number of observations were reduced primarily because we used the modified Jones model to estimate the discretionary accruals for each sample firm. The model parameters are determined industrywise, and each firm-year observation is required to have at least three observations lying in the same two-digit NIC code.

Earnings Management—Dependent Variable Measures

The use of accruals adjustment as a proxy for earnings management has been widely used in literature, as it is less discernible than, say, a change in an accounting method, which needs to be adequately disclosed and justified. We start by using three variables to proxy for earnings management based on the existing literature (Dechow et al.,, 1995). These are total absolute accruals (tacc_abs), total absolute accruals adjusted for size measured by average total assets (tacc_rel) and discretionary accruals (abs_da), arrived at by using the modified Jones model. The total accruals have been divided into discretionary accruals and non-discretionary accruals. The non-discretionary accruals reflect the underlying economic performance of the firm and are not influenced by managerial discretionary choices with regard to, say, the amount of receivables. Discretionary accruals constitute the abnormal part of accruals, which are unexplained by any change in the revenue

[236] These companies in the banking and finance sector are governed by a different set of regulations, with their working capital structure requirements being different from those of other firms (Klein, 2002).

net of the change in receivables and gross Property Plant and Equipment (PPE). These are scaled by the average total assets in order to reduce heteroscedasticity problems.

$$Tat - Non\ DACt = DACt$$

$$TAt = \Delta CAt - \Delta Casht - \Delta CLt + \Delta STDt - DEPt$$

where:
ΔCAt is the change in current assets in year t
ΔCasht is the change in cash and cash equivalents in year t
ΔCLt is the change in current liabilities in year t
ΔSTDt is the change in the short-term debt included in the current liabilities in year t
DEPt is the depreciation and amortization expense in year t

Discretionary Accruals constitute the difference between the Total Accruals and Non-discretionary Accruals.

We compute the Non-discretionary Accruals by using the method given below:

$$Non\ DACt = 1(1/At\text{-}1) + 2(\Delta REVt\ \ \Delta RECt / At\text{-}1) + 3(\Delta PPEt / At\text{-}1) + \ \varepsilon$$

where:
ΔREVt is the revenues in year t less revenue in year t-1
ΔPPEt is the gross PPE at the end of year t
ΔRECt is net receivables in year t less net receivables in year t-1.
At-1 is the average total assets at the end of year t-1
$\alpha 1$, $\alpha 2$, and $\alpha 3$ are the firm-specific parameters
ε refers to the residuals
Thus DACt = TAt - Non DACt

The data needed to compute abnormal/discretionary accruals like revenue, receivables, PPE, etc. are taken from the CMIE Prowess database. A cross-sectional regression model for Jones (1991) is used to estimate the unadjusted abnormal accruals for each firm in the sample. Following the NIC 2 digit classification code and the firm years, the accruals are estimated by OLS with the industry and year combination, by having at least three firms in the industry as a pre-requisite.

The main dependent variable is thus the absolute discretionary accruals (abs_da) with two variations. One is a dummy of the absolute discretionary accruals (dummy abs_da) with a value derived by splitting the sample from the median value of the absolute discretionary accruals measured as '1' for greater than equal to ($>=$) and as '0' for less than ($<$) the median of absolute discretionary accruals. This would take care of high versus low earnings management, if not income increasing versus income decreasing earnings management, and the other proxy is a logarithmic transformation of the absolute discretionary accruals (lnabs_da), which is used in the regression model.

Table 4: The variable definitions are as follows:

Sno	Variable	Definition
1	Size of the board	Number of directors on the board at the end of financial year
2	No. of independent directors	Number of independent directors on the board at the end of financial year
3	% of independent directors	No. of independent directors / size of the board
4	Avg. no. of board meetings attended	Average number of board meetings attended during the year by all the directors who are on the board at the end of financial year
5	Max. no. of board meetings	Maximum number of board meetings attended by any directors, who is on the Board at the end of financial year (Proxy for total number of meetings)
6	% of board meetings attended	Avg. no. of board meetings attended/max. no. of board meetings
7	Avg. no. of other chairpersonships held	Average number of chairpersonships held in the other companies by all the directors, who are on the board at the end of financial year
8	Avg. no. of other directorships held	Average number of directorships held in other companies by all the directors, who are on the board at the end of the financial year
9	CEO_Chair	1 if Chief Executive Officer of the firm is also Chairperson of the Board of at the end financial year, else 0
10	Promoters - shares held	% age shares held by promoters
11	Indian promoters - shares held	% age shares held by domestic promoters
12	Foreign promoters - shares held	% age shares held by foreign promoters
13	Foreign promoters	Dummy; 1 if % age held by foreign promoter > 0, else 0
14	Institutional %	% age shares held by institutions
15	Institutional_for %	% age shares held by foreign institutions
16	Foreign institutional promoters	Dummy; 1 if % age held by foreign institutional promoter > 0, else 0
17	Institutional_dom %	% age shares held by domestic institutions
18	Block 5% share	% age shares held by blockholders (where blockholder is defined as any shareholder holding >= 5%)
19	Block 5% count	Number of blockholders (where blockholder is defined as any shareholder holding >= 5%)
20	Block 10% share	% age shares held by blockholders (where blockholder is defined as any shareholder holding >= 10%)

...table continued

Sno	Variable	Definition
21	Block 10% count	Number of blockholders (where blockholder is defined as any shareholder holding >= 10%)
22	Auditor_top_3	Dummy; 1 if Auditor is among member companies of Top 3, else 0
23	Auditor_top_4	Dummy; 1 if Auditor is among member companies of Top 4, else 0 (where Top 4 are Deloitte, PwC, E&Y and KPMG)
24	Average total assets	log of Average total assets in Rs crores
25	Total absolute accruals	change in Current assets – change in cash - change in Current liabilities + change in short-term debt – Depreciation
26	Total accruals relative to size	absolute total accruals/average total assets
27	Non-discretionary accruals	A function of change in revenue net of change in receivables and gross Property Plant & Equipment (PPE)
28	Discretionary accruals	Total Accruals relative to size - Non Discretionary Accruals
29	Absolute discretionary accruals	Total Accruals relative to size - Non Discretionary Accruals

Results and Analyses

The descriptive statistics for the variables used in the study are given in Table 5. The mean and median statistics for the discretionary accruals proxy reveal both income increasing and income decreasing earnings management in the sample firms, which is taken care of by the absolute discretionary accruals showing a median value of 0.13 and a range of 67.69. The wide variation in the variable firm size, measured as the average total assets (avgta), suggests that one should control for firm size and check for the said bias of large versus small firms through interaction terms in the regression equations. On an average, the sample firms[237] have seven directors on board (size), with 50 per cent of them being independent (ind), with a median average of three directors. On an average, 75 per cent of the board meetings were attended by the directors (att). A promoter shareholding (pro_sh) median value of 50 per cent shows that the contextual concentrated ownership issue is a determining factor for examining whether the nature of the promoters' shareholding is primarily Indian or foreign and its impact on the association between earnings management and corporate governance attributes. On an average, the

[237] A considerable difference was reported between the mean and the median.

institutional share—holdingboth domestic and foreign—in the sample firms is 8.69 per cent. The audit quality proxied by the presence of one of the big three auditors is measured as a (0,1) dummy variable, showing that roughly 15 per cent of the sample firms engage the services of the big three audit firms as their auditors, implying thereby that not all big firms in India engage the big three auditors. Standard deviations for most of the corporate governance attributes are low, probably signalling a kind of standardized adherence to similar norms of good corporate governance among firms in India.

