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Inclusive model of Corporate Governance:

The leitmotif of the Companies Act, 2013

Unless the inclusive model of corporate governance propounded by the Companies Act, 2013 becomes a self-enriching way of life for major companies in India, the statutory provisions founding this model of corporate governance would remain a law for ritualistic compliance, thereby robbing India of a great opportunity for corporate resurgence.

Section 166 (2) of the Companies Act, 2013 while dealing with the duties of the directors, says that the director of the company 'shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of environment'. This is the touchstone upon which the new company legislation founds the model for corporate governance in India. The American model of an overarching shareholder centric corporate governance has fortunately been given a go-bye; thereby breathing fresh air into an inclusive model of corporate governance which augurs well for wealth creation. The 2008 Global meltdown has been largely due to the failure of a shareholder centric model of governance in some of the venerated American institutions where focus shifted from such institutions to

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Wall Street. It is just as well that in a country like India where wealth has to be generated to solve some of the daunting problems of extreme poverty and economic inequality, the shareholder centric model of governance which at its best only re-distributes wealth, has been given a quiet statutory burial.

Definition of an inclusive model of corporate governance

The inclusive model of corporate governance can be defined as a set of principles, processes and structures by which a company is governed in the best interests of the employees, customers, shareholders, community and the environment. Principles of such model of governance would include following the principles of transparency, accountability, accounting standards and auditing standards in the governance of a company. Processes would include the actual ways of following these principles in the governance of a company. Structures would include how the Board and the Committees of the Board are constituted with independent directors and others so that the processes to adopt the principles as above are actually implemented to govern the company in the best interests of the employees, customers, shareholders, community and the environment.

A robust definition of an independent director

One of the most relevant and recent innovations in the field of corporate law has been the institution of independent directors. Section 149 (6) of the Companies Act, 2013 provides a robust definition of an independent director. Section 149 (10) of the Companies Act, 2013 seeks to provide a fixed term up to five consecutive years for an independent director to be on the Board of a company. Section 149 (11) of the Companies Act, 2013, allows an independent director two such consecutive terms up to five years each. Section 149 (12) of the Companies Act, 2013, provides a limited immunity to an independent director from company prosecutions for acts of omissions or commissions which have occurred not due to his consent, connivance or lack of diligence. Section 150 of the Companies Act, 2013 provides the manner of selection of independent directors from an impartial data bank maintained by prescribed institutions and the actual appointment of an independent director being made by a general meeting of shareholder after a due process is followed. Schedule IV to the Companies Act, 2013 contains the code for independent directors which has been statutorily mandated on the company and the independent directors by Section 149 (8) of the Companies Act, 2013. The code for independent directors broadly lays down the guidelines for professional conduct for independent directors, role and functions of an independent director, duties of an independent director, manner of appointment and re-appointment of an independent director, resignation or removal of an independent director, holding a separate meeting of independent directors to review the performance of non-independent directors on the board of directors of the company, review of performance of the chair person of the company and to assess the quality, quantity and timeliness of information flow to the Board so that the Board can function effectively. The code also lays down the evaluation mechanism for the performance of independent directors. All in all, the code for independent directors is a robust statutory tool to provide traction to the institution of independent directors in India. It is a matter of

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gratification that across major jurisdictions for the first time it is only the new company legislation in India which provides such a robust statutory foundation for the institution of independent directors. It is for us, the people of India, to make or mar a great beginning.

Reinforcement of the auditing function

One of the visible fault lines for good corporate governance the world over has been the lack of effective auditors. India has been no exception. Some of the major scams in India can be traced back to the auditors not doing their jobs. The new company legislation in India provides some interesting solutions for this seemingly intractable problem. To begin with, Section 139 of the Companies Act, 2013 provides for rotation of statutory auditors every five years for all listed companies. Section 140 (5) of the Companies Act, 2013 provides *suo motu* powers to the National Company Law Tribunal to remove the auditors in connection with any fraud in the company. Section 132 of the Companies Act, 2013 provides for a National Financial Reporting Authority to monitor the auditing profession including its disciplinary process. Section 144 of the Companies Act, 2013 prohibits an auditor from rendering services relating to accounting and book keeping, internal audit, design and implementation of any financial information system, actuarial services, investment advisory and banking services, outsourced financial services and other kinds of services as may be prescribed, in respect of the company of which he is auditor or its holding company or its subsidiary company. Under Section 138 of the Companies Act, 2013, in respect of certain companies as may be prescribed, appointment of an internal auditor has been mandated. All these provisions aim at restoring auditor independence and effectiveness which is the cornerstone of a good model of corporate governance.

