Corporate Governance: Aspirational or Attainable

1. Introduction

Be it large scams in the eye of the public, or the ones which do not necessarily make the headlines, corporate governance is in the eye of a storm since a long time in India. It has definitely hit the radar screen of the government, lawmakers and regulators potentially due to the scandals that shook India Inc. in the past decade. Satyam, Kingfisher, Ranbaxy, IIFL, Infosys, Tata group, Jet Airlines all have been besieged by varied issues, be it funds siphoning, exercise of inadequate controls by the Board, providing contracts to entities or businesses where there is a direct or indirect interest of the promoters or directors, "managing" audits. The list is vast and when such events come to light, investor confidence gets destroyed.

The legal framework for corporate governance is enshrined in Companies Act, 2013 (**"CA 2013"**) and various regulations issued by the Securities and Exchange Board of India. The Ministry of Corporate Affairs issued voluntary guidelines[1] too. Additionally, in the last few years, be it via changes in Companies Act, market regulator Securities Exchange Board of India's frequent monitoring, steps have been taken to enhance corporate governance. In June 2017, the Government formed Kotak Committee under the Chairmanship of Uday Kotak to suggest steps to improve governance further in Indian corporations. Of its 81 recommendations, SEBI accepted about half of them, and issued the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) (Amendment) Regulations, 2018 (**"SEBI LODR 2018"**). Effective April 1, 2019, several of these amendments came into effect for listed entities.

This newsletter examines the issues in challenges surrounding corporate governance in action, its effective enforcement and how all the stakeholders need to align.

2. CA 2013 Changes and Beyond

When the 1956 Companies Act was replaced by CA 2013 there were a lot of expectations in terms of how that would improve all Indian companies, be it listed, public or private. With a changing business environment there was a dire need to introduce changes and which included provisions on board composition and role of directors; codification of their duties; responsibilities regarding financial reports; corporate social responsibility; vigil mechanism; mode of appointment, role and obligations of independent directors and creation of a serious fraud investigation office. CA 2013 also provides for compulsory rotation of individual auditors after five years and audit firms after ten years, to eliminate or, at least, minimize malpractices, financial oversight and ensure independence of auditors. Further, significant monetary and penal sanctions were provided in the overall legal framework[2] in case of violations. The monetary fine could be nominal, less than even USD 10 in some cases, to something as severe as imprisonment extending to a decade. Such penal impact is extended to the company, its officers, key managerial personnel as well as external advisers like auditors. Clearly, therefore, the statute armed and empowered the enforcement agencies with tools to enforce.

[1]These are Corporate Governance Voluntary Guidelines, 2009 and National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business, 2011 both issued by the MCA

[2] Depending on the type of company, penalties could be found in CA 2013 and even in SEBI LODR 2018

Then, why does corporate governance remain a thorny issue?

Looking back on some of the biggest headline-making scandals of poor governance referred to in the first paragraph in the last decade, it is clear that a common thread runs through them. While it is not possible to describe or even know all the causes for failure of companies, the key ones that come back each time include the inability of the promoters to relinquish control and who, in some cases, continue to remain privy to confidential data despite retirement; unjust enrichment combined with fraud; falsification of accounts; creation of shell companies to divert funds; diversion of funds to related parties, lack of independence of independent or other directors; absence of implementation of necessary checks and balances, both by the company, its officers and, in some cases, by the auditors. Recently, the role of the Board came under intense scrutiny in ICICI Bank's case where the renowned CEO had allegedly violated the bank's code of conduct on conflict of interest. Briefly, a committee was established to probe allegations of nepotism regarding credit disbursement to some entities which found evidence of a nexus between the CEO, her husband and chairman of one of the beneficiaries. All this only reinforced a dire need to establish standards for those who aspire to key managerial positions. This is true for all types of companies and not only listed ones.

The above demonstrates there is no single cause why corporate governance is not deeply entrenched as it should be since systemic challenges persist. These could be the sheer inability of the board directors, and not necessarily "independent directors," to express a clear view without any coercion by the promoters, lack of enforcement and ability of different agencies to have an aligned approach. If the management operates as a custodian of the stakeholders, including protection of the minority, it would lead to a greater sense of accountability for majority shareholders who, inevitably, manage a corporation. Then, lack of cases where fines are imposed effectively even though the law permits it further complicates the issue. Money always talks loudly and if the deterrent statutory provisions are implemented effectively, perhaps, that could aid in changing mindsets. Then, the delays of the judicial system combined with potential gaps between CA 2013 and criminal procedure leads to an outcome of negligible or nil cases and penal sanctions remain sanctions on paper.

3. The Future Essentials

So, what key aspects assume importance?