Table 5: Descriptive Statistics

Variable	N	Mean	Median	Min	Max	Sd
Size	13848	7.61	7.00	1.00	27.00	2.79
Ind	13848	0.45	0.50	0.00	1.00	0.23
ind_num	13848	3.46	3.00	0.00	16.00	2.10
meet_num	13848	4.65	4.25	0.00	31.00	2.82
meet_max	13848	6.35	6.00	0.00	55.00	3.82
Att	12790	0.74	0.75	0.11	1.00	0.15
Chp	13848	0.04	0.00	0.00	6.14	0.26
Dir	13848	2.66	2.00	0.00	31.36	2.61
ceo_chair	13848	0.01	0.00	0.00	1.00	0.08
pro_sh	13166	50.31	51.12	0.00	99.59	19.02
indpro_sh	13166	42.12	44.12	0.00	99.59	22.35
forpro_sh	13166	6.05	0.00	0.00	94.87	16.73
forpro_num	13166	0.20	0.00	0.00	1.00	0.40
Inst	13166	8.69	2.02	0.00	99.97	14.08
inst_for	13166	3.45	0.00	0.00	74.18	7.24
inst_dom	13166	5.24	0.78	-0.01	99.97	10.84
forinstpro_num	13166	0.47	0.00	0.00	1.00	0.50
bigthree	13800	0.15	0.00	0.00	1.00	0.36

...table continued

Variable	N	Mean	Median	Min	Max	Sd
bigfour	13800	0.17	0.00	0.00	1.00	0.37
block5_sh	13174	7.66	0.00	0.00	134.44	12.78
block5_num	13174	0.81	0.00	0.00	13.00	1.24
block10_sh	13166	3.10	0.00	0.00	123.60	8.71
block10_num	13166	0.20	0.00	0.00	5.00	0.52
avgta	12248	13319.32	1472.33	0.15	2680749.00	75417.76
tacc_abs	12349	326.58	4.25	-167317.90	235640.70	5968.04
tacc_rel	12210	0.06	0.01	-126.52	176.78	3.49
nondisc_acc	11719	0.01	0.00	-31.62	49.19	1.22
disc_acc	11712	0.00	0.01	-67.69	64.92	2.02
abs_da	11712	0.46	0.13	0.00	67.69	1.97

Quartiles Analysed

The firm size has been an important influencing variable in literature (Becker, et al., 1998[238]). Thus, we use firm size measured as an average of the total assets and segregate the sample into quartiles. We analysed the means of all the variables within these quartiles with the smallest firms being in Quartile 1 and the biggest ones in Quartile 4. The general observation was that the bigger firms tend to manage their earnings upwards due to the targets to be met in terms of market expectations (Rs. 1167.53 crore), while the smaller firms manage their earnings downwards to create a buffer for the next year (Rs. - 0.18 crores). Firms with higher discretionary accruals were smaller in size, while those with higher assets size had smaller discretionary accruals. Big firms would have larger analysts following their data and benchmarks to be achieved while smaller firms would have lower external expectations. Thus, variables like board size, foreign promoter shareholding, institutional shareholding, and the choice of big three auditors are seen to increase with the firm size, while the absolute discretionary accruals are higher for smaller firms, implying that income decreasing earnings management is more popular among smaller firms in India. Thus, there is an overbearing need to control for the impact of firm size while analysing the associations. Therefore,

[238] Becker, C., M. Defond, J. Jiambalvo and K.R. Subramanyam, 1998. "The Effect of Audit on the Quality of Earnings Management", *Contemporary Accounting Research*, Vol. 15, Spring, pp. 124.

in the regression models, we have controlled for firm size through the log of the average total assets and examined the interactions of the independent variables with firm size.

Table 6:

		Quartile of Firm Size (avgta)										
avgta_dum	avgta	size	ind	ind_num	meet_num	meet_max	att	chp	dir	ceo_chair	pro_sh	indpro_sh
1	174.2	5.75	0.41	2.4	4.5	5.83	0.78	0.01	1.15	0.01	43.45	38.02
2	835.65	7.06	0.46	3.23	4.87	6.67	0.74	0.02	2.19	0	52.02	44.52
3	2949.46	8.08	0.49	3.93	4.82	6.7	0.73	0.04	3.16	0.01	53.56	44.39
4	49317.98	9.69	0.48	4.63	4.8	6.63	0.73	0.09	4.35	0.01	52.97	43.64
Total	13319.32	7.67	0.46	3.56	4.75	6.46	0.75	0.04	2.73	0.01	50.7	42.77
avgta_dum	forpro_sh	forpro_num	inst	inst_for	forinst pro_num	bigthree	bigfour	block5_sh	block5_num	ceo_chair	block10_sh	block10_num
1	2.78	0.11	1.78	0.36	1.42	0.09	0.01	0.02	6.03	0.67	2.24	0.16
2	5.25	0.18	3.52	1.14	2.39	0.29	0.06	0.07	7	0.71	3.3	0.22
3	7.79	0.24	7.93	3.29	4.64	0.61	0.19	0.22	8.7	0.92	3.42	0.22
4	8.66	0.27	22.14	9.66	12.49	0.91	0.35	0.39	9.7	1.06	3.32	0.2
Total	6.24	0.2	9.17	3.76	5.41	0.49	0.15	0.17	7.93	0.85	3.09	0.2
avgta_dum	tacc_abs	tacc_rel	nondis_acc	disc_acc	abs_da							
1	-0.18	0.14	-0.01	-0.03	1.1							
2	0.56	-0.01	0.01	-0.03	0.37							
3	149.18	0.05	0.02	0.02	0.26							
4	1167.53	0.04	0	0.04	0.18							
Total	330.2042	0.056408	0.005286	0.003039	0.457335							

Correlations

It is observed that the main dependent variable, that is, the absolute discretionary accruals (abs_da), is significantly negatively correlated with a majority of the corporate governance attributes. The correlation matrix reveals significant negative correlations between absolute discretionary accruals (abs_da) and some corporate governance variables like board size (-ve), the number of independent directors (-ive), the number of meetings held (-ive), the number of other directorships held (-ive), promoter shareholding (-ive), institutional shareholding (-ive), and audit quality (-ive), thereby revealing the importance of good corporate governance in controlling earnings management. There also exists a high correlation between many of the corporate governance measures, implying the possibility of multi-collinearity if used in the same regression. This leads to the use of factor analysis for the corporate governance variables for extracting the relevant factors to be used in the regression analysis.

