Corporate Governance: A Comparison between India and China

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ABSTRACT:
Corporate governance has become a matter of heightened importance and attention in government policy circles, academia, and the popular press throughout the world because of the recent financial scandals such as Enron, WorldCom, Satyam, Kingfisher etc and the resulting loss of confidence by the investing public in the market. Whilst globalization of economies has increased, and international corporate guidelines have been adopted, each country has its own values, societal norms, way of doing business, and special circumstances. In the study, an attempt has been made to compare and contrast the corporate governance provisions, guidelines and efforts to ensure compliance between the two fast-growing economies, India and China. It was concluded that Indian companies are governed better than companies in China and there is no political interference with boards in India unlike China. Although India has an edge over China in meeting international standards of corporate governance, as far as corruption is concerned, both the economies are tantamount.

Keywords: Corporate Governance, India, China, directors, auditors, corporatization, privatization, control.

INTRODUCTION:
Corporate Governance has been drawing a great deal of public interest because of its significance for the economic strength of corporations and the interests of society. High profile scandals and the consequent reform in corporate governance are becoming a global trend. Modern anxieties, originating in the United States and United Kingdom, have extended to Europe, the Asia pacific, and beyond. It has become a very hot topic in India as well, especially after the collapse of Satyam Services Ltd. in 2008. The fundamental significance of corporate governance for accountability and performance is now fully recognized in the industrial world, and perhaps even more acutely in the transitional economies of Eastern Europe, East Asia and Latin America. It has now become a matter of considerable public interest which earlier used to occur quietly behind closed boardroom. Consecutive recent controversies have highlighted some of the dilemmas of corporate governance, but since the origin of industry there were deep apprehensions regarding the ownership and control of businesses.

The fact that corporate governance is now at the heart of the political agenda is not simply a response to the recent wave of scandals in the US and in Europe. A sound corporate governance framework is a key condition for liquid capital markets to function well. Corporate governance is about building trust and confidence in corporations and markets by enhancing transparency and ensuring the fairness and accountability of corporations towards shareholders and other stakeholders. It is a prerequisite to the integrity and credibility of individual companies, financial institutions, stock exchanges and indeed the entire market economy.

The study on this topic is inspired by certain key facts.
1. China and India are growing at an extraordinary and exceptional pace and seem to have survived the Global Financial Crisis of 2008-09 better than most other economies.
2. China and India are not western countries, but have been heavily influenced by “globalized” Anglo-American notions of corporate law, corporate governance norms, and securities regulation.
3. China and India are presently two of the most popular destinations for foreign capital in the world – whether via foreign direct investment (FDI) in essentially private (or pre-public) transactions or public capital markets transactions.
4. Both China and India have undergone, and are progressing through, incredibly important programs of economic reform and restructuring. At the same time they are increasingly “opening to the outside world”.

These are the shared facts which, of course, are met by many deep differences, in particular relating to the history, internal organization and political and economic structures of the two great nation-civilizations. These common facts provide an interesting and rich platform for consideration of popular or contested corporate governance and corporate governance reform percepts.

METHODOLOGY
The methodology used in the study is solely based on the data collected from the secondary sources such as articles
The China-India comparison is central to the Asia debate. It is also of great value to the rest of the world. In the end, it may not be an ‘either-or’ consideration. While the Chinese economy has surpassed India by a substantial amount over the past 17 years, past performance is not necessarily indicative of what lies ahead. Each of these vibrant nations is now at a significant phase in its development challenge – facing the option of whether to go with the flow or change the approach. The outcome of these choices has insightful repercussions – not just for the 40% of the world’s population residing in China and India but also for the future of Asia and the broader global economy.

China and India represent the future of Asia – and quite possibly the future for the global economy. Yet both economies now need to fine-tune their development strategies by expanding their economic power bases. If these mid-course corrections are well executed – and there is good reason to believe that will be the case – China and India should play an increasingly powerful role in driving the global growth dynamic for years to come.

