Evolving legal framework of corporate governance in India – issues and challenges

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Abstract
Investors now started considering corporate governance as very essential factor before investment especially in view of the unstable environment in the securities market. It is considered that good corporate governance inspires, strengthens and maintains investor’s confidence by ensuring company’s commitment to higher growth and profits. Corporate Governance has become a major concern for global economies particularly the transition world. Sound corporate governance is extremely important for transition economies for creation of the key institutions, the private corporations, which drive the successful economic transformation to a market based economy, effective allocation of capital and development of financial markets, attracting foreign investment and making a contribution to the process of national development. The Corporate Governance issue has emerged primarily because of the growing importance of corporations in the national economies and their interaction with the international agencies and institutions. This paper presents the current scenario of corporate governance in India, the evolving legal framework and identified the major issues and challenges that need to be addressed to implement an effective system of corporate governance in India.

Keywords: Corporate Governance, Ownership, Control, Board of Directors

JEL Classification: K22, K23

I. Introduction

Corporate governance has become an increasingly prominent issue for companies because of the increasing emphasis on the separation of ownership and control1. Investors have now started considering corporate governance as essential factor before investing in companies in light of the unstable environment in the securities markets. A number of empirical studies show that good corporate governance creates trust for long time period between shareholders and firms.

Issue of corporate governance stems from managing firms in a manner that the firms are owned by one group of persons whilst being managed by another

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group of people, which creates an issue of trust. If the information were available
to all stakeholders in the same form at the same time, corporate governance would
not be an issue at all. Shareholders are becomingly active because they believe that
good corporate governance leads to higher rewards. In recent years, corporate
scandals like WorldCom, Enron, Satyam Computers etc. around the world are
raising awareness among managers, investors and regulators, and an effort is under
way in many countries to produce quantitative measures on ownership and
governance, and to estimate their impact on the value and decision-making process
of firms. In India, economic liberalization and deregulation of industry has
accentuated the increasing need of corporate governance coupled with the growing
corporate scams and demand for new corporate ethos.

Indian stock market has been developing in the last two decades and has
outperformed most of the markets in the emerging and developed world. According
to estimates, the combined market cap of Sensex and Nifty (Indian major stock
indices) is now of $1.42 trillion which is higher than Australia’s $1.40 trillion,
Brazil’s $1.1 trillion and South Korea’s $1.25 trillion (Economic Times, 22nd May
2014) with China $3.14 trillion and Hong Kong’s $3.40 trillion lead by US with
$22.31 Trillion. The argument for effective and efficient corporate governance is
absolutely essential to keep this pace.

Studies indicate that sustainability of the Indian capital market is
dependent upon the corporate governance system in the country. According to
World Bank, Corporate governance is concerned with holding the balance between
economic and social goals and between individual and communal goals. The
governance framework is essential to encourage the efficient use of resources that
requires accountability for the stewardship of those resources. The aim is to align
as nearly as possible, the interests of individuals, organizations and society. In the
last two decades, governments, shareholder activism, have bought several changes
and the insistence of mutual funds and large institutional investors is also growing.
There are various high powered committees that have been set by the Indian
government to look into the matter of corporate governance practices and make
recommendations on codes and guidelines on corporate governance that can be put
in practice. In a post crisis situation, developing a system of good corporate
governance has also been made difficult by problems such as complex corporate
ownership structures, vague and confusing relationships between the state and
financial sectors, weak legal and judicial systems, absent or underdeveloped
institutions and scarce human resource capabilities. We are motivated to examine
the status of corporate governance problem in India with special reference to the
legal framework and identify the major concerns and issue that need to be
addressed.
II. Corporate Governance – conceptual framework

Corporate governance is defined as the system of rules, practices and processes by which a company is directed and controlled. Sir Adrian Cadbury defined Corporate Governance as the system by which companies are directed and controlled.” Corporate governance essentially involves balancing the interests of the many stakeholders in a company by allocating the corporate resources in a manner that maximizes the value for all stakeholders - these includes its shareholders, management, customers, suppliers, financiers, government and the community. Since corporate governance also provides the framework for attaining a company's objectives, it encompasses practically every sphere of management, from action plans and internal controls to performance measurement and corporate disclosure. Corporate governance system is the combination of mechanisms, which ensure that the management (the agent) runs the firm for the benefit of one or several stakeholders (principals). Such stakeholders may cover shareholders, creditors, suppliers, clients, employees and other parties with whom the firm conducts its business.