Table 7: Correlation Matrix

	size	ind	ind_ num	meet_ num	meet_ max	att	chp	dir	ceo_ chair	pro_sh	indpro_ sh	forpro _sh	forpro _num	pro_sh	inst_for	inst_ dom	forinstp ro_num	bigthree	bigfour	block5 _sh	block5 _num	block10 _sh	block10 _num	avgta	tacc _abs	tacc_rel	nondisc _acc	disc _acc	abs_da
size	1																												
ind	0.870*	1																											
ind_num	0.6281*	0.7697*	1																										
meet_num	- 0.0459*	0.2168*	0.0940*	1																									
meet_max	0.0636*	0.2112*	0.1545*	0.9025*	1																								
att	- 0.3151*	0.0239*	-0.1784*	0.2968*	- 0.1328*	1																							
chp	0.0967*	0.0216*	0.0744*	-0.0046	-0.0038	-0.0083	1																						
dir	0.2706*	0.2096*	0.3118*	0.0448*	0.0446*	0.0017	0.0829*	1																					
ceo_chair	-0.0017	0.0348*	0.0216*	-0.0052	-0.0081	0.0149	0.0072	0.0029	1																				
pro_sh	0.1219*	-0.0709*	0.0177*	-0.0685*	-0.0677*	-0.0166	0.0054	0.1344*	-0.0321*	1																			
indpro_sh	0.0578*	0.0306*	0.0650*	0.0631*	0.0279*	0.1066*	0.0011	0.0820*	- 0.0418*	0.6317*	1																		
forpro_sh	0.0751*	-0.0857*	-0.0365*	-0.1439*	-0.0972*	-0.1552*	0.0153	0.0692*	0.0236*	0.2681*	-0.4938*	1																	
forpro_num	0.1350*	-0.0369*	0.0424*	-0.1381*	-0.0899*	-0.1530*	0.0066	0.0952*	0.0274*	0.1454*	-0.3926*	0.7272*	1																
inst	0.3534*	0.0242*	0.2226*	0.0273*	0.0515*	-0.0561*	0.0768*	0.2462*	0.0116	-0.0515*	-0.0283*	0.0111	0.0484*	1															
inst_for	0.2786*	0.0703*	0.2257*	0.0470*	0.0728*	-0.0482*	0.0643*	0.2489*	0.0259*	-0.1396*	-0.1019*	0.009	0.0644*	0.6528*	1														
inst_dom	0.2727*	-0.0155	0.1383*	0.0041	0.0183*	-0.0406*	0.0568*	0.1535*	-0.0022	0.0264*	0.0313*	0.0084	0.0198*	0.8625*	0.1798*	1													
forinsttpro_ num	0.3582*	0.0866*	0.2805*	-0.0001	0.0387*	-0.0911*	0.1001*	0.3270*	0.0443*	0.0145	-0.0589*	0.1341*	0.1567*	0.4580*	0.5097*	0.2543*	1												
bigthree	0.2385*	0.0456*	0.1790*	-0.0668*	-0.0458*	-0.0606*	0.1040*	0.2813*	0.0181*	0.0718*	-0.1442*	0.3125*	0.2572*	0.2519*	0.2539*	0.1577*	0.2921*	1											
bigfour	0.2452*	0.0508*	0.1837*	-0.0746*	-0.0537*	-0.0625*	0.0969*	0.2947*	0.0227*	0.0845*	-0.1797*	0.3771*	0.2962*	0.2632*	0.2701*	0.1616*	0.3133*	0.9357*	1										
block5_sh	0.0532*	0.0404*	0.0590*	0.0196*	0.0439*	-0.0597*	0.0053	0.0485*	0.0156	-0.3281*	-0.2091*	-0.0736*	-0.0242*	0.2371*	0.2180*	0.1623*	0.1142*	0.0672*	0.0731*	1									
block5_num	0.0539*	0.0506*	0.0701*	0.0278*	0.0486*	-0.0490*	0.01	0.0597*	0.0207*	-0.2998*	-0.1815*	-0.0746*	-0.0231*	0.2573*	0.2854*	0.1435*	0.1446*	0.0677*	0.0685*	0.8772*	1								
block10_sh	0.0209*	0.0236*	0.0237*	0.0147	0.0353*	-0.0506*	0.0045	0.0192*	0.0016	-0.2723*	-0.1828*	-0.0578*	-0.0229*	0.1338*	0.0469*	0.1424*	0.0232*	0.0285*	0.0379*	0.7297*	0.4309*	1							
block10_num	0.0212*	0.0318*	0.0288*	0.0259*	0.0464*	-0.0474*	0.0079	0.0156	-0.0031	-0.2612*	-0.1731*	-0.0560*	-0.016	0.1234*	0.0522*	0.1254*	0.0183*	0.0159	0.0210*	0.6859*	0.4944*	0.9061*	1						
avgta	0.2505*	0.0018	0.1454*	0.0836*	0.0806*	0.0043	0.0491*	0.0976*	-0.004	0.0612*	0.0625*	-0.0024	0.002	0.3504*	0.1700*	0.3402*	0.1635*	0.0974*	0.1060*	0.0264*	0.0209*	0.0065	0.008	1					
tacc_abs	0.0623*	0.0004	0.0288*	0.0267*	0.0213*	0.0099	0.0134	0.0163	0.008	0.0323*	0.0433*	-0.0175	-0.0164	0.1083*	0.0477*	0.1085*	0.0451*	-0.0005	0.009	-0.0088	-0.0089	-0.0007	-0.0046	0.2444*	1				
tacc_rel	0.0069	-0.0217*	-0.0013	-0.0008	0.0067	-0.018	-0.0001	-0.0063	0.0018	-0.0048	-0.0075	0.0028	-0.0013	0.0032	0.0117	-0.0036	0.0069	-0.0038	-0.0081	0.0272*	0.0201*	0.0168	0.0143	-0.0016	0.0512*	1			
nondisc_acc	0.0186*	-0.0311*	-0.0043	-0.0009	0.0112	-0.0374*	-0.0003	0.003	0.0115	-0.0162	-0.0288*	0.0051	-0.0003	0.0104	0.0261*	-0.0039	0.0413*	0.0023	0.0049	0.0104	0.012	0.0036	-0.0025	0.0011	0.016	0.5251*	1		
disc_acc	0.0042	-0.0029	0.0121	0.0016	0.0062	-0.0063	0.000	-0.0021	-0.0032	0.0216*	0.0202*	0.002	0.0058	-0.0001	0.0052	-0.0036	0.0029	0.0023	-0.0058	-0.0063	-0.0052	-0.0056	0.0008	0.0007	0.0591*	0.8573*	0.0121	1	
abs_da	- 0.1030*	-0.0179	-0.0733*	-0.0282*	-0.0300*	0.0044	-0.0162	-0.0751*	0.0003	-0.0740*	-0.0404*	-0.0352*	-0.0424*	-0.0481*	-0.0555*	-0.0254*	-0.0808*	-0.0508*	-0.0472*	0.0026	-0.011	0.0153	0.0023	-0.0300*	-0.0287*	-0.0930*	0.0332*	-0.1293*	1

Factor Analysis

Factor analysis reveals eight factors, the use of which leads to moderate results in explaining earnings management. Thus, we pick the eight variables that find the highest representation in each of the eight factors identified and run a regression by using only those factors. We include the size of the board along with the percentage of attendance in board meetings (att), due to the positive contribution of 'size' probably interacting with the negative contribution of 'att' in the rotated component matrix. We also include the foreign institutional promoter holding number and the natural logarithm of the average total assets in the regression analysis.

Table 8: Rotated Component Matrix[a]

	Component							
	1	2	3	4	5	6	7	8
size		.392	.195			.302	.138	.623
ind						.907		-.184
ind_num		.180	.142			.900		.281
meet_num				-.112	.952			-.213
meet_max					.970			.139
att				-.210				-.810
chp			.325	-.216			-105	.257
dir		.230	.483		-.119	.160	.194	
ceo_chair						.118	-.110	-.198
pro_sh	-.278		.115	.138			.850	
indpro_sh	-.166			-.555			.743	
forpro_sh			.198	.893				
forpro_num			.135	.842				
inst	-.133	.956	.134					
inst_for		.594	.348	-110			-.361	
inst_dom	-.144	.842					.203	
forinstpro_num		.523	.394			.109	-.158	.178
bigthree			.871	.252				
bigfour		.107	865	.309				
block5_sh	.892	.138					-.188	
block5_num	.713	.191					-.264	
block10_sh	.914							
block10_num	.913							

Extraction Method: Principal Component Analysis.
Rotation Method: Varimax with Kaiser Normalization.
a. Rotation converged in eight iterations.

The Regression Model

We examine the association between the corporate governance attributes and earnings management proxied by the discretionary accruals by estimating the following pooled OLS regression for each of the three variations of the dependent variable, being absolute discretionary accruals (abs_da), a dummy variable for the absolute discretionary accruals (abs_da_dummy) and the natural logarithm for the absolute discretionary accruals proxy (lnabs_da):

$$abs\_dait = b0 + b1lnavgtait + b2sizeit + b3indit + b4meet\_maxit + b5attit + b6pro\_shit + b7forpro\_shit + b8instit + b9forinstpro\_numit + b10block10\_numit + b11bigthreeit + eit \quad (1)$$

$$abs\_da\_dummyit = b0 + b1lnavgtait + b2sizeit + b3indit + b4meet\_maxit + b5attit + b6pro\_shit + b7forpro\_shit + b8instit + b9forinstpro\_numit + b10block10\_numit + b11bigthreeit + eit \quad (2)$$

$$lnabs\_dait = b0 + b1lnavgtait + b2sizeit + b3indit + b4meet\_maxit + b5attit + b6pro\_shit + b7forpro\_shit + b8instit + b9forinstpro\_numit + b10block10\_numit + b11bigthreeit + eit \quad (3)$$

We then include the interactions of the independent variables with size in the regression model to isolate the impact of the association by removing the bias of size.

$$abs\_dait = b0 + b1lnavgtait + b2sizeit + b3indit + b4mee\_tmaxit + b5attit + b6pro\_shit + b7forpro\_shit + b8instit + b9forinstpro\_numit + b10block10\_numit + b11bigthreeit + g1size\_intit + g2ind\_intit + g3meet\_max\_intit + g4att\_intit + g5pro\_sh\_intit + g6forpro\_sh\_intit + g7inst\_intit + g8forintpto\_num\_intit + g9block10\text{-}num\_intit + g10bigthree\_intit + eit \quad (4)$$

$$abs\_da\_dummyit = b0 + b1lnavgtait + b2sizeit + b3indit + b4meet\_maxit + b5attit + b6pro\_shit + b7forpro\_shit + b8instit + b9forinstpro\_numit + b10block10\_numit + b11bigthreeit + g1size\_intit + g2ind\_intit + g3meet\_max\_intit + g4att\_intit + g5pro\_sh\_intit + g6forpro\_sh\_intit + g7inst\_intit + g8forintpto\_num\_intit + g9block10\text{-}num\_intit + g10bigthree\_intit + eit \quad (5)$$

$$Lnabs\_dait = b0 + b1lnavgtait + b2sizeit + b3indit + b4meet\_maxit + b5attit + b6pro\_shit + b7forpro\_shit + b8instit + b9forinstpro\_numit + b10block10\_numit + b11bigthreeit + g1size\_intit + g2ind\_intit + g3meet\_max\_intit + g4att\_intit + g5pro\_sh\_intit + g6forpro\_sh\_intit + g7inst\_intit + g8forintpto\_num\_intit + g9block10\text{-}num\_intit + g10bigthree\_intit + eit \quad (6)$$

We run the pooled OLS regression with all the three dependent variable proxies (see Tables 9 and 10).