China and India had similar development strategies prior to their breaking out of their deliberate insulation from the world economy and the ushering of market-oriented economic reforms and liberalization. China began reforming its closed, centrally planned, non-market economy in 1978. India always had a large private sector and functioning markets which were subject to rigid state controls until the hesitant and piecemeal reforms of the 1980s. These became systemic and far broader after India experienced a severe macroeconomic crisis in 1991. The political environments under which reforms were initiated and implemented in the two countries and their consequences were very different. India continues to be an open, participatory, multiparty democracy, while China has an authoritarian, one party regime, though it is liberalizing.

If China has become the manufacturing centre of the world, India has embarked on becoming the business and information technology service centre of the world and is enjoying some success in the quest. If the economic growth rate of India does not quite match that of China, it is substantial and sustained enough to offer many business opportunities for the thriving entrepreneurs of the country. The comparison of corporate governance between India and China can be highlighted as follows:

CORPORATE GOVERNANCE: INDIA VS CHINA

1. ORIGIN OF CORPORATE GOVERNANCE REFORMS

In China, reforms were initiated at a modest level in 1978. However, to improve the Corporate Governance standards, China passed the Company Law in 1993, which became effective in 1994 and further modified in 1999 which provides the guidelines about the rights, responsibilities and liabilities of different groups such as shareholders, board of directors, and managers. In 1998, China enacted Securities Law, to regulate the stock markets and strict prohibition of unfair practices such as market manipulation and insider trading. In response to various corporate scandals despite the regulations, China Securities Regulatory Commission (CSRC) issued a Code of Corporate Governance for Listed Companies in 2001 which specifies several requirements for listed companies, such as presence of independent directors in the boards, adherence to strict information disclosure norms, and equal status to minority shareholders with the objective to establish CG standards similar to the US system.

On the other hand, in India, due to severe balance of payment crisis, reforms were initiated in 1991, by constitution of Securities and Exchange Board of India (SEBI) as an independent regulator of capital markets. SEBI instituted four committees over the years, headed by prominent industrialists, to suggest CG reforms for Indian firms. These committees have given recommendation on issues such as the composition of the board of directors, audit committee, shareholder rights, and board procedures. On the basis of recommendations of such committees, Clause 49 on Corporate Governance was inserted and subsequently amended in the Listing Agreement. In August 2013, the new Companies Act 2013 was passed in the parliament which replaces the Companies Act 1956 with effect from April 1st, 2014. By introducing various new emergent provisions, this Act is expected to bring remarkable improvements in the current status of corporate governance.

2. LEGAL SYSTEMS:

Legal systems in most countries have their roots in one of the four distinct legal systems – the English common law, French civil law, German civil, law and Scandinavian civil law.

Most observers believe China in the twentieth and twenty-first centuries closer to a civil law jurisdiction. However, China’s legal system is a different case because it partakes of different traditions or origins – all at same time- in different sectors of application (Soviet and European civil law in criminal law and procedure; German civil law in commercial and contract law, and the Anglo-American tradition in recent corporate and securities law. Thus,
divining a connection between legal origins, corporate governance and stock market growth in China is not a straightforward exercise.

The Indian legal system is obviously built on the English common law system. The English common law countries lead the four systems in the shareholder rights index with an average of 4 (out of a maximum possible 6) followed by Scandinavian origin countries with an average score of 3 with the French-origin and German-origin countries coming last with average scores of 2.33 each. Thus, English-origin legal systems provide the best protection to shareholder rights. India, for instance has a shareholder rights index of 5, highest in the sample examined - equal to that of the USA.

3. CORPORATIZATION VERSUS PRIVATIZATION
The reform efforts of the 1970s in China saw the transformation of the old state-owned enterprise sector, the listing of shareholder companies on China’s stock exchanges and the widespread adoption of the corporate form for private business activity in China. Corporatization, rather than privatization, was adopted as the strategy for the reform of the state-owned enterprise sector. Indeed, the Chinese authorities have sought to improve corporate governance of SOEs as an alternative to, and as a means of avoiding, privatization. Corporatization has become the generic solution for improving the performance of SOEs and also for the external financing of firms through a rapidly growing equity market. There were political as well as economic considerations behind the corporatization program. Politically, corporatization was a way to reduce state intervention and improve corporate governance of SOEs without full privatization.