Corporate governance refers to the set of systems, principles and processes by which a company is governed. They provide the guidelines as to how the company can be directed or controlled such that it can fulfil its goals and objectives in a manner that adds to the value of the company and is also beneficial for all stakeholders in the long term. Stakeholders in this case would include everyone ranging from the board of directors, management, and shareholders to customers, employees and society. The management of the company hence assumes the role of a trustee for all the others. OECD (1999), which plays an important role in advancing the corporate governance agenda on the international level, defined corporate governance as that it is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. World bank President J. Wolfensohn defines corporate governance as promoting corporate fairness, transparency and accountability. According to World Bank, corporate governance is Blend of law, regulation and appropriate voluntary private sector practices which enables the corporation to attract financial and human capital to perform efficiently and prepare itself by generating long term economic value for its shareholders while respecting the interests of stakeholders and society as a whole. Similarly, IFC’s (International Finance Corporation) views corporate governance are structures and processes for the direction and control of companies.

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4 Cadbury Committee Report, 27 May 1992: A report by the committee on the financial aspects of corporate governance. The committee was chaired by Sir Adrian Cadbury and issued for comment on.


6 World Bank President, J. Wolfensohn, April 1999: (Quoted in Financial Times, June 21, 1999)
Good corporate governance embodies both enterprise (performance) and accountability (conformance). The Confederation of Indian Industry (CII) constituted committee defines that “Corporate governance deals with laws, procedures, practices and implicit rules that determine a Company’s ability to take informed managerial decisions vis-à-vis its claimants— in particular, its shareholders, creditors, customers, the State and employees. There is global consensus about the objective of ‘good corporate governance: maximizing long-term shareholder value’”. The Institute of Company Secretaries of India (ICSI) has defined the term Corporate Governance as under: "Corporate Governance is the application of best management practices, compliance or jaw in true letter and spirit and adherence to ethical standards for effective management and distribution of wealth and discharge of social responsibility for sustainable development of all stakeholders." ICSI also defines that ‘corporate governance as a blend of rules, regulations, laws and voluntary practices that enable companies to attract financial and human capital, perform efficiently and thereby maximize long term value for the shareholders besides respecting the aspirations of multiple stakeholders including that of the society.” Also in terms of Wilson7, corporate governance is the manner in which corporations are directed, controlled and held to account with special concern for effective leadership of the corporations to ensure that they deliver on their promise as the wealth-creating organ of the society in a sustainable manner. Similar opinions on corporate governance can be seen in Mayer8, Keasey, Thompson and Wright9 and Shleifer and Vishny10.

The N.R. Narayana Murthy Committee (2003) on corporate governance constituted by SEBI (Securities and Exchange Board of India) has observed "Corporate Governance is the acceptance by management, of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the management of a company.” Also, Kumar Mangalam Birla Committee (1999) constituted by SEBI has commented that "Strong corporate governance is indispensable to resilient and vibrant capital markets and is an important instrument of investor protection. It is the blood that fills the veins of transparent corporate disclosure and high quality accounting practices. It is the muscle that moves a viable and accessible financial reporting structure.

Corporate governance around the world can also be viewed in terms of the Anglo-American “model” of the corporation also known as ‘outsider’ model that emphasizes on the interest of shareholders and the German and Japanese model also known as coordinated or multi-stakeholder model. Insider model separates management control and shareholder ownership to maximise shareholder’s value. Outsider model prevalent in continental Europe and Japan considers company as a social institution and recognizes the interests of workers, managers, suppliers, customers, and the community.

