***Pratidhwani the Echo***
*A Peer-Reviewed International Journal of Humanities & Social Science*
***ISSN: 2278-5264 (Online) 2321-9319 (Print)***
***UGC Enlisted Serial No. 48666***
***Impact Factor: 6.28*** *(Index Copernicus International)*
*Volume-VII, Issue-I, July 2018, Page No. 256-265*
*Published by Dept. of Bengali, Karimganj College, Karimganj, Assam, India*
*Website: http://www.thecho.in*

# Quality evaluation of corporate governance in the Indian Context

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**Abstract**

*Corporate governance is the system of processes, rules and regulations that helps a firm in running in accordance with the benefit of all the stakeholders. However, the observance of corporate governance practices by companies is done in two ways- in the form of compliance and in the substance of compliance. Along with the observance of good governance practices, another important factor is the evaluation of quality of corporate governance in the country. Evaluation of corporate governance in India is done by following various methods. The main methods of governance evaluation in India are the rating procedures followed by the rating agencies like the CRISIL, ICRA etc., the wealth management processes like the Economic value Addition (EVA) Method and the Market Value Addition (MVA) Method. In addition to these methods of governance, the study also attempts to bring forth the wealth management process of a good governance company along with the various pillars of governance. The current study is a theoretical take on the processes of evaluation, with the data mainly being collected from the secondary sources like books, websites, articles etc. The main purpose of the study is to bring to attention the topic of evaluation of corporate governance which is seldom being followed in the companies due to certain technical difficulties or sometimes due to lack of awareness on the given subject.*

***Keywords: Corporate Governance, evaluation, methods, wealth management, processes.***

**Introduction:** The creation of joint stock companies has been one of the most significant contributions to the economies around the globe. But their creation is one of the most challenging tasks than what it seems from outside. The creators of these companies have to deal with numerous factors in order to set them up. One of the first and foremost requirement is resources. The society provides a helping hand in this regard by bringing in the contributors mainly financial helps in forming the base. Along with these contributors there are many other dimensions which forms a joint stock company. Very often it is seen that the dimensions of a joint stock company are not managed properly by the promoters and they are also not conducted in the best interest of the shareholders. There have been many instances where there have been reports of frauds and malpractices in the management practices of the companies. Therefore various associations across the globe sat down to form the practices which will help them in regulating the practices and help in maintaining good environment across the companies. These new regulations bought about the concept of corporate governance.

Corporate governance is basically a system of rules and guidelines which help the firm in running efficiently and in accordance to the benefit of all stakeholders. The focus on the topic of corporate governance grew more with the dependence of companies on the financial market. The future of the capital market of any country depends on the quality of corporate governance. The importance of corporate governance was mostly felt with the control failures in many of the US based companies, with the reports of most of them resorting to corrupt practices and various legislations passed by the administrators and finally the passing of the Sarbanes Oxley Act in 2002. The various developments in the USA sparked debate in the United Kingdom and in order to prevent various malpractices the Cadbury Committee was set up under Sir Adrian Cadbury by the London Stock Exchange in May 1991. The Committee then passed its report in 1992 under the 'Code of Best Practices' which had 19 recommendations relating to the Board of Directors, Executive Directors, Non-executive directors and the manner of reporting and control.

While in Germany the provisions of corporate governance are mostly governed by the German Stock Corporation, the German Codetermination Act and the German Corporate Governance Code. They call for a separation between the role of managers and supervisors. They have clearly underlined the duties of the managerial board and the supervisory board. In the year 2003, the German Government Commission formed the Corporate Governance Code. However, there is no legal binding on the companies to follow these rules but they must give a clear explanation of why certain rules were not followed by them.

In China the corporate governance mechanisms are generally seemed to be weak, though the Chinese economy have shown enormous development and are determined to create a western style economy. In the year 2003 the World Economic Forum ranked China 44th out of 49 countries in terms of corporate governance. Previously most of the companies in China were controlled by the government. The first step towards corporate governance was taken in the 1990's by establishing the Shanghai and Shenzhen Stock Exchange. In the succeeding 10 years China established its first Company Law. With these developments there is increasing globalization of companies mostly those listed in Hong Kong and investors can be sure of better days in the field of Corporate Governance in China.