We have given the 'p' values based on the robust standard errors to take care of auto-correlation and heteroscedasticity. The results, in general, lend support to most of our hypotheses. For all the three variations of the dependent variable (the measure of earnings management), we find the overall F values significant. However, lnabs_da gives the best results with an adjusted R2 of 9.3 per cent. The size of the firm measured as lnavgta has a significant negative association, implying that small firms, which are put less under the scanner by analysts and the media than larger firms, manage their earnings more, thereby reporting higher levels of discretionary accruals. Thus, big firms are not smoothing their earnings as much as the smaller firms, as they would not be able to hide their discretionary accruals as compared to the smaller firms.

The size of the board has a negative and significant coefficient, indicating that larger boards are able to do justice to their roles of monitoring earnings management. Smaller boards are poor at effectively monitoring and curbing earnings management behaviour. Thus, the results are in agreement with those indicated by Xie Davidson & Dalt, (2003), and Peasnall, Pope & Young (2005) that larger boards are more effective in preventing managerial discretionary decision-making. Boards of larger sizes appoint various sub-committees for delegating their responsibilities to achieve greater efficiency than smaller boards. Since the responsibilities are divided among these sub-committees, they perform better monitoring as compared to smaller boards (Klein, 2002).

The percentage of independent directors as compared to the board size (ind) is significantly negatively associated with lnabs_da, a finding that is consistent with Beasley (1996), Klein (2002), and Davidson, et al. (2005). This suggests that if a board has a greater number of external directors, it would be effective at restraining the management of earnings, thereby supporting H2. Thus, larger boards are more likely to induct a higher number of competent independent directors as compared to smaller boards (Xie Davidson & Dalt, 2003). Directors who are appointed from outside the firm take the effort of maintaining the integrity and credibility of the financial reporting process in the firm through lesser accruals and earnings management.

The higher the numbers of board meetings, the lower are the discretionary accruals suggesting that active board members are more vigilant monitors. The attendance of directors at board meetings shows the expected negative sign, though it is not statistically significant, suggesting that higher attendance of board members in the meetings lowers the management of earnings. We need to look at the interaction

of firm size with attendance for achieving more clarity on this issue. Promoter shareholding has a strong significant negative association with all the three proxies of discretionary accruals, showing that the contextual concentrated shareholding impact of Indian firms has a positive contribution in restraining unprecedented earnings management behaviour. This suggests that as the promoter shareholding in the company reaches a certain benchmark while aligning their interests with the firm, their opportunistic behaviour reduces. This supports our hypothesis (H5) and indicates fewer agency problems and a greater alignment of interests or rather better control among Indian firms (Jensen, 1976; Shleifer and Vishny, 1997; Chtourou, et al. 2001; Yeo, et al., 2002). These firms have to manage the risks to their reputation, which may be a contributing factor towards the negative association.

Both institutional shareholding and foreign institutional shareholding (forinstpro_num) have significant positive association with discretionary accruals and thus, our hypothesis (H6) does not find support. This is counter-intuitive except that the low institutional ownership fails to incentivize management enough to refrain from managing their earnings. Although the correlation coefficient indicates a significant negative correlation with the absolute discretionary accruals, the regression model shows a positive and significant coefficient at less than 1 per cent. The average institutional holding in our sample firms is quite meagre at 8.69 per cent (2.02 per cent), more so since the foreign institutional holding is 3.45 per cent (0 per cent). This could be a determining factor in explaining why the sample firms lack the power to restrain their managements. The short horizon problem laid out by Lang and McNichols (1999), however, supports our results, suggesting that foreign institutional investors with insignificant exposure fail to exercise an effective disciplining role in the Indian context. The interaction effect needs to be analysed for achieving more clarity on the issue.

The presence of the Big Three as auditors did not find support in the regression model. As a test of robustness, we have replaced the Big Three with the Big Four in our sample of BSE 500 companies, which are discussed later in the study.

Regressions with Interactions

As discussed earlier, since our sample size is considerably larger, with a significant dispersion in firm size, we need to include the interaction terms of the independent variable s with firm size measured as the average of the total assets.

The results with interacting terms have similar coefficients and signs, with some of the variables further improving their significance and coefficient value like board

independence (ind), except for the attendance of the directors in board meetings (att), where the coefficient becomes positive and highly significant, which might seem counter-intuitive. However, when the interaction term (att_int) was used, the coefficient became negative and highly significant again. Thus, the interaction term (att_int) shows that given two firms of the same size, a firm with a board that attends more meetings will manage earnings less, again a sign of board diligence. But the same finding, when examined holistically, could throw a positive relation, as smaller firms have lower board size, while the percentage of attendance across the firm size quartiles is almost the same. The attendance, thus, is probably a sign of not board diligence but just higher quorum requirements.

The interaction of board independence with size reveals (for two out of three proxieslnabs_da and abs_da_dummy) that in the case of bigger firms, the higher the number of independent directors on board, the greater would be the earnings management. Thus, we find support for arguments like evils of excess policing (Baysinger and Butler, 1985) and the lack of relevant expertise (Patton and Baker, 1987), as the pool of competent independent directors in India is rather limited.

Promoter shareholding and the number of foreign institutional promoters seem to suggest that there are higher earnings management in large-sized firms. Foreign promoter shareholding has a similar association as board attendance, a clear increasing trend with size, showing a positive relationship for the standalone regression model, but a significantly negative relationship in terms of interaction with firm size. This implies that given the same size, greater foreign promoter shareholding will reduce earnings management.

The presence of the Big Three as auditors in the firm suggests better audit quality and lower earnings management, as we observe a highly significant negative association with discretionary accruals. The presence of the top three reputed audit firms as auditors signals the use of a better monitoring mechanism as far as the financial disclosures are concerned, thereby curbing earnings management behaviour (Xie, et al., 2003; Bedard, et al., 2004; Jaggi and Leung, 2007). However, this does not hold true for the bigger firms in the sample.

The significance of the constant and the low R2 show that all the important variables have not been captured. Corporate governance is only one aspect related to earnings management. Other firm characteristics like ownership group, debt exposure of the firm, performance, etc., also play important roles in explaining earnings management behaviour in firms.

Table 9: Dependent Variable is abs_da_dummy

	Model 1 b/t	Model 2 b/t
lnavgta	-0.327***	.-0.361***
	(-17.49)	(-10.19)
size	-0.031***	-0.032
	(-3.14)	(-1.27)
ind	-0.024	-0.532*
	(-0.21)	(-2.04)
meet_max	-0.036***	-0.016
	(5.59)	(0.92)
att	-0.291	-0.632*
	(-1.88)	(2.25)
pro_sh	-0.004***	-0.009**
	(-2.82)	(-2.89)
forpro_sh	-0.000	-0.011*
	(-0.30)	(2.30)
inst	-0.007***	-0.021**
	(4.02)	(2.65)
forinstpro_num	0.171***	-0.291
	(3.19)	(-1.89)
block10_num	-0.052	-0.274*
	(-1.23)	(-2.41)
bigthree	0.051	0.580*
	(0.81)	(-2.21)
size_int		0.001
		(0.09)
ind_int		0.218*
		(2.21)
meet_max_int		0.008
		(1.28)
att_int		-0.385***
		(-3.95)
pro_sh_int		0.002*
		(2.14)
forpro_sh_int		-0.004*
		(-2.47)
inst_int		-0.004*
		(-1.90)
forinstpro_num_int		-0.170**
		(3.07)
block10_num_int		0.085*
		(2.10)
bigthree_int		0.188*
		(2.42)
Constant	2.659***	2.840***
	(13.69)	(9.52)
N	9920.000	9920.000
r2_p	0.054	0.057
ll	-6498.275	-6476.888
p	0.000	0.000

*P<0.05, **p<0.01, ***p<0.001

Table 10: Dependent Variable is lnabs_da

	Model 1 b/t	Model 2 b/t
lnavgta	-0.275***	.-0.327***
	(-21.85)	(-14.41)
size	-0.017*	-0.044
	(-2.47)	(-2.52)
ind	-0.127	-0.442*
	(-1.61)	(-2.53)
meet_max	-0.014**	-0.009
	(3.19)	(-0.81)
att	-0.214*	-0.602*
	(-1.98)	(3.19)
pro_sh	-0.004***	-0.008***
	(-4.37)	(-4.03)
forpro_sh	-0.001	0.007*
	(-1.25)	(2.14)
inst	-0.007***	0.012*
	(5.74)	(2.26)
forinstpro_num	0.125***	-0.269*
	(3.31)	(-2.51)
block10_num	-0.041	-0.079
	(-1.41)	(-1.00)
bigthree	0.015	-0.679***
	(0.35)	(-3.64)
size_int		0.009
		(1.74)
ind_int		0.142*
		(2.15)
meet_max_int		0.009*
		(2.21)
att_int		-0.357***
		(-5.46)
pro_sh_int		0.002**
		(2.80)
forpro_sh_int		-0.003*
		(-2.66)
inst_int		-0.002**
		(-1.17)
forinstpro_num_int		0.146***
		(-3.83)
block10_num_int		-0.017
		(0.61)
bigthree_int		0.204***
		(3.75)
Constant	0.034*	0.668***
	(2.30)	(3.44)
N	9920.000	9920.000
r2_p	0.095	0.102
ll	96.120	54.792
p	0.000	0.000