The provisions in Section 177 of the Companies Act, 2013 reinforce the existing provisions relating to an audit committee, its role and its functioning. Section 177 (9) and Section 177 (10) of the Companies Act, 2013 provide for a vigil mechanism for directors and employees and for providing safeguards against victimization of those who use such a mechanism. Further, Section 177 (10) of the Companies Act, 2013 states that the vigil mechanism should provide for direct access to the chairperson of the audit committee in appropriate and exceptional cases for those who use the vigil mechanism. These are all good processes especially for an inclusive model of corporate governance.

Nomination and Remuneration Committee

Section 178 of the Companies Act, 2013 provides for a nomination and remuneration committee with not less than half the number of members to be independent directors. Sub-section (2) of Section 178 of the Companies Act, 2013 states that the nomination and remuneration committee shall identify persons for directorial and senior management positions and recommend to the board the appointment of such persons to such positions. This sub-section also states that in accordance with the criteria laid down and after objective evaluation of a director's performance, recommend to the board the appointment or removal of such a director. Sub-section (3) of Section 178 of the Companies Act, 2013 says that the nomination and remuneration committee shall formulate the criteria for determining qualifications, positive attributes and independence of a director and recommend to the board a policy

relating to the remuneration of directors, key managerial personnel and other employees. Sub-section (4) of Section 178 of the Companies Act, 2013 states that the nomination and remuneration committee while formulating such a policy shall ensure that the level and composition of remuneration is reasonable and sufficient to attract, retain and motivate directors of the quality required to run the company successfully. Also that such a policy shall ensure that the relationship of remuneration to performance is clear and meets appropriate performance bench marks, with such a remuneration consisting of a right balance of fixed and incentive pay reflecting short term and long term performance objectives appropriate to the working of the company and its goals. Such a policy is now mandated to be disclosed in the Board's report. Without doubt, it can be said that these provisions through statute strive to provide for the best processes in the interests of the employees who are the key stakeholders in a inclusive model of corporate governance.

Corporate Social Responsibility

Section 135 of the Companies Act, 2013 deals with corporate social responsibility. The Proviso to Section 135 (5) very clearly states that a company shall give preference to the local area and areas around it where it operates, for spending the amount ear marked for corporate social responsibility activities. Schedule - VII to the Companies Act, 2013 deals with activities which may be included by companies in their corporate social responsibility policies. These activities include -

(i) eradicating extreme hunger and poverty;

(ii) promotion of education;

(iii) promoting gender equality and empowering women;

(iv) producing child mortality and improving material health;

(v) combating human immuno-deficiency virus, acquired immuno-deficiency syndrome, malaria and other diseases;

(vi) ensuring environmental sustainability;

(vii) employment enhancing vocational skills;

Indubitably, these activities are in best interests of the community and the environment.

Class Action

Section 245 of the Companies Act, 2013 deals with class action by members or depositors so that wrong doing by a Company or any of its insiders is redressed, by the shareholders or depositors filing class action suits before the Tribunal. What is innovative in this provision is that that the expenses for such legal action by order of the Tribunal would have to be paid for either by the company and / or the wrong doers. This statutory provision is a good bulwark for safeguarding the interests of the shareholders.

Conclusion

The Companies Act, 2013 by providing a statutory basis for an inclusive model of corporate governance has paved the way for creation of corporate wealth. It is for corporate leaders to grasp the spirit behind this legislative intendment, so that this becomes a reality. Unless the inclusive model of corporate governance becomes a self enriching way of life for major companies in India, the statutory provisions founding this model of corporate governance as has been stated above would remain a law for ritualistic compliance, thereby robbing India of a great opportunity for corporate resurgence. Along with the enactment of law, it would be just as well if advocacy for such a model of corporate governance is taken up by the policy makers. Let us be cautiously optimistic that corporate India would rise to the occasion.

Appointment

Required

Company Secretary at Pune

Contrinex Automation Private Limited, having its registered office at Pune requires dynamic, diligent & result oriented Company Secretary.

The Candidate should be a qualified Company Secretary with 2 Years of experience preferably worked in Company or similar industry.

Candidate should be capable of liaison with various Government authorities.

Should have flair for writing, drafting and vetting of legal documents, agreements, contracts, MOU. Drafting and filing of various returns with different Government authorities.

Interested candidates fulfilling the above criteria can email their CVs to info@contrinex.in

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Managerial Remuneration:
Corporate Performance and Social Disconnect - A Global Overview

Directors' pay is a live issue in governance practices of the corporate sector and has gained priority on the agenda of reforms.This article portrays the law and practice prevalent in other countries and the position in India in the matter of managerial remuneration.