In India corporate governance practices were introduced by the Confederation of Indian Industry (CII). After the CII, the Securities and Exchange Board of India (SEBI) also introduced recommendations on corporate governance under Clause 49. The governance practices were further strengthened by the formation of various committees on corporate governance like the Kumar Mangalam Birla Committee in 1999. The main recommendations of the committee was related to listed companies with paid up capital of 30 million or more, composition of board of directors, the audit committee should have at least 3 independent directors, there should be at least four meetings of the board in a year with a gap of four months between two meetings, management discussion and analysis report, internal control system report should be included. The SEBI also ratified key recommendations of this committee and this was also incorporated in Clause 49 of the SEBI.

The Naresh Chandra Committee was formed in 2002 by the Department of Company Affairs to examine various matters related to corporate governance practices. The committee also brought into account recommendations in the central areas of corporate governance in the country. The major recommendations of the company was passed on the areas of auditor-company relationship, disqualifications of auditors for audit assignments, independence standards in auditing, rotation of auditors etc.

The Narayan Murthy Committee set up in 2003 by the SEBI. The committee has laid emphasis on proper functioning of the audit committee and if it is seen that certain items are treated differently from the prescribed accounting standard than proper justification for such alternative treatment should be given. Another clause incorporated was related to related party transaction the company has to provide details of all the transactions entered into with the related parties. The companies should also provide procedures related to risk management and the procedures adopted for risk minimization in the concerned companies and how far they have overcome the risk factors. Another non mandatory recommendation passed was to train the members of the company in the matters related to the company.

The latest addition to the list of committees is the Uday Kotak Committee formed in 2017. The committee passed various recommendations which as predicted by the experts will bring in new reforms in the area of corporate governance. Most of the recommendations of the committee will come into force from 1$^{st}$ April, 2018 and few other recommendations from 1$^{st}$ April,2020. The key areas in which most of the recommendations were passed are composition of the board, disclosures and transparency, related party transaction, board committees, remuneration of directors, independent directors etc.

**Review of literature:**

**Branston, Cowling and Sugden** (2001) throws light on the fact that that interest of the public in corporate governance is much more important than framing of laws and regulation. The important factor in the current scenario is the nurturing of a civil society in which all the people develop and perform the process of governance. Focus through appropriate all-round education and learning helps in the nurturing of citizens who have the ability to think about and participate in the governance process.

**Amiram Gill** (2008) states that convergence of corporate governance and corporate social responsibility has opened new doors in the field of corporate management. Though integration of corporate governance and corporate social responsibility sounds challenging but further development on the integration of the two concepts will give a new dimension to the global business environment.

**Panchasara Bhavik** (2012) found that the financial disclosures among the Indian banks stands at a very good position but the same cannot be said of the governance systems of the banks. Out of the total six non financial disclosures only one was met by the Indian banks. So the performance in this area was poor. But all the banks did produce compliance certificate with the best practices of corporate governance.

**Palanisamy Saravanan** (2012) found that there is a considerable difference between the board size of manufacturing and non manufacturing firms. It ranges from 8.65 in manufacturing firms to 8.84 in non manufacturing firms. He also found that corporate governance factors significantly affect the value of a firm. The factors which affect the firm value are age, sales and asset tangibility.

**Priyanka Aggarwal** (2013) brought to light the relationship between corporate governance and corporate financial performance. Both were found to be related to each other with good corporate governance helping in achieving a good performance rating for the companies. Factors such as transparency, stakeholder reporting etc. also help in achieving a good performance rating.

**Ruchi Kulkarni and Balasundram Maniam** (2014) in their article mentioned about the history of corporate governance and the division of corporate governance theory into parts i.e. the Anglo American and Continental European. The study threw light on the evolution of corporate governance in our country from the liberalization of 1991, reforms in the Securities and Exchange Board of India (SEBI), formation of the Confederation of Industry (CII) in 1996, formation of the various committees on governance i.e. the Kumar Mangalam Birla Committee, The Naresh Chandra Committee, The Narayan Murthy Committee and the introduction of Clause 49 of the SEBI. Special references were also made about the formation of audit committee and the selection of auditors. The study also highlighted the importance of independent directors and how their role is important for companies. In the end the researchers mentioned that the scope of governance practices in India is becoming clearer with the passage of time and more and more companies are becoming inclined towards following the good governance practices.