3.1 *The Board*: The role of Board generally and that of independent directors have generated widespread controversy. If the Board is unable to manage governance issues with a clear, cogent, objective perspective to an issue, no number of rules will help. It is absolutely imperative to look for and encourage directors to be forward thinking, who question deeply on matters raised to the board, who are willing to articulate an opinion fearlessly on any matter, but particularly in potential conflict of interest situations, are individuals who are not scared to take a defined position for safeguarding minority interests. In other words, pen-pushers are a no-no. How the Board has to function and ensure it safeguards the interests of all stakeholders, be it promoters, employees or minority shareholders, will be key if Indian companies have to move forward effectively. The important changes introduced for the Board of listed companies under SEBI LODR 2018 are a move in the right direction to tackle (mis)governance. They embody the principle that directors should not be burdened with too many companies and should not be too old. So, effective April 1, 2019:

- a person can be a director in only 8 listed entities;
- if non-executive directors want to continue beyond 75 years, special resolution[3] of shareholders is required;
- women independent directors are mandatory for top 500 listed entities;
- board has to evaluate all independent directors; if they resign before term expiration, reasons for resignation have to be notified to the stock exchange; and the corporate governance report of the company has to disclose the independence of independent directors

Amongst all the essential qualities of a director, courage with strong communication skills is crucial. A curious and a questioning mind will allow for effective checks and balances to be reinforced.

3.2 *The Audit Committee:* Committees are formed to improve the effectiveness and efficiency of the Board, more so where it is necessary to have experts weigh in on issues. An important one is the audit committee. Creation of this committee is necessary for certain types of companies which include both listed and unlisted public ones, where specified thresholds for paid-up capital[4] or turnover[5] are crossed. Another trigger is when outstanding loans or borrowings or debentures or deposits aggregate INR 50 million or above, roughly about USD 715,000. The audit committee should have at least 3 directors out of which majority should be independent and all members should be able to understand financial statements. They are expected to meet four times a year, and both auditors and key managerial personnel of the company must attend. Amongst various other functions, they can seek auditors' comments about internal control systems and can investigate any matter. Furthermore, they are supposed to operate the vigil mechanism.[6] So, the provisions under CA 2013 have been fairly wide, but despite the existing framework there has been no dearth of scandals, which highlight weaknesses in the system. SEBI LODR 2018 has now made it mandatory for listed companies audit committee to review utilization of loans, advances and investments. Hopefully, such reviews including purpose of loaning funds and credit evaluation should help to mitigate risks. Details of audit committee composition, its meetings and situations where the Board does not accept its recommendations have to be necessarily disclosed in the Board's annual report.

3.3 *Others:* SEBI LODR have prescribed other changes too and some selective ones are mentioned. These include enhanced obligations regarding subsidiaries, widening of related parties' definition,[7] restrictions on related parties from voting on resolutions pertaining to material transactions. Even the definition of material subsidiary has been widened to mean those whose income or net worth exceeds 10% of the consolidated income or net worth of the listed entities and its subsidiaries in the immediately preceding accounting year. And, it is now necessary to appoint at least one independent director on the board of unlisted material subsidiary including foreign ones. This effectively means that companies with a large number of subsidiaries will need

[3] This requires at least 75% of the votes cast by shareholders in favor of a resolution for it to pass
[4] This is INR 10 million and beyond which translates to about USD 140,000
[5] This is INR 100 million and above, equivalent to about USD 1.4 million
[6] Every listed company and public companies who accept deposits from public *or* who have borrowed money from banks and public financial institutions in excess of USD 715,000, must have a vigil mechanism. Its details must be published on company website and Board's report
[7] The definition is modified to include any person or entity belonging to the promoter group holding 20% or more shareholding in the listed entity

to put in place a proper governance mechanism across the group, including its unlisted subsidiaries.

3.4 *The Advisers:* It is clear that the Board, the committees, the management and the officers, including key managerial personnel cannot afford to become lax. The people at the top need to possess a mindset which is of good governance and they need to periodically evaluate what systems and policies need to change to bring about transparency. While a company, its officers and culture play a key role in enhancing corporate governance, it can elevate with active participation by its external advisers, be it auditors, lawyers or others. They are, in a sense, its watchdogs and are obligated to ensure that the company stays on track. To that end, making them accountable too is absolutely crucial and need of the hour. When financial frauds are unfurled, one automatically thinks they occur when multiple parties connive together. There has to be a strong appetite for checks and balances, clean practices and transparency.

Finally, for private and unlisted public companies that do not come in the ambit of SEBI and its various regulations, it would be prudent to use the norms established for listed companies to reassess their existing systems and implement ethical standards of operation which will only enhance the corporate governance culture and not leave it as a box to be ticked.

4. Conclusion

The Board has to always act in the larger interests of all the shareholders, but particularly of the minority. They have to possess the capability to identify red flags that could potentially morph into bigger issues and stop them from a downward spiral. Where both promoter and independent directors co-exist on a board, the latter must monitor the former and ensure that the company has adequate risk management systems in place. At the moment, the overlap between management and shareholding is like a malaise which must be eliminated and promoters need to understand that they need to place management in the hands of those who walk the talk and can stand up to the owners. Change will not happen overnight and enforcement can be successful only if all parties commit collectively. It is not easy to build organizations where transparency and accountability are its key hallmarks. Even regulatory actions will not really act as an effective deterrent factor and failures of corporations will continue to eat at the system unless the mindset and DNA changes. Good corporate governance is attainable provided there is a will, else the aspirations of Modi 2.0 to be a superpower that matters globally will remain just that – an aspiration, and so will corporate governance.

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