*P<0.05, **p<0.01, ***p<0.001

Robustness Tests

As a robustness test, we truncated the sample to BSE 500 firms and analysed it. The results were qualitatively similar to the results of the entire sample. However, there were lesser variations with regard to the variables under study due to obvious reasons. For example, all the board characteristic features were reportedly better[239] as far as the descriptive characteristics for the BSE 500 sample were concerned as compared to our initial sample of 2315 firms. The overall promoter shareholding percentage improved to 52.93 per cent (as against 42.12 per cent earlier) with the foreign promoter holding increasing to 10.64 per cent (as against 6.05 per cent earlier).

[239] The higher the number of independent directors, the better are the board attendance measures in the sample.

Table 11: Descriptive Statistics

Variable	N	Mean	p50	Min	Max	Sd
size	2758	9.66	9.00	1.00	27.00	3.12
ind	2758	0.45	0.50	0.00	1.00	0.21
ind_num	2758	4.39	4.00	0.00	14.00	2.33
meet_num	2758	4.66	4.25	0.00	28.00	2.66
meet_max	2758	6.50	6.00	0.00	36.00	3.70
att	2593	0.73	0.74	0.24	1.00	0.13
chp	2758	0.10	0.00	0.00	4.64	0.41
dir	2758	4.27	4.00	0.00	31.36	3.02
ceo_chair	2758	0.02	0.00	0.00	1.00	0.12
pro_sh	2567	52.93	51.73	0.00	99.59	19.27
indpro_sh	2567	41.12	42.50	0.00	99.59	25.77
forpro_sh	2567	10.64	0.00	0.00	90.00	21.78
forpro_num	2567	0.30	0.00	0.00	1.00	0.46
inst	2567	24.85	21.56	0.00	99.97	19.63
inst_for	2567	10.83	8.20	0.00	57.44	9.99
inst_dom	2567	14.02	9.46	0.00	99.97	17.91
forinstpro_num	2567	0.95	1.00	0.00	1.00	0.21

...table continued

Variable	N	Mean	p50	Min	Max	Sd
bigthree	2699	0.40	0.00	0.00	1.00	0.49
bigfour	2699	0.44	0.00	0.00	1.00	0.50
block5_sh	2567	9.84	6.08	0.00	134.44	13.60
block5_num	2567	1.08	1.00	0.00	11.00	1.28
block10_sh	2567	3.50	0.00	0.00	123.60	9.37
block10_num	2567	0.22	0.00	0.00	4.00	0.51
avgta	2427	57760.24	17472.30	7.15	2680749.00	161760.90
tacc_abs	2448	1316.98	305.86	-167317.90	235640.70	13094.69
tacc_rel	2425	0.05	0.02	-0.79	4.38	0.19
nondisc_acc	2371	0.02	0.02	-8.84	3.73	0.27
disc_acc	2371	0.03	0.01	-3.46	9.79	0.30
abs_da	2371	0.11	0.06	0.00	9.79	0.28

The quartiles analysed showed similar results as earlier. However, for the foreign promoter shareholding percentage in the BSE 500 sample, the percentage in the total had increased, though it showed a decreasing trend with an increase in firm size. Thus, as the firm size increased in this sample, the percentage of foreign promoter shareholding went down.

The regressions were run for all the three proxies of discretionary accruals. The results are qualitatively similar to our complete sample, except that in case of the larger sized firms in the BSE 500 sample, the dependent variable proxy had decreased in magnitude (the quartile analysis validates the same for all the proxies computed). Firm size is still significantly negatively associated with earnings management, though the board size is not significant any more, as the sample in general has larger sized boards. Board independence is seen to pickup the association given by the correlations. Promoter shareholding shows a significant positive association, suggesting that with a considerably higher promoter shareholding percentage, earnings management is higher in the sample. This validates the similar findings of Cornett, et al. (2008), suggesting that the returns are diminishing due to entrenchment, leading to an increase in

earnings management. We included the Big Four auditors as the variable for audit quality with the usual negative though not significant association, suggesting that having a reputed audit firm as an external auditor does not deter firms from managing their earnings among the chosen sample of firms. Institutional shareholding is not significant, thereby suggesting the lack of effective power other than the enhanced liquidity in the BSE 500 sample firms, shown by an increase in the average shareholding percentage among the institutional shareholders, in general.

Interacting the variables for size was not necessary for the BSE 500 sample as the variations in firm size have been taken care of.

Table 12: Dependent Variable is lnabs_da

	Model 1 b/t	Model 2 b/t
lnavgta	-0.126***	-0.078
	(-4.92)	(-1.46)
size	-0.002	-0.021
	(-0.17)	(0.77)
ind	-0.155	0.311
	(0.91)	(0.75)
meet_max	-0.041***	0.124***
	(4.38)	(6.03)
att	-0.182	-0.718
	(-0.78)	(-1.56)
pro_sh	-0.006***	0.001
	(3.33)	(0.31)
forpro_sh	-0.002	-0.001
	(-1.26)	(-0.31)
inst	-0.001	-0.004
	(-0.45)	(-0.66)
forinstpro_num	0.029	0.055
	(0.18)	(0.19)
block10_num	0.076	0.074
	(1.26)	(0.45)
bigthree	-0.056	-0.004
	(-0.87)	(-0.02)
size_int		-0.008
		(-0.94)
ind_int		0.065
		(-0.44)
meet_max_int		-0036*
		(-4.51)
att_int		0.246
		(1.49)
pro_sh_int		0.002
		(1.28)
forpro_sh_int		-0.000
		(-0.09)
inst_int		0.001
		(0.71)
forinstpro_num_int		0.015
		(0.13)
block10_num_int		0.002
		(0.03)
bigthree_int		-0.023
		(-0.38)
Constant	-2.214***	-2.794***
	(-6.48)	(-4.91)
N	2106.000	2106.000
r2_p	0.029	0.036
ll	6.713	4.695
p	0.000	0.000

*P<0.05, **p<0.01, ***p<0.001

Table 13: Dependent Variable is abs_da_dummy

	Model 1 b/t	Model 2 b/t
lnavgta	-0.186***	.-0.112
	(-4.55)	(-1.29)
size	-0.006	0.071
	(-0.35)	(1.63)
ind	-0.702**	0.618
	(2.61)	(0.92)
meet_max	-0.074***	0.213***
	(4.47)	(4.93)
att	-0.523	-0.813
	(-1.42)	(-1.08)
pro_sh	-0.008**	0.004
	(3.00)	(0.63)
forpro_sh	-0.001	-0.004
	(-0.39)	(-0.68)
inst	-0.000	-0.012
	(0.03)	(-1.36)
forinstpro_num	-0.085	-0.701
	(-0.32)	(-1.35)
block10_num	0.169	0.152
	(1.76)	(0.57)
bigthree	-0.023	0.324
	(-023)	(1.19)
size_int		-0.028*
		(-1.97)
ind_int		0.016
		(0.07)
meet_max_int		-0.055***
		(-3.65)
att_int		0.163
		(0.61)
pro_sh_int		0.002
		(0.71)
forpro_sh_int		0.001
		(0.63)
inst_int		0.004
		(1.59)
forinstpro_num_int		0.304
		(1.52)
block10_num_int		0.009
		(0.10)
bigthree_int		-0.133
		(-1.38)
Constant	1.058	0.060
	(1.94)	(0.06)
N	2106.000	2106.000
r2_p	0.025	0.032
ll	-1423.730	-1423.529
p	0.000	0.000

*P<0.05, **p<0.01, ***p<0.001

Summary and Conclusions

The findings of the study have significant implications for policy-makers, who are interested in reducing earnings management avenues for improving the quality of financial reporting in firms. The objective of this study was to analyse the relationship between corporate governance characteristics and earnings management in the Indian context. Primarily, a significant negative association exists between discretionary accruals and most of the corporate governance attributes, particularly implying that the board of directors at the helm of the internal control systems in corporate organizations plays a very significant monitoring role. Thus, firms exhibiting good corporate governance manage their earnings less. There is a significant firm size effect on the discretionary accruals, with bigger firms ensuring lesser earnings management. The results suggest that firms with bigger boards, a greater percentage of independent directors, a higher number of board meetings, and higher attendance in these meetings, resort to lesser earnings management. Thus, from the regulator's point of view, it can be seen that boards are effective in discharging their duties and are reasonably beyond management dominance. This is in conformity with the other empirical findings.