**Meghna Thapar and Arjun Sharma** (2017) in their theoretical study gave a view of the corporate governance practices followed in India. They threw light on the corporate governance framework of India and the history of evolution of corporate governance concept. A regulatory framework of these practices has also been given where the provisions of the Companies Act 2013,Securities and Exchange Board Of India and Standard listing Agreements of the stock exchanges has been given.

**Research gap:** Though moderate amount of studies has been conducted in the field of corporate governance in India but most of the studies relate to financial performance of firms and corporate governance, corporate social responsibility and its relation with corporate governance, value of a firm and corporate governance but very few studies relate to quality evaluation of corporate governance in India and the wealth management practices of a good governance firm. Thus, the present study is an attempt to throw light on these aspects and contribute towards building a new bunch of knowledge.

**Objectives of the study:**

The present study has been conducted with the following objectives

- To study the methods followed for evaluation of corporate governance in India.
- To find out the wealth management practices of a good governance firm.

**Methodology of the study:** The present study is a theoretical study of the given problem.
Sources of data: For the current study data has been collected mainly from the secondary source i.e. from various books, journals, research papers etc.

**Corporate governance rating in India:** In India the rating of corporate governance is mainly governed by the credit rating agencies namely the Credit Rating Information Services of India Limited (CRISIL) and the Investment Information and Credit Rating Agency of India Limited (ICRA), the Unit Trust of India (UTI) also had a rating frame for a long time. The rating pattern of the various institutes has been discussed as under:

**CRISIL Governance and Value Creation (GVC) Rating:** The Governance rating of CRISIL provides an independent assessment of a firm's performance and future expectation on balanced value creation through corporate governance practices. The main focus is on balancing the quantitative value creation with qualitative value creation and helps in knowing the expected future performance of the firm and also assesses the stakeholders.(Bajpai,2017,p.209). The main focus of the rating is on building a significant value for its owners and stakeholders. The GVC rating of CRISIL is based on two main broad aspects;

1) Value creation and distribution of a company: Here the main focus is on the company's track record of creating and distributing value among the stakeholders. The main parameters used for value creation are weighted average cost of capital, dividend payout ratio, debt protection measures, market share, customer satisfaction, salary level of employees etc.
2) Wealth management of a company: The main factors on which a company focuses during wealth management are managerial capabilities, financial transparency, disclosure standards, board composition, board evaluation and succession policies.

The ratings of CRISIL are valid for a period of one year from the date of assignment and is assigned on a eight scale level.

**ICRA Ratings:** ICRA's stakeholders value and governance (SVG) Rating indicates the relative level to which an organization creates and manages value for its stakeholders along with an opinion on the quality of corporate governance. (Bajpai, 2017, p. 211)

The main rating variables for the SVG ratings are as follows:

1. Wealth Creation and Management- The sub parameters evaluated here by ICRA are-
a) Shareholders – Return on net worth in regard to the cost of equity, Return on capital employed, risk adjusted on market return, dividend policy.
b) Debt holders – Level of credit rating, financial indicators of debt and financial risk thereof.

2. Financial Discipline- The additional parameters studied here are business segments in which the country operates, presence in multiple business, dividend policy, number od subsidiaries etc.
3. Transparency of Disclosures Standards - The key parameters studied here by ICRA are accounting quality, changes in accounting policies, disclosures of transactions with subsidiaries etc.
4. Shareholders relations – ICRA's rating considers the value of the stakeholders i.e. shareholders, creditors, suppliers etc.
5. Shareholding Structure – ICRA takes into account the organizations shareholding structure to identify the shares held by the promoter group, the dominant shareholders, cross- holdings etc.
6. Board structure and processes- The duty of the Board of Directors is to lend leadership and strategic guidance to the organization. The sub parameters fixed here are-

a) Size of the board
b) Selection of directors
c) Number of independent directors
d) Details regarding professional commitment of independent directors.
e) Retirement policy
f) Number of board meetings
g) Time gap between meetings
h) Composition of various committees