India followed a path of privatization rather than corporatization so as to reduce the influence of state over firms. Privatization was to take the form of selling off some of the SOEs and the beginning to sell off or rationalize the state’s interest in other firms. Further, the DFIs were now to be assessed on bottom line measures rather than the amount of loans sanctioned or assets created. Moreover, trade barriers were to be reduced, foreign investment permitted increased domestic and foreign competition. Thus, post-1991 India would have new competitive spaces opening up (where the SOEs would no longer be the sole provider of goods and services), old industries becoming more competitive with the inflow of foreign competition and new domestic competition, and government institutions more motivated by efficiency than before. Perhaps the single most important development in the field of corporate governance and investor protection in India has been the establishment of the Securities and Exchange Board of India in 1992 and its gradual empowerment since then.

4. CORPORATE GOVERNANCE MODEL
China’s model of corporate governance can be best described as control-based or relationship-based model, in which the controlling shareholders (in most cases, the state) employ all kinds of governance mechanism to tightly control the listed firms. Such a model provides the controlling shareholders a large room to seize minority shareholders, and eventually undermine the public’s confidence in the stock market. State serves not only as the dominant owners in listed state-owned enterprises but also as the regulators and interveners that often powerfully change the judiciary institutional and economic parameters that affect corporate governance. Moreover, business practices in China emphasize personal trust rather than systems trust. Systems trust assumes that the system is functioning correctly; trust is placed in the system, not in specific individuals or officials. Agencies which form part of the system function to generate trust, reduce reliance on people, and make personal guarantees indispensable. Thus, system trust is associated with professionalism and rationalism. Although Chinese economy has enacted thousands of laws, rules and regulations, few are completely enforced since personal interpretations are often made in lieu of legal interpretations.

On the other hand, the Indian system of corporate governance has been described as a ‘hybrid’ of the outsider and insider model, as small shareholders participate in corporate governance. There is also significant institutional investor involvement in listed companies. The corporate governance in India is, or will be moving closer to the Anglo-Saxon system than that in China. That is, there will be a greater and faster convergence of Indian corporate governance with the Anglo-Saxon paradigm compared to China. This is because, in India, the economic sectors are more privatized, state ownership and government control are substantially reduced, political regimes are more accommodating to market force determination, and there is increasing system trust. For instance, in India, the Securities and Exchange Board of India recently provided a few key provisions in compliance with the Anglo-Saxon model. For example, if the chairman of the board is an executive director, at least one half of the board must comprise independent directors. In addition, independent audit committee must be established within the board, and this committee must have adequate power to review all major investments and transactions.

5. DOMINANT SHAREHOLDERS
In China, the State acts as a majority shareholder in many listed corporations. This situation will probably remain unchanged in the near future. State shareholder status may trigger a number of conflicts of interest—on one hand, the government may be concerned about whether the State is sufficiently protected as a shareholder of the enterprise, and on the other hand, minority shareholders and potential
investors may be concerned about potential misuse of the controlling shareholder position by the State. Both concerns are understandable. Protective and restrictive mechanisms are, therefore, indispensable with respect to the State shareholder.

The problem of the dominant shareholder arises in three large categories of Indian companies.

1. The public sector units (PSUs) where the government is the dominant (in fact, majority) shareholder and the general public holds a minority stake (often as little as 20%).
2. Multinational companies (MNCs) where the foreign parent is the dominant (in most cases, majority) shareholder.
3. Indian business groups where the promoters (together with their friends and relatives) are the dominant shareholders with large minority stakes, government owned financial institutions hold a comparable stake, and the balance is held by the general public. The governance problems posed by the dominant shareholders in these three categories of companies are slightly different.