INTRODUCTION

Around the world, the debate on alleged excessive directors' remuneration shows no sign of abating. Corporate governance has become a subject of active academic and policy debate throughout the world. In the UK and US, there is much discussion of the deficiencies of the market system in delivering effective governance.

Corporate governance has been traditionally associated with a principal-agent relationship problem. Investors (the principals) employ managers (the agents) to run firms on their behalf. The interests and objectives of investors and managers differ. Corporate governance is concerned with ways of bringing the interests of the two parties into line and ensuring that firms are run for the benefit of investors. Demb and Neubeauer (1992) state: "corporate governance is a question of performance accountability." Recently the debate has been extended to the notion that firms have responsibilities to parties other than shareholders. At one level, it has been proposed that it is in the interests of shareholders to take account of a broader constituency including employees,

suppliers and purchasers from the firm. This view regards the development of long-term relations, trust and commitment as part

of the successful development of firms. The best firms, according to this line of argument, are the ones with committed suppliers, customers and employees. This line of argument sees the firm as an entity which is distinct from its investors, where ownership and control is spread amongst a number of parties. Kester states that "the central problem of governance is to devise specialized systems of incentives, safeguards, and dispute resolution processes that will promote the continuity of business relationships that are efficient in the presence of self-interested opportunism".

USA

In US many class actions are being brought against directors since the decade of 90s. Jack Wells, President of GE was questioned for not disclosing the pension arrangements to the shareholders. Bill McDonough, the President of New York Federal Reserve and Head of the Accounting Oversight Board, declared that huge US executive pay increases might have been morally reprehensible. He cited studies showing that the average chief executive made 400 times as much as the average production worker compared to the ratio of 42:1 two decades ago and that there is nothing in the US corporate performance to justify this rise in the ratio and commented that it was terribly bad social policy. Warren Buffet, a highly regarded investor and Chairman of Berckshire Hathaway Inc, pointed out that "CEOs of the companies are the only people in the economy who effectively decide what they are going to pay themselves. Excessive CEO pay is a mad disease of American boardrooms moving from company to company. Culture of American economy promoted the monstrosities such as Enron, Tyco and the list goes on and on". J. Richard, Chairman of US Center for Corporate Public Governance says the excesses of US has provoked demand for a ceiling on managerial pays. According to a study reported by KRS Murthy (1998), Chief Executive officers in USA earn 109 times the average base pay, compared to 35 times in UK and 17 times in Japan. Such growing disparities in income have encouraged some economists to look for reforms in the system of corporate governance.

Bebchuk and Fried state that, while increase in executive remuneration during the 1990s (in the United States) did not arise from changes in managerial power per se, several other factors consistent with the presence of managerial power may have contributed to the observed phenomenon. First, the authors argue that executives used their influence to obtain substantial option-based pay without giving up corresponding amounts of cash remuneration, and that options granted to executives did not tightly link pay to performance, allowing them to receive windfall gains from general increases in share prices. Second, they state that the rise in share prices in the 1990s, which was not confined to well-performing companies, provided a 'convenient justification' for increase in remuneration in many instances. Finally ,Bebchuk and Fried note that strong market conditions can weaken outrage constraints, thus reducing the scrutiny to which 'generous' pay packages would otherwise be subject.

UK

In a study titled "Managerial remuneration and disciplining in the UK" carried out by Luc Reneneboog and GrezorzTrojanowski in December 2010, they note that executive compensation remains one of the most widely discussed governance issues in the UK where it continues to attract the attention of the business community, academics, and the popular press. Numerous calls for improving the code of good practice for managerial remuneration contracting and for stronger shareholder involvement in the pay setting process followed the dispute over the pay of the GlaxoSmithKline's CEO Jean Paul Garnier in 2003. This shareholder revolt against corporate 'fat cats' and the concerns of the investment community were voiced as follows:

"Companies must be free to run themselves as they think best and to pay their executives appropriately. But they must also act responsibly when company performance is poor. Shareholders must hold them to that responsibility and ensure that the days of the overfed felines are numbered. (The Times, May 10, 2003)".

The mood has turned very ugly indeed, and not just in Britain. In many countries popular resentment at Croesus-like pay packages of chief executives has promptedcritical headlines and a loud chorus of complaints from politicians. Although bankers have been the targets of the sharpest barbs, plenty of bosses in other industries are also getting a tongue-lashing. Faced with public outrage over what they consider to be unbridled executive greed, many governments are preparing new rules to rein in pay. (The Economist May 30, 2009).

One of the really alarming aspects of global capitalism during the 1990s was the increasing disconnect between the managerial cadres who ran companies and shareholders who owned them. Managers and the boards that appointed them stopped seeing themselves as custodians of other people's money and became a

self-serving interest group, dedicated to grabbing more of the cake (The Independent, May 21, 2003).