Vives has classified corporate governance systems in two categories: market-oriented system and bank-oriented system or otherwise known as relations-based system. The market-oriented system is followed in the US and UK and the ownership structure of companies are dispersed to individuals or institutions. Companies rely on the capital market for funds and face the threat of hostile takeovers. Shareholders and management is different and management has powers to monitor and control the organization, which may result in conflicts. Glass-Steagall Act promulgated during the Great Depression, the US commercial banks were prohibited from owning equity of other companies so they played a limited role in direct monitoring and controlling company affairs. Bank-oriented system is practiced in most continental European countries and Japan wherein the ownership structure is highly concentrated. Commercial banks have bigger role in these countries capital market and there is a diluted or restricted voting power, which prevents hostile takeovers. In Germany, banks are allowed to organize proxy votes to receive general power of attorney from shareholders and can exercise their influence by ways of direct ownership of shares, provision of loans, seats in supervisory board and organizing proxy votes.

Schlitzer\(^{11}\) has pointed out that there is no uniform model for corporate governance practices in the world. Every country follows and prepared their corporate governance system. Organization for Economic Cooperation and Development (1998) argues that there is a lack of a single model of corporate governance practice even in the same country and organizations follow different corporate governance practices. With the increase of its importance, its definition and scope have also been broadened as compared to the existing definition. Good governance should not be limited to maximizing shareholders wealth or other people closely associated with the organization and each corporate entity should align its corporate purpose with this larger goal of social welfare. Researches show that market restrictions provide the best measure of corporate governance evidenced from stock mispricing stemming from poor corporate governance.

Literature also confirms a direct linkage between share price and good governance practice. Coombes and Watson\(^{12}\) have conducted a survey of 200

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12 Paul Coombes and Mark Watson, Three surveys on corporate governance, „the Mckinsey Quarterly“, 2000 Number 4: Asia Revalued.
institutional investors across the globe and find that investors would pay more for the shares of good governed companies. Black, Jang and Kim\(^{13}\) show that corporate governance affects firm value and leads to the improvement in the cash flows that can be distributed to investors. Gompers and Metrick\(^{14}\) have constructed a “Governance Index” by using 24 governance rules at about 1500 large firms during the 1990s. They find that firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower capital expenditures, and made fewer corporate acquisitions.

In other similar survey carried out by ICRA\(^{15}\) among domestic fund managers, significant close to 84% respondents said as more important or as important of corporate governance vis-à-vis financial numbers/ growth prospects. In a recent study made by Mittal and Gupta\(^{16}\) reveals that shares of good governance companies are less mispriced compared to bad governance companies.

There also has been debate that with the adoption of the corporate governance philosophy, corporate failures and scandals can’t be avoided. Failed corporations include Enron and WorldCom in the United States and the Golden Quadrilateral in India proved this debate\(^{17}\). This leads to the new debate about what should be included in a comprehensive corporate governance framework. Some scholars suggested that a comprehensive corporate governance framework should include large number of independent directors, access to outside advice for boards, review of board and executive remuneration and limitations on the power of CEOs\(^{18}\).

Corporate governance has got momentum in India after government took some policy measures such as induction of independent directors, awareness in stakeholders, issue of voluntary CSR guidelines and disclosure requirements. Some studies have been conducted in India on narrower perspectives of governance. Chakrabarti, Megginson and Yadav\(^{19}\) study supports the system of legal protection to investors but raises questions on enforcement and deep-rooted corruption. In corporate India the ownership concentration still exists and modern principles of governing enterprises are still to be practiced. However, corporate governance in

15 Credit Rating Agency.
India does not compare unfavorably with any of the other major emerging economies: Brazil, China and Russia. KPMG Survey of 2006, 2008 and 2010 reveal a continued persistence of corporate frauds and warn the presence of fraud risk in the business structures of large and medium size organisations including banks. It is a dire necessity for the policy makers to examine the effectiveness of regulatory framework and government policy in general toward corporate governance, which essentially has macro-economic impacts.