7. Governance structure – Here the internal decision making process of the company is rated. ICRA also believes that the functioning of a company's board of directors is mostly dependent on the information supplied to it. (Bajpai,2017,p.215)

**Unit Trust of India:** The scores allotted in UTI's methodology are as follows. The weights allotted against each criteria are as follows.

| | |
|---|---|
| 1. Governance Structure: | 30 percent |
| 1A. Composition of the board | (15 percent) |
| 1B. Committees of the board | (15 percent) |
| 2. Disclosure in the annual report | 20 percent |

| | |
|---|---|
| 2A. Statutory disclosure | (10 percent) |
| 2B. Non-Statutory disclosure | (10 percent) |
| 3. Timelines and content of information to the investors and public | 20 percent |
| 3A. Compliance with listing agreement | (6.67 percent) |
| 3B. Contents on websites | (6.67 percent) |
| 3C. Grievance resolution ratio | (6.67 percent) |
| 4. Enhancement of shareholder value | 30 percent. |
| 4A. Share prices | (7.5 percent) |
| 4B. Return on net worth | (15 percent) |
| 4C. Book value | (7.5 percent) |
| Total | 100 percent |

(Bajpai, 2017, p. 216)

**Wealth creation and wealth management:** Wealth creation in simple words means the excess of the value of the output over the input of a firm. A particular firm becomes responsible for maximizing the wealth of the shareholders who entrusts the responsibility of running the company to a limited number of persons i.e. the board of directors. Thus they have to invest in wealth creation for the benefit of the shareholders. The reference point for creation of wealth can be the enterprise value. In case of a listed company the easiest way of wealth creation is arriving at the market value in a matured market. Both the methods have been discussed as under-

## Methods of wealth creation

1. **EVA method (Economic value addition method):** The EVA method of assessing wealth creation is considered as the foremost method. EVA is the net operating profit minus the appropriate charge for opportunity cost of all capital invested in the enterprise. The concept of EVA method was formulated by Stewart & Co. EVA is an estimate of economic profit or the amount by which earnings exceed or fall short of the minimum required rate of return that shareholders and lenders would get by investing in other securities of similar risk. (Bajpai, 2017, p. 219)

The following three components are essential for calculating EVA:

| | |
|---|---|
| NOPAT | Net operating profit after tax |
| Capital | Capital employed in the business |
| Cost of capital | Weighted average cost of capital |

The formula for calculating EVA is as follows

EVA= Net Operating Profit after Tax (NOPAT) – [ Capital x Cost of Capital]

The concept of EVA is important for a company because it indicates the profitability of the projects undertaken by a company and indicates the managerial performance of a company. It clearly indicates the amount of profit made by a company and from where it has been earned.

**2. MVA Method (Market value addition method):** MVA is represented by the difference between the total value of the firm and the capital (both equity and debt) employed. MV is actually the present value that the market offers.

The Market value is arrived at by calculating the cost of equity capital and then adding it to the sum of interest on debt.

The formulae for calculating MVA is-
Market Value Added= Market value – Capital invested

The concept of MVA is important because when the shareholders of a business wants to look into how a business is performing they take into consideration the MVA. From the point of view of corporate governance, the MVA is important because a high MVA is a indication of profitability of a company and it also indicates that the companies have good governance standards

The process of wealth creation of a company depends on the principles, people and processes of a company.

The principles followed in any organization reflect the values and culture of that particular organization. Any company should consider wealth maximization as one of the important values.

All the people in an organization right from the board of directors to the salesman in the shop should know the value and best use of resources in the organization and should use it to the best of their ability also the habit of commitment and accountability should be developed in them.

The processes followed in an organization should be in line with the principles. A particular decision may not be quite feasible in the beginning but when done in a particular process will yield good results.