6. OWNERSHIP STRUCTURE
It is the government (state) that controls firms in almost all strategically important industries in China. Even where the Chinese government is a minority shareholder in a privatized SOE, it still retains its control over the firm through appointing top managers and board of directors. The continuing influence of the state in Chinese firms may adversely affect the speed at which, and the extent to which, Chinese firms can adapt to western standards in corporate governance.

In India, state ownership is found most often on public sector units (PSUs), where the government very often is the majority shareholder and the general public holds a minority stake, often as little as 20%. However, equity ownership by the state is still significantly lower than that controlled by the promoters of large and small companies, who, along with their friends and relatives, owned, on average, in excess of 45% of shareholdings in all Indian companies in 2002.

7. BOARD STRUCTURE
China has adopted a two-tier structure of board governance, consisting of both a supervisory and management board. Chinese company law stipulates that the number of directors must total between 5 and 19 in a listed company. Similar to the German system, the management board is the main decision-making authority, whilst the supervisory board acts as a monitor. The advantage of the two-tier structure theoretically is that the supervisory board is independent, and performs a monitoring role for both the board of directors and the management. Employee representatives should also be present on the supervisory board.

India is having a one-tier board structure consisting of executive directors and non-executive or independent directors. Executive directors are those who look into the day to day transactions of the company. They exercise greater extent of control over the company affairs. Non-executive directors are normally appointed primarily for their contribution to the strategic planning and monitor the functioning of the Company. They do not get involved in the day to day activities of the company like the Executive Directors. In addition, the Non Executive Directors may in certain circumstances contribute valuable expertise not otherwise available to the management or act as mentors to the inexperienced executives.

8. AUDIT COMMITTEE
The key roles and responsibilities of the audit committee in China are to ensure, on behalf of the Board of Directors, that the external and internal auditors are qualified and independent; to review the company's financial statements and auditor's report; to review and monitor the effectiveness of the company’s internal controls and of its internal control self assessment process; and to coordinate internal control audits and other related matters. The audit committee also plays a key role in ensuring the board of directors is accountable to the company's stakeholders.

Clause 49 and now the new Companies Act, 2013 pays special attention to the composition and functioning of the audit committee, requiring at least three members on it, with an independent chair and with two-thirds made up of independent directors—and having at least one “financially literate” person serving. It spells out the role and powers of the audit committee and stipulates minimum number and frequency of and the quorum at the committee meetings. With regard to “material” non-listed subsidiary companies (those with turnover/net worth exceeding 20% of a holding company’s turnover/net worth), Clause 49 stipulates that at least one independent director of the holding company must serve on the board of the subsidiary. The audit committee of the holding company should review the subsidiary’s financial statements, particularly its investment plans. The minutes of the subsidiary’s board meetings should be presented at the board meeting of the holding company, and the board members of the latter should be made aware of all “significant” (likely to exceed in value 10% of total revenues/expenses/assets/ liabilities of the subsidiary) transactions entered into by the subsidiary.

9. INFORMATION DISCLOSURES
The CSRC Code, issued in 2002, clearly states that information disclosure is an ongoing responsibility of listed companies. In addition to disclosing mandatory information, companies are encouraged to disclose in a
timely basis all other information that may have a material effect on the decision of shareholders and stakeholders. This includes information on the composition of the board of directors and supervisory board; attendance records, performance assessments, and compensation of directors; establishment of functional subcommittees and their operating details; independent directors’ opinions on related-party transactions; controlling shareholders’ interests; and executive appointments/removals. Companies seeking a listing must have financial statements prepared in accordance with local rules for the three years prior to an IPO.

Furthermore, the “comply or explain” rule in the CSRC Code requires all listed companies in China to disclose the gap between their existing practices and the recommendations.

In the Code, reasons for any gap, and whether/how they plan to close such a gap. Meanwhile, it should be noted that there is no penalty for failing to close the gap or requirement that the company must do so.

The areas where Clause 49 stipulates specific corporate disclosures are: (i) related party transactions; (ii) accounting treatment; (iii) risk management procedures; (iv) proceeds from various kinds of share issues; (v) remuneration of directors; (vi) a Management Discussion and Analysis section in the annual report discussing general business conditions and outlook; and (vii) background and committee memberships of new directors as well as presentations to analysts. In addition, a board committee with a non-executive chair should address shareholder/investor grievances. Finally, the process of share transfer, a long-standing problem in India, should be expedited by delegating authority to an officer or committee or to the registrar and share transfer agents.