III. Rationale for Corporate Governance

Good corporate governance inspires, strengthens and maintains investor’s confidence by ensuring company’s commitment to higher growth and profits. It is considered that the good corporate governance maximizes the shareholders wealth for the long run and has a bearing on the growth and stability of the companies and economy. Good corporate governance standards are essential for the integrity of corporations in the current scenario and must ensure that the needs and interest of all stakeholders of an organization are taken into account in a balanced and transparent manner. It has to be embedded into the culture of the organization from the top down. In India, the interest of FIIs in Indian stock market can be seen as improvement of the trust of stakeholders in the Indian firms. Gross FIIs portfolio investment has risen from US $ 2.7 billion in FY 1996 to US $ 166.2 billion in FY 2013 (National Stock Exchange India). The companies have to follow the CG practices in order to get their shares listed on the stock exchanges. In order to get the shares listed on the foreign stock exchanges the companies have also to follow the respective country corporate governance practices. Corporate governance has the following benefits:

(a) A well informed supervisory board, with a majority of independent directors which have to be directly involved in the progressive policy formulation, control and giving direction to the executives of the company.
(b) Decisions should be made in the best interest of the shareholders rather than the undue influence of the larger shareholders or dominating CEO’s.
(c) Integrity of strategies, operating systems and controls
(d) Transparent organizational structures and business processes, including transparency in the corporate decision making process.
(e) Interest of all the shareholders must take into account to maintain investors’ confidence, which helps the company to raise capital efficiently and effectively. This leads to positive impacts on the share prices and long-term wealth maximization of shareholders.
(f) People who make decisions in a company must be held accountable for their decision.

20 CG – Corporate Governance
(g) A commitment to the creation and preservation of shareholders value while meeting the expectations of other stakeholders.

(h) Good corporate governance ensures corporate success and economic growth by controlling risks and avoiding mismanagement.

The importance of sound corporate governance for transition economies like India can be explained through its four main influences: (1) creation of the key institution, the private corporation, which drives the successful economic transformation to a market based economy, (2) effective allocation of capital and development of financial markets, (3) attracting foreign investment and (4) making a contribution to the process of national development. Authors show that solving the conflict of interests between stakeholders has given importance to CG\textsuperscript{21}. The methods of handling these conflicts include processes, customs, policies, laws, and institutions, which have an impact on the way a company is controlled.

IV. CG Scenario in India

India inherited one of the world’s poorest economies at the time of independence, but at independence, India inherited four functioning stock markets (predating the Tokyo Stock Exchange) with clearly defined rules governing listing, trading and settlements, a well-developed equity culture (if only among the urban rich), and a banking system replete with well-developed lending norms and recovery procedures\textsuperscript{22}.

Until early 1990’s corporate governance was never been an agenda of Indian Companies. Corporate governance concept got the importance only after the globalization and liberalization. When the government approached IMF after the fiscal crisis of 1991, suggested the Government to adopt reformative actions for economic stabilization through liberalization. As a part of liberalization process, in 1999 the Government amended the Companies Act, 1956. Further amendments have followed subsequently in the year 2000, 2002 and 2003. A variety of measures have been adopted including the strengthening of certain shareholder rights (e.g. postal balloting on key issues), the empowering of SEBI (e.g. to prosecute the defaulting companies, increased sanctions for directors who do not fulfill their responsibilities, limits on the number of directorships, changes in reporting and the requirement that a ‘small shareholders nominee’ be appointed on the Board of companies with a paid up capital of Rs. 5 crore or more (Regional Training Institute, Allahabad, India).