Promoter shareholding with a significant negative association suggests a monitoring effect, though in the case of bigger firms, the interaction term suggests that concentrated promoter shareholding leads to higher earnings management. Foreign promoter holdings in relatively large-sized firms restrain earnings management. Institutional shareholders seem to have shorter horizon problems with a focus on current higher returns, thereby providing avenues for the managers of these portfolio firms to exercise discretion and to excessively manage their earnings in order to meet the required benchmarks. Probably with their increasing stakes[240] over a period of time, the relationship between institutional shareholding and earnings management may become non-linear. In other words, higher exposure in Indian firms may lead institutional investors to align their interests with the long-term prospects of the firm and to actively participate in the effective monitoring of managerial discretionary behaviour.

From the point of view of policy-making, the results suggest that concerted efforts need to be made towards training these institutional investors to fulfil their active roles in board activities. The Institutional Investors Advisory Services India Ltd. (IIAS)[241] currently focuses on BSE 200 companies with a considerable institutional investor exposure on providing detailed information for facilitating informed decision-making on corporate governance matters.

Finally, the presence of the Big Three as auditors has a significant restraining impact on the managerial discretionary choices in the case of smaller firms. However, the effect is opposite in the case of big firms where their presence is merely felt. This might imply that bigger firms are more prone to earnings management, irrespective of the presence of top auditors or institutional investors. From the regulator's point of view, there may be opportunities for according greater powers to the internal audit function in organizations, and thereby enhancing the efficiency of audit committees for curbing earnings management, which would, in turn, reduce reliance on the external auditors to perform their whistle-blower tasks in the organization.

Another policy implication could be the compulsory replacement of auditors after they have completed a pre-defined tenure. Similarly, investors need to be aware that big firms audited by the Big Three may still be engaging in earnings management for achieving better performance. The findings thus reiterate the importance of contextualizing the issue under consideration in view of the legal and institutional structures and processes in place rather than experimenting with some good corporate governance practices used in other contexts. This would go a long way towards strengthening the reputations of the firms concerned and in the reposing of investor confidence in them.

[240] The sample shows their average presence of 8.96 per cent (median of 2.02 per cent) in Indian firms.

[241] IIAS is a start-up by Anil Singhvi and Amit Tandon for educating the institutional investors about voting on agenda items in board meetings.

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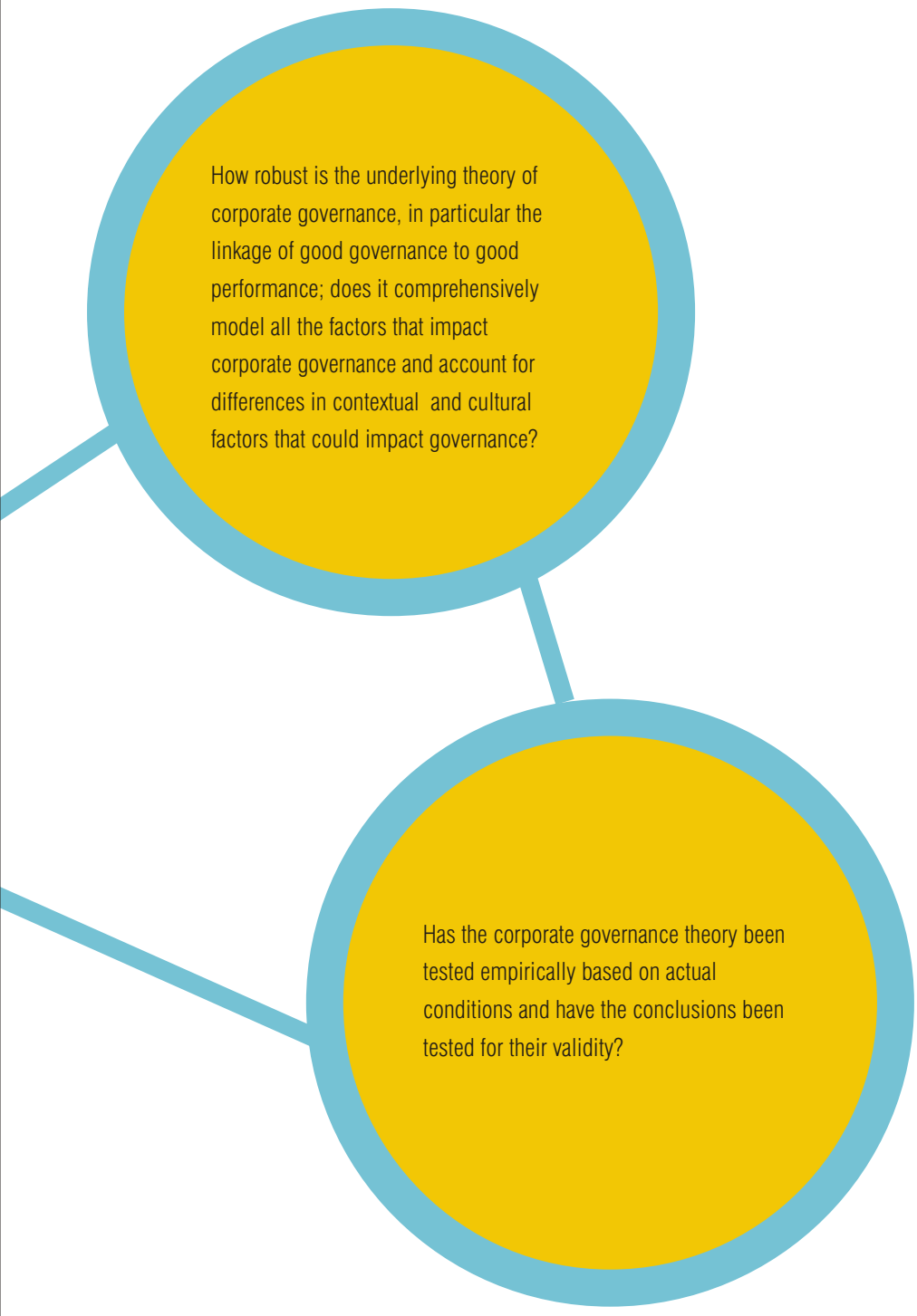
Onward Journey

In the last century or so, corporations have come to dominate global life like never before. They wield immense economic power (sometimes more than the GDP of certain countries), and based on this economic power, sometimes, a lot of political power as well. The governance of the corporation might be as important as governance in the political sphere, which has been so vigorously pursued in diverse forums and arenas.

It is not surprising then that the need to regulate corporations is demanded with increasing intensity all over the world. This is reflected in a flurry of new rules, legislations etc that have come up in recent times: Sarbanes Oxley, the Cadbury committee, Frank-Dodd to name a few. The success of these regulations is still under debate, more so because they have not really been able to control corporate financial misbehaviour wholly. In other words, they are in flux and constantly evolving. There are no set and final answers , the quest for good governance is a matter of on-going challenge to be studied and measured , leading to practicable solutions , which in turn need to be properly applied.

India has for the most part looked to its western counterparts for guidance on these issues. Indian context however is different; it needs unique, custom-tailored solutions. Some yardsticks to ascertain how effective a corporate governance framework are:

Are the regulatory changes in corporate governance based on sound theory; or are they based on popular perceptions and a common position that is arrived at based on the negotiation of the divergent views of various interest groups, who are affected by the regulatory changes?



This research is an attempt to find some answers to these questions. Ideas and suggestions made in this report are based on analytical research and are expected to initiate debate to find solutions more suited to Indian realities. Solutions that bridge theory and practicality–a thought arbitrage that will harness the best of both the worlds.

Annexure

Annexure I – Gatekeepers of Corporate Governance RBI

Actions Taken by RBI in Case of Breach of Trigger Points

In case of breach of the stipulated ratios, the following actions (mandatory/discretionary) may be taken, depending upon the level of breach:

a) Capital Adequacy Ratios Less than 9 per cent

Mandatory Actions

- Submission and implementation of capital restoration plan.
- Restriction on expansion of risk-weighted assets.
- Restriction on entry into new lines of business.
- Paying off of costly deposits and CDs.
- Reduction in/suspension of dividend payments.
- Discussion with the bank's Board on implementation of a corrective plan of action.
- Ordering of recapitalization.
- Reduction in stake in subsidiaries.
- Revision of credit/investment strategy and controls.
- Reduction in advances/capital expenditure/overheads.