10. SHAREHOLDER PARTICIPATION & STOCK MARKET DEVELOPMENT

In the case of India, there has been very active participation of retail and institutional investors in recent years. This can be gauged by the fact that the Bombay Stock Index, which is the index of the main stock exchange in India, has increased more than 1600% from 1000 in 1992 to close to 16000 in 2007. This has been accompanied by improvements in investor protection and corporate governance laws, making it difficult for a majority owner to expropriate the firm value at the expense of minority owners. The improvement in the external governance environment means that the negative effects of ownership concentration are minimized, while the effectiveness of ownership concentration as a governance mechanism increases.

As compared to India, the corporate governance laws and governance standards are not very strong in China in spite of the progress made in recent years. The stock market in China is relatively new, and firms are still learning effective strategies for operating in a free market economy. With poorly functioning stock markets, ownership concentration as a governance mechanism is not as effective as it is in India. In fact, owners/managers in these firms are known to take actions which not only harm themselves but also others around them in their pursuit of non-rational goals. The participation of institutional investors in the market is also lacking compared to India.

11. MINORITY SHAREHOLDER RIGHTS

In China, minority shareholders are a highly fragmented group of individuals. The presence of institutional investors (e.g., pension funds, mutual funds, asset managers) is still not sizable and retail investors often lack investment knowledge and awareness of shareholders’ rights. The CSRC Code made an attempt to draw attention towards minority shareholders protections by revising the Company Law and Securities Law, which came into effect on 1 January 2006. The various developments were as follows:

- Proxy voting is permitted.
- Cumulative voting is encouraged to empower minority shareholders to appoint directors and/or supervisors.
- A stricter duty of care has been imposed on directors, supervisors, and senior management.
- Shareholders are granted the right to bring a derivative suit or direct suit against directors, supervisors, and senior management.
- The concept of “piercing the corporate veil” has been introduced, enabling courts to look beyond the principle of limited liability.
- Shareholders are granted the right to check and copy the company’s account books and meeting minutes, allowing share buybacks and granting shareholders the right to petition for liquidation of a company.

In India, while the Companies Act provides clear instructions for maintaining and updating share registers, in reality minority shareholders have often suffered from irregularities in share transfers and registrations - deliberate or unintentional. Sometimes non-voting preferential shares have been used by promoters to channel funds and deprive minority shareholders of their dues. Minority shareholders have sometimes been defrauded by the management undertaking clandestine side deals with the acquirers in the relatively scarce event of corporate takeovers and mergers.

The most significant challenges for India’s corporate governance reforms remains the closed ownership structure of Indian firms and the failure of existing reforms to address both the potential oppression of minority shareholders and the extensive power of promoters in Indian companies. In India, there are no significant
shareholder associations, and minority shareholders have minimal avenues for protecting their rights. Even large institutional investors show minimum involvement in corporate governance issues.

12. CERTIFICATION OF FINANCIAL STATEMENTS BY MANAGEMENT

In India, CEO and CFO or their equivalents need to sign off on the company's financial statements and disclosures and accept responsibility for establishing and maintaining effective internal control systems. The company is also required to provide a separate section of corporate governance in its annual report, with a detailed compliance report on corporate governance. It should also submit a quarterly compliance report to the stock exchange where it is listed. Finally, it needs to get its compliance with the mandatory specifications of Clause 49 certified by auditors or by practicing company secretaries. On the other hand, Chinese Corporate governance reforms do not address this issue.

13. INDEPENDENT DIRECTORS

In China, in August 2001, the CSRC circulated the guidelines for introducing independent directors to the boards of directors in listed companies in which listed companies must have at least one-third of their boards consist of independent directors by June 2003. However, qualified independent directors were a scarce resource in China. By May 2003, it was reported that only 62 percent of listed companies met this requirement (Green, 2004). The proportion of independent directors has significantly increased since then, but it remains doubtful how well they represent the interest of minority shareholders and how much influence they may have on management and other directors of the board.