LEGAL FRAMEWORK IN INDIA

\textsuperscript{21} Goergen, Marc, International Corporate Governance, Prentice Hall 2012

\textsuperscript{22} Omkar Goswami, 2002, Corporate Governance in India, „Taking Action against Corruption in Asia and the Pacific“, Manila: Asian Development Bank, Chapter 9.
The CII Code

Confederation of Indian Industry (CII) constituted committees to examine corporate governance issues, and recommend a voluntary code of best practices to be adopted by the Indian companies (private sector, the public sector, banks and financial institutions that are corporate entities), a code by CII carrying the title “Desirable Corporate Governance” was released. It was the first institutional initiative in Indian industry. The committee was driven by the conviction that good corporate governance was essential for Indian companies to access domestic as well as global capital at competitive rates. The first draft of the code was prepared by April 1997, and the final document (Desirable Corporate Governance: A Code), was publicly released in April 1998. The code was voluntary, contained detailed provisions, and focused on listed companies. The code requires the following disclosures:

1. Listed companies should give data on high and low monthly averages of share prices in a major stock exchange where the company is listed; greater detail on business segments, up to 10% of turnover, giving share in sales revenue, review of operations, analysis of markets and future prospects.
2. Major Indian stock exchanges should gradually insist upon a corporate governance compliance certificate, signed by the CEO and the CFO.
3. If any company goes to more than one credit rating agency, then it must divulge in the prospectus and issue document the rating of all the agencies that did such an exercise. These must be given in a tabular format that shows where the company stands relative to higher and lower ranking.”
4. Companies that default on fixed deposits should not be permitted to accept further deposits and make inter-corporate loans or investments or declare a dividend until the default is made good.

Kumar Mangalam Birla committee Report and Clause 49

While the CII code was well-received and some progressive companies adopted it, it was felt that under Indian conditions a statutory rather than a voluntary code would be more purposeful, and meaningful. Consequently, The SEBI appointed committee, known as the Kumar Mangalam Birla committee’s recommendations led to the addition of Clause 49 in the Listing Agreement. Listed companies largely made compliance of provisions of Clause 49 mandatory. The committee’s recommendations have looked at corporate governance from the point of view of the stakeholders and in particular that of shareholders and investors and recommended that there should be a separate section on corporate governance in the Annual reports of companies in order to inform the shareholders of specific initiatives taken to ensure corporate governance. The committee accorded recognition to the three vital aspects of corporate governance, namely
accountability, transparency and equality of treatment for all stakeholders. The recommendations have been classified as mandatory and non-mandatory.

Mandatory recommendations include – (a) **accountability** of the board of directors to the shareholders, (b) **composition of the board** – to include independent directors - the board of a company have an optimum combination of executive and non-executive directors with not less than fifty percent of the board comprising the non-executive directors. In case a company has a non-executive chairman, at least one third of board should comprise of independent directors and in case a company has an executive chairman at least half of board should be independent. Further, all pecuniary relationship or transactions of the non-executive directors should be disclosed in the annual report; (c) **Nominee directors** - institutions should appoint nominees on the boards of companies only on a selective basis where such appointment is pursuant to a right under loan agreements as where such appointment in is considered necessary to protect like interest of the institutions. The committee also recommended that a non-executive chairman should be entitled to maintain a chairman’s office at the company’s expense and also allowed reimbursement of expenses incurred in performance of his duties. Audit committee should meet at least thrice a year. One meeting must be held before finalization of annual accounts and one necessarily every six months. The quorum should be either two members or one third of members of audit committee, whichever is higher and there should be a minimum of two Independent directors. It has also specified powers, functions and remunerations of the audit committee.

Among the non–mandatory recommendations, the committee emphasises that the progressive standards of governance applicable to the full board should also be applicable to the audit committee. Board of a company should set up a qualified and independent audit committee.

**Naresh Chandra Committee Report**

The department of company fairs also constituted on August 21, 2002 a high level committee, popularly known as Naresh Chandra committee, to examine various corporate governance issue and recommend inter-alia amendments to the law involving the auditor client relationships and the role of independent directors. The Committee submitted its report in December 2002. It made recommendations in two key aspects of corporate governance: financial and non-financial disclosures: and independent auditing and board oversight of management. The committee submitted its report on various aspects concerning corporate governance such as role, remuneration, and training etc. of independent directors, audit committee, the auditors and then relationship with the company and how their roles can be regulated as improved. The committee stingily believes that “a good accounting system is a strong indication of the management commitment to governance”.