Discretionary Actions

- Shedding of risky business.
- Restrictions on borrowings from the inter-bank market.
- Bringing in a new Management/Board.
- Appointment of consultants for business/organizational restructuring.
- Change of promoters/change in ownership.
- Effecting a merger if the bank fails to submit/implement recapitalization plan or fails to recapitalize pursuant to order, within such period as may be stipulated by RBI.

b) Non-Performing Assets Ratio Less than 10 per cent

Mandatory Actions

- Special drive to reduce the stock of NPAs and contain generation of fresh NPAs.
- Review of the loan policy.
- Upgrading of credit appraisal skills and systems.
- Strengthening of follow-up of advances including loan review mechanism for large loans
- Effective follow-up of suit filed/decreed debts.
- Putting in place of proper creditrisk management polices/process/procedures/prudential limits.
- Reduction of loan concentrationfor individuals, groups, sectors, industries, etc.

Discretionary Actions

- Restriction on entry into new lines of business.
- Reduction in/suspension of dividend payments.
- Reduction in stake in subsidiaries.

c) Return on Assets Less than 0.25 per cent

Mandatory Actions

- Paying off of costly deposits and CDs
- Increase in fee-based income.
- Containing of administrative expenses.
- Initiation of special drive to reduce the stock of NPAs and contain generation of fresh NPAs.
- Restriction on entry into new lines of business.
- Reduction in/suspension of dividend payments.
- Restrictions on borrowings from inter-bank market.

Discretionary Actions

- Capital expenditure allowed only for technological upgradation and for day-to-day operations within limits approved by the Board.
- Staff expansion/filling up of vacancies only with the prior approval of RBI, except in the case of recruitment of specialists.

If a bank's performance under any of the three broad parameters mentioned above crosses the trigger points, the bank would be placed under a corrective action programme. Such corrective action would consist of specific mandatory and discretionary actions, which in the opinion of RBI, may be applied to the concerned bank.

Annexure II – Gatekeepers of Corporate Governance SEBI, Pending cases

As per the Annual Report of SEBI for the year 201011, pp. 110112, there are 3493 pending cases as on 31 March 2011. The details of the cases are as follows:

Year	Cases U/Sections 11, 11B and 11D	Enquiry Proceedings	Adjudicating Proceedings	Prosecution Proceedings	Summary Proceedings	Total Cases	Percentage of cases
1995–96	0	0	0	7	0	7	0.20
1996–97	0	0	0	4	0	4	0.11
1997–98	2	0	0	5	0	7	0.20
1998–99	0	0	8	9	0	17	0.49
1999–2000	0	2	0	23	0	25	0.72
2000–01	29	1	4	24	0	58	1.66
2001–02	1	0	2	81	0	84	2.40
2002–03	48	6	11	193	0	258	7.39
2003–04	80	14	13	381	19	507	14.51
2004–05	66	0	13	61	0	140	4.01
2005–06	0	0	42	24	62	128	3.66
2006–07	63	33	134	23	0	253	7.24
2007–08	119	53	371	39	0	582	16.66
2008–09	0	13	120	29	0	162	4.64
2009–10	277	17	301	30	0	625	17.89
2010–11	316	16	287	17	0	636	18.21
Total	**1001**	**155**	**1306**	**950**	**81**	**3493**	**100**

Annexure III - Gatekeepers of Corporate Governance SEBI, Disposed cases

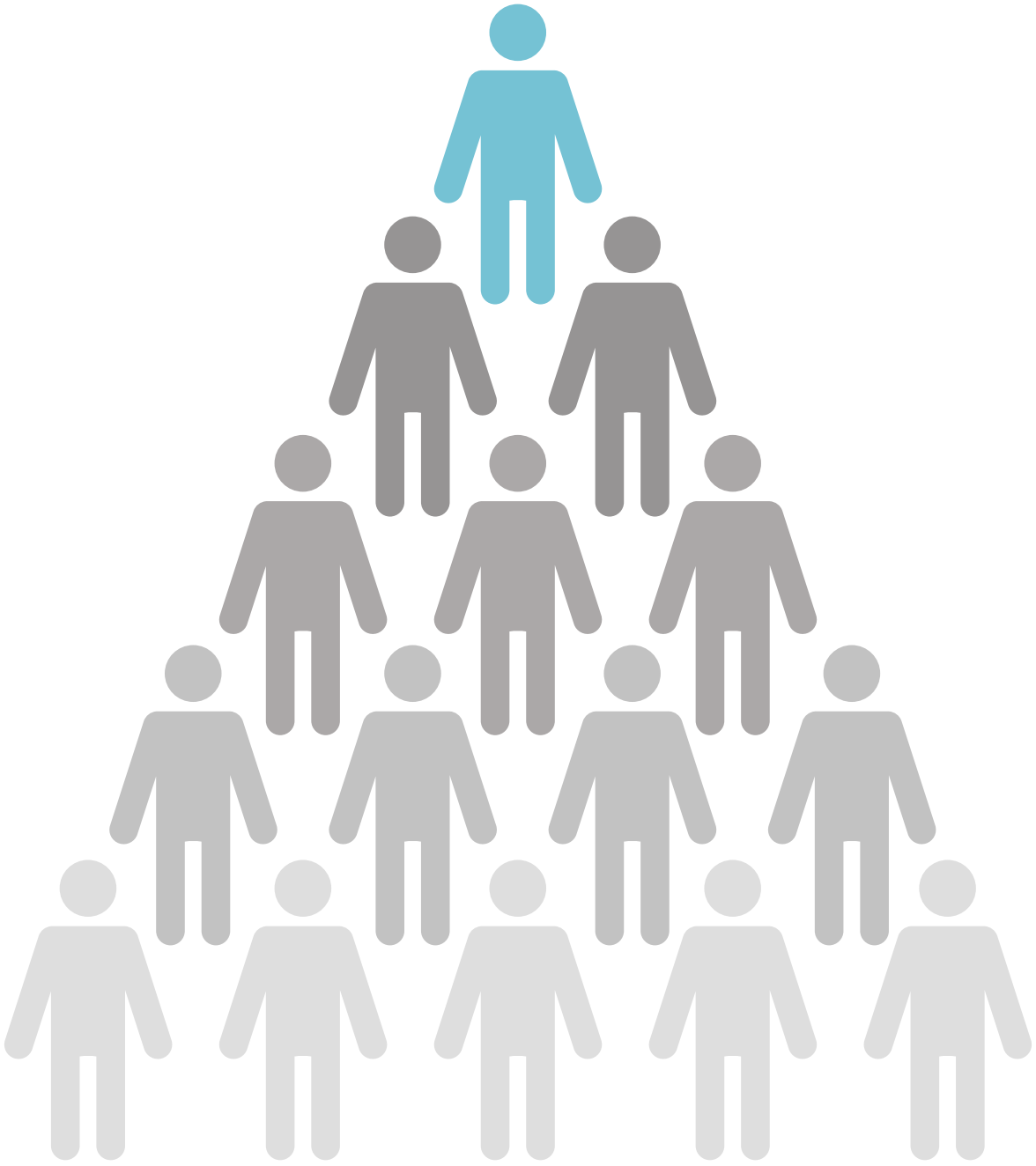
During the year 2010-11, a total of 1801 cases were disposed of by SEBI. The details of these cases are as follows:

Year	Cases U/Sections 11, 11B and 11D	Enquiry Proceedings	Adjudicating Proceedings	Prosecution Proceedings	Summary Proceedings	Total Cases	Percentage of cases
1995–96	0	0	0	0	0	0	0.00
1996–97	0	0	0	0	0	0	0.00
1997–98	0	0	0	0	0	0	0.00
1998–99	0	0	0	0	0	0	0.00
1999–2000	3	0	0	0	0	3	0.17
2000–01	3	0	0	2	0	5	0.28
2001–02	0	0	1	2	0	3	0.17
2002–03	7	14	5	15	0	41	2.28
2003–04	33	14	3	3	4	57	3.16
2004–05	19	10	23	0	0	52	2.89
2005–06	18	13	56	0	90	177	9.83
2006–07	54	27	106	0	0	187	10.38
2007–08	61	14	295	0	0	370	20.54
2008–09	23	3	255	0	0	281	15.60
2009–10	69	5	229	0	0	303	16.82
2010–11	30	8	284	0	0	322	17.88
Total	**320**	**108**	**1257**	**22**	**94**	**1801**	**100**