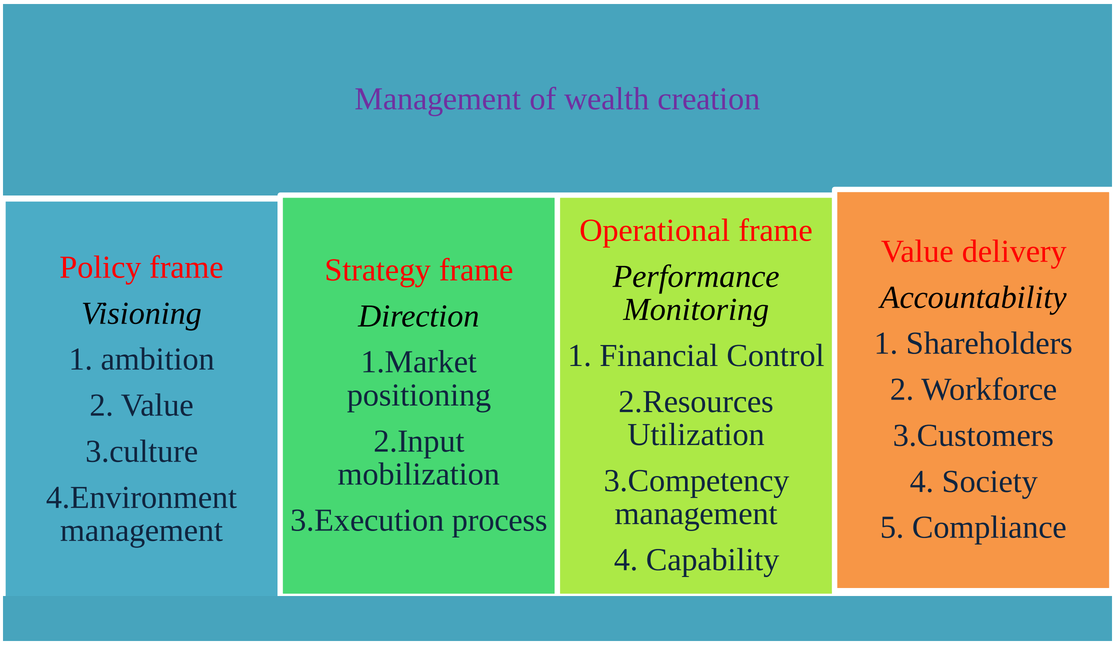


FIG. 1.1 Pillars of wealth creation.
Source. (Bajpai,2017,p.223)

The four pillars as shown in the above figure 1.1 plays an important part in the wealth creation of an enterprise.

Vision is the long term goal of the enterprise which helps it in realizing in which direction it wants to develop in the future. This goal of an enterprise is to be supported by value and culture of the organization.

The strategy frame mainly describes the market positioning of an enterprise, it's pricing strategies and the products it wants to launch in the market. In most of the companies it is mainly the board which decides the products to be launched and the prices to be fixed.

Performance monitoring enables the board to keep an eye on the working of the enterprise. The board needs to look into the financial matters, proper utilization of company resources, competency of the people working in the organization and their capability.

Value delivery is finally delivering the end result of the value creation to the various stakeholders of the business.

**Findings:** The present paper throws light on the corporate governance rating procedure of various institutions situated in India. The main focus is on the three key institutions i.e. the CRISIL, the ICRA and the Unit Trust of India and the parameters fixed by them for evaluating the quality of corporate governance in India. Along with the quality of governance the focus is also on the wealth creation and wealth management of a company. The methods of wealth creation and wealth management are the Enterprise Value Method (EVA) and the Market Value Method (MVA). Further it is also seen that the pillars of wealth management in India mainly are visioning, monitoring, performance monitoring and accountability.

**Conclusion:** Corporate governance is one of the key factors on which a modern organization depends. Proper adherence to the policies of good governance will help an organization to sustain in the long run. The quality evaluation of the governance practices is an important factor which helps an organization to determine the standard of governance it is following. Also, the amount of wealth creation of a company will help in determining how good governance aids in the creation of wealth in a company.

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