**Narayana Murthy Committee report on Corporate Governance**

The fourth initiative on corporate governance in India is in the form of the recommendations of the Narayana Murthy committee. The SEBI analyzed the
statistics of compliance with the clause-49 by listed companies and felt that there was a need to look beyond the mere systems and procedures if corporate governance was to be made effective in protecting the interest of investors. The committee was set up by SEBI, under the chairmanship of Mr. N. R. Narayana Murthy, to review Clause 49 i.e. implementation of corporate governance code by listed companies and 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.

V. Major Issues and challenges

The most important deterrent to the corporate governance in India is the conventional dominance of major stakeholders that are \textit{individual family dominated}. The promoter’s act as the dominant shareholders, the promoters’ shareholding is spread across several friends and relatives. The promotors, as dominant shareholder can transfer of assets between group companies and carry preferential allotments of shares to themselves. There are no effective legislations to deal with the minority interest though there are provisions in the recent promulgated Companies Act, 2013.

Another crucial issue in the Indian corporate is related to the independent directors. Independent directors are one of the important factors in all the corporate governance reform committees. The dominant shareholders appoint these and majority of shareholders in the largest corporation of India is either individual or family\textsuperscript{23}. They conventionally appoint friends or allies as the independent directors. A number of studies have proved that \textit{independent director is ineffective} in Indian corporations. Corporate do not follow the exact code of corporate governance and cases of misgovernance are frequent. This can be evidence from the recent scams.

A number of empirical studies have shown that most industrial and business organizations have succeeded because of unethical practices they follow. Industrial growth along with the development of corporate culture began in India after independence. The governance of most countries’ industrial and business organizations in India has flourished on unethical business practices at the market. Most of Indian corporate governance shortcomings are no worse than in other Asian countries and its banking sector has one of the lowest proportions of non-performing assets, signifying that corporate fraud and tunneling in India are not out of control\textsuperscript{24}.

In some corporations CEO himself is the chairman of the Board of Directors as well implying that the supervisory role of the board is often severely


compromised. Management can potentially use corporate resources further their own self-interests rather than the interests of the shareholders. This causes the disadvantage to the minority shareholders. Thus there is a need to have control of shareholders in the process of selection of board of directors.

Increasing corruption in the government and its various services had kept the managements of country’s industrial and business organizations above accountability for their misdeeds as suggested by Raut25. This encourages corporate to indulge in more and more of unethical practices. The disclosure of interest requirement in erstwhile Section 299 of Companies Act, 1956 to disclose the connections and economic interest of the directors with the company thus remained ineffective. Not only that any contract or arrangement entered into or to be entered into between two companies where any of the directors of the one company or two or more of them together holds less than two percent of paid up capital are exempted from disclosure of interest. The ineffective meeting of shareholders and dispersed manner of owners with no logical meetings or communication between themselves is also the biggest issue. Kumar26 (2007) has also suggested that the most important challenge we face today towards better corporate governance in India is the mindset of the people and the organizational culture. This requires rethinking on the work of government or the regulatory agencies to provide environment that may be conducive for changing mindsets.

VI. Remarks

We conclude that the major challenge to the corporate governance in India is the power of the dominant shareholders that are able to exercise influence over the political system of the country. Investments in the sophisticated governance systems do not produce visible returns, though they are helpful to the implementers in valuation and resource mobilisation. However, good governance impact can be visualised in developed countries. India has weak monitoring system with multiplicity of regulators. Recent corporate frauds are sufficient to justify this phenomenon. India lacks professionals and entrepreneurial managerial personnel who can work as independent professional directors on boards. Even Though the research studies in the area of corporate governance have been growing and some institutions like ICSSR, Ministry of Finance have taken some initiatives to promote research in this area still the empirical exploration is missing.

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