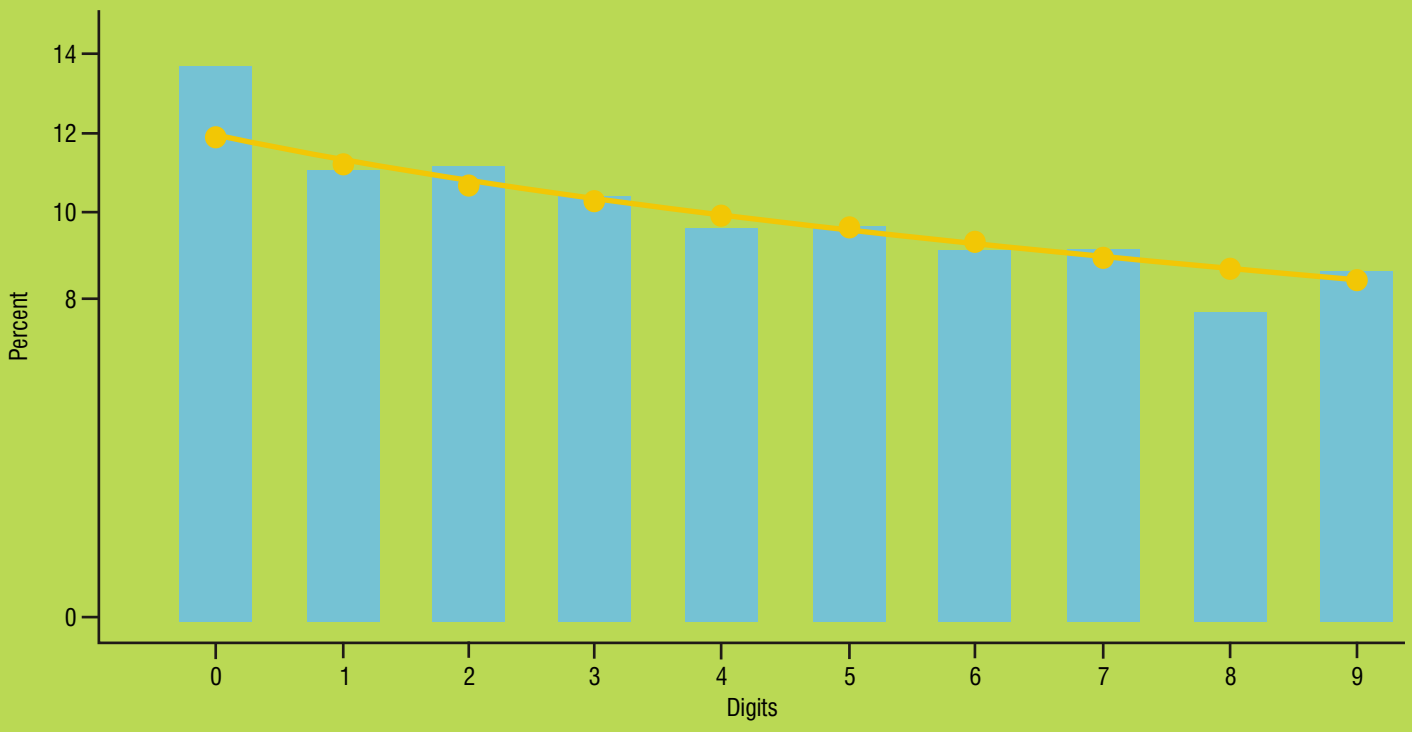
Annexure IV - Exploring the Relation between Earnings Management and Corporate Governance Characteristics in the Indian Context

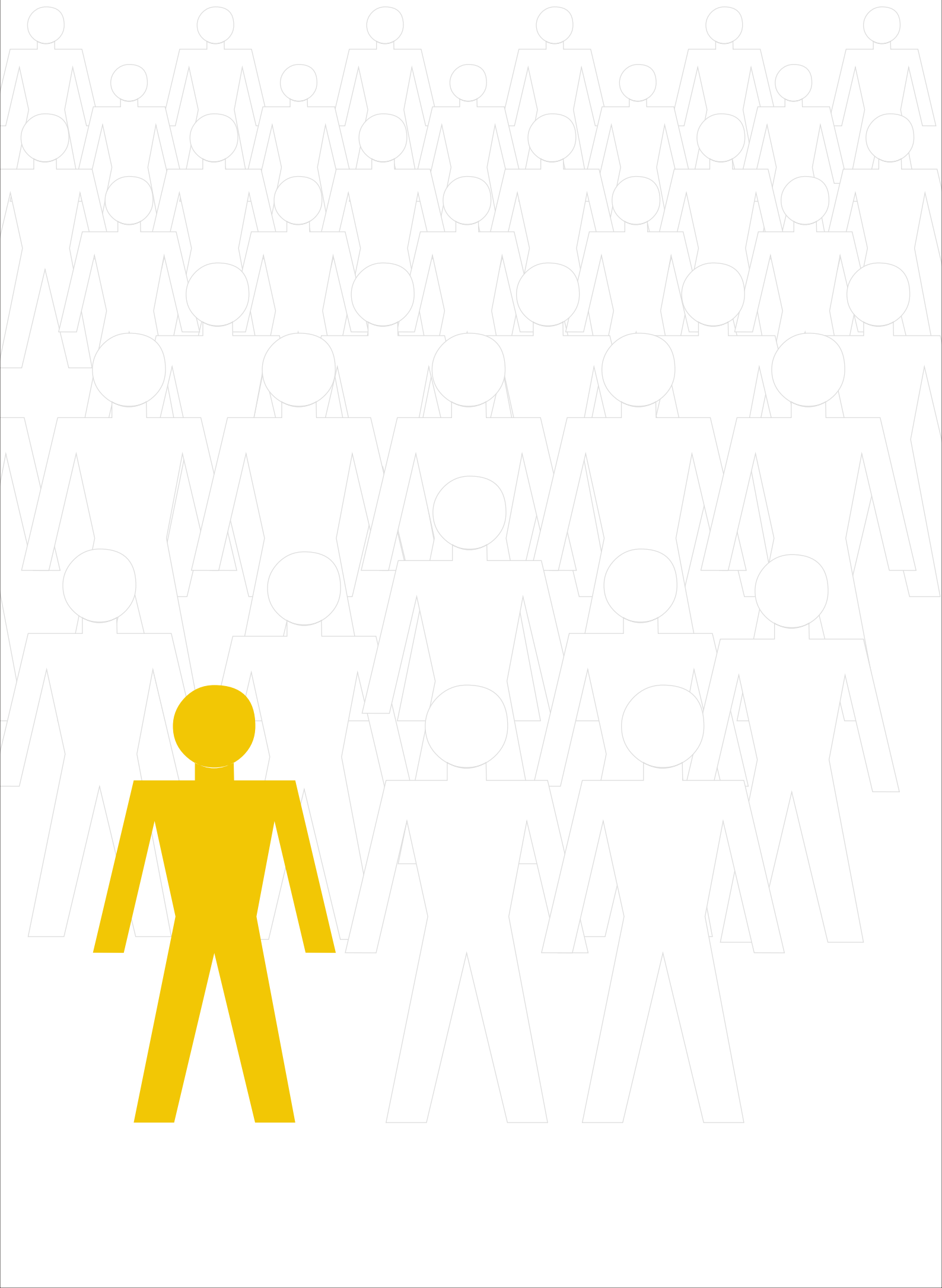
Benford Test Results for the variable Sales

	Digit Distribution of Sales (2nd Digit)				
Value	**Count**	**Percent**	**Percent**	**Diff.**	**P-Value**
		Observed	**Expected**	**(MAD)**	
0	1931	13.689	11.968	1.721	0
1	1563	11.08	11.389	-0.309	0.2544
2	1574	11.158	10.882	0.276	0.2917
3	1466	10.393	10.433	-0.04	0.8905
4	1365	9.677	10.031	-0.354	0.1653
5	1359	9.634	9.668	-0.034	0.9093
6	1280	9.074	9.337	-0.263	0.2908
7	1285	9.11	9.035	0.074	0.7578
8	1071	7.593	8.757	-1.164	0
9	1212	8.592	8.5	0.092	0.6947
Total	**14106**	**100**	**100**	**0.433**	



Number of obs	14106	Percentage of Companies
N of outcomes	10	
Chi2 df	9	
Goodness-of-fit	**Coef.**	**P-value**
Pearson's X2	62.01023	0
Log likelihood ratio	61.51816	0





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