While, India’s Clause 49 and the New Companies Act mandated the appointment of independent directors in the board of directors. Clause I, sub clause (ii) of annexure-1 of clause 49 mandates that “where the chairman of the board is a non-executive director, at least 1/3rd of the board, should comprise of independent directors and in case the chairman of the board is an executive director at least ½ of the board should comprise of independent directors.” There is no provision for their selection process, independence, there is ambiguity in law about the qualifications of an independent director in the present company bill. Conclusion:

From the study of background of corporate governance in India and China and the connection between the two developing countries, the following points makes the two countries different with respect to corporate governance:

- Corporate Governance in India is better than China or in other words, Indian companies with global ambitions are better governed than their Chinese counterparts. Indian companies aspiring to become world-spanning multinationals demonstrate better corporate governance than their Chinese rivals. But Chinese companies may not need world-class governance to emerge as fierce competitors.

- The corporate governance system of India and China are, in a way, opposite to each other. Indian companies are so much better governed. India is sort of a noisier version of the U.S. system, which is that you have to be accountable to shareholders and all the other stakeholders. The principles are the same, but the information acquisition is a little bit more problematic in India compared to the U.S. It's not so easy to figure out everything you need to. But there's a very vibrant, credible business media. No opinion is forbidden to be expressed. Information is noisy and unbiased—no one is willfully distorting the truth. China is the opposite—it's noise-free but biased. You get a clean story but the story isn't always right. There are views that cannot be expressed.

- Corporate governance rules in China are applicable to all publicly held corporations, whether listed or non-listed. However, in India, the corporate governance rules are applicable only for the listed companies.

- In the Audit committee of Chinese companies, the majority are the independent directors including the chairman. The committee renews internal audit and controls and oversees financial disclosures. In the Audit committee of Indian companies, at least three directors should be non-executive. The chairman should be an independent director and oversees financial reporting.

- In India, there is a spectrum of companies, such as Infosys (INFY), which on some dimensions is better governed than companies in the West in terms of how quickly it discloses things and how quickly it complies with NASDAQ norms. At the other end of the spectrum there are companies that are still the fiefdoms of families, many of which are badly governed. But even those companies are accountable to the market. Market pressures will force them to clean up their act to some extent. The equity markets function so well that it’s hard to believe you could be a continuous violator of norms of good governance and still have access to the equity markets. On the other hand, none of that matters in China because the financial markets do not work in the sense that we think of them working in the U.S. In China, all stock prices move together. They move up on a given day or they move down. There is no company-specific information embodied in the stock price. Investors cannot possibly decide that a company is good or bad because the market is not working in that sense. What do investors see is aggregate enthusiasm, or lack thereof, for China Inc. The market is not
putting pressure on managers to behave in ways that approximate corporate governance in the West.

- Political interference is not there in the Indian Board, at least in the private sector. However, in the state-owned enterprises of China, there would be political influence.

- As far as corruption is concerned, India and China are both close to the bottom of that list. China does a little bit better than India. In China, there is corruption, but it is constructive corruption. You, as a bureaucrat, get to be corrupt but only after you generate some value for society. You get a piece of it. In India, there is corruption but it’s not constructive. You’re not fostering new bridges or highways. It’s just shuffling stuff back and forth.

On the final note, we can say that Indian companies, on the whole, have an edge over the Chinese in reaching international standards of governance. Although Chinese have huge capital at their disposal because of their $1.5 trillion in foreign exchange reserves, they do not have good corporate governance. Corporate governance matters because you want to reassure the providers of inputs—whether it's time and talent, or ideas, or capital—that their rights will be respected and they will get a return on it. The reason the Chinese feel less pressured to do something about it is not because they don’t know how to do it—far from it, they have the best technical help from Hong Kong and other places. It’s because they make a reasoned judgment that it’s not worth their while.

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