Right and left, Americans and Europeans, stock market investors all share one belief: top managers pay themselves too much. The evidence seems to bear them out. Greedy chief executives, abetted by weak, sycophantic boards, gorged themselves at the expense of savers - more often than not the very pension and mutual fund investors who, as workers, had seen their salaries and benefit packages fail to grow. To add to the grievance, many executives did not seem to deserve such rewards. It is routinely said that extraordinary pay for great performance is fine. But many executives have been paid a fortune for presiding over mediocrity. (The Economist, January 20, 2003).

AUSTRALIA

Like the US, Australia has in recent times experienced a number of dramatic corporate collapses, such as HIH and One.Tel in which executive remuneration appears as an interesting subtext. While there has been a tendency to view executive remuneration as a specialized topic, its connection to these corporate collapses emphasizes the fact that executive remuneration presents general corporate governance problems in a highly concentrated form. (Corporate Governance and Executive Remuneration: Rediscovering Managerial Positional conflict by Jennifer by Hill, Jennifer G, and Yablon and Charles M. Nov 15, 2010).

FRANCE

Corporate governance first appeared as a topic of conversation in France in the mid-1990s in the wake of two quasi-simultaneous developments: the growing importance of foreign ownership (i.e. Anglo-Saxon institutional investors) and the succession of spectacular financial losses resulting from unmonitored managerial initiatives. In France, the terms "corporate governance" and "shareholder value" have generally been associated with lay-offs and short term thinking that privileges the next quarter's financial results over the long- term health and social responsibility of the corporation. The contempt shown by managers, state officials, trade unionists, and the general public toward foreign mutual and pension funds was not a surprise. (Michel Goyer, Massachusetts Institute of Technology).

The old model of corporate governance has changed beyond recognition. Its transformation is most prominent in three areas. First, the ownership structure of companies underwent a major transition in recent years from concentrated cross-shareholdings in the hands of friendly fellow domestic companies to high levels of foreign ownership. Foreign investors- composed primarily of Anglo-American mutual and pension funds, now own a little over 40 percent of the equity capital of blue chip CAC 40 firms. This was a result, in large part, of the deliberate strategy of firms to sell their cross-shareholdings in an effort to convince foreign investors that they would be responsive to shareholder concerns. Second, large French firms have reversed their strategy of corporate diversification in many business areas and have dismantled their conglomerate structure. Blue-chip companies, with the notable exception of some traditional family-owned firms, are currently focusing on a limited set of core competencies. As a result, employees of French companies can no longer enjoy the employment protection offered by the internal labor market of conglomerates and the cross-subsidization from fast growing units to poorer performing counterparts. Their employment tenure is increasingly dependent on the financial performance of the firm. Third, French firms have adopted managerial performance incentives. A little over half of the total remuneration of French CEOs and top managers now comes in the form of variable pay based on some performance measure as opposed to a fixed salary. As a result, large French firms now pay out the biggest stock options packages among continental European companies.

Germany

The German corporate governance system is very different from that of the USA or the UK. Listed firms in Germany, as in most countries, usually have highly concentrated ownership, with only a small minority having dispersed ownership. All listed German firms are required to have both a supervisory and a management board. Responsibility for the operation of the firm rests with the management board, whose members cannot also serve on the supervisory board. The German Aktiengestz (Stock Corporation Act) specifies that the main function of the supervisory board is control of the management board, including its appointment, dismissal and remuneration. Co-determination laws require that employee representatives should typically comprise either one third or one half of the supervisory boards of listed firms. Employees are therefore formally able to influence the remuneration of senior managers of listed German firms.

Empirical studies regarding managerial compensation consistently conclude that the elasticity of compensation to firm performance is very low, and that managerial pay is more strongly affected by firm size than by firm performance. Germany is no exception (Elston

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and Goldberg 2003). The effect of co-determination on the link between managerial compensation and firm performance in Germany has been investigated by Gorton and Schmid (2004), who find that this link to be significantly weaker in firms where employee representatives comprise one half rather than one third of supervisory boards. The empirical analysis shows that the elasticity of managerial pay with respect to firm profitability is very low and is hardly affected by the ownership structure of the firm, although there seems to be a negative effect of ownership concentration on pay for performance if the largest owner of a firm is a financial institution.

INDIA

The global events have equally impacted India Inc as well. The determination of executive compensation has emerged as an issue of public debate. A central theme in the debate is whether directors pay is adequately tied to measures of corporate performance.

According to Companies Act, a company may pay up to 11% of its profits as directors' remuneration. The actual remuneration in each case is decided by the Board of Directors of the company/ Remuneration Committee and approval of shareholders. In the event of companies having no profits or inadequate profits the remuneration is determined as per Schedule XIII of the Act which prescribes 3 slabs of remuneration depending on the effective capital of the company.

The constitution and terms of reference of the remuneration committee is not mandatory under Clause 49 of the Listing Agreement. However, it stipulates the requirement of setting up a remuneration committee to determine on their behalf and on behalf of the shareholders with agreed terms of reference, the company's policy on specific remuneration strategies for executive directors including pension rights and any compensation payment. It further states that to avoid conflicts of interest, the remuneration committee should comprise of at least three Directors, all of whom should be non-executive directors and the Chairman of committee being an independent director.

The basket of Sensex contains 30 representative companies. An analysis of these companies reveals that 6 companies are under the category of public sector, 3 companies are under multi nationals, 4 are under professionals and 17 are under promoter group.

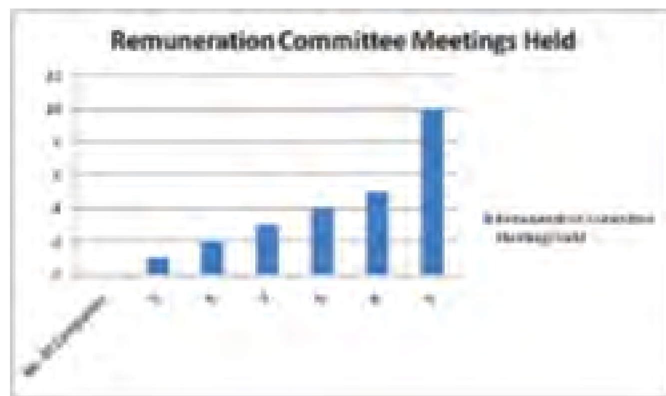
The Corporate Governance report of the Sensex companies for the financial year 2011-12 reveals that there is no remuneration committee in three Sensex Companies. In fifteen Sensex companies there are 3-4 remuneration committee members. Table "A" below gives the picture of remuneration committee members in 30 Sensex companies for the financial year 2011-12:

Table "A"
Remuneration Committee Members of Sensex companies

Source: Annual Reports of the Companies

In Table "B" below given, the details of remuneration committee meetings held by Sensex companies for Financial Year 2011-12.

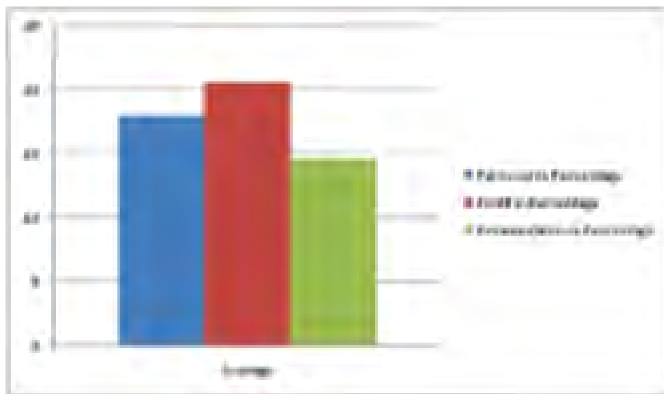
TABLE -B



Source: Annual Reports of the Companies

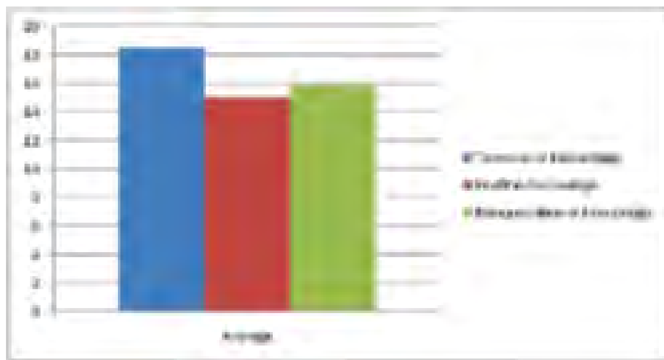
Study of companies which did not have remuneration committees

A study of the 30 Sensex Companies over the three years period - 2009-10, 2010-11 and 2011-12 reveals average increase in managerial remuneration is not excessive when compared with the average turnover and profit. While the average picture of managerial remuneration appears to be in line with the turnover and profit, there are individual cases where the remuneration has exceeded the corporate performance and in others where due to global melt down the remuneration has been reduced considerably, the same is reflected in the Chart below:



Source: Annual Reports of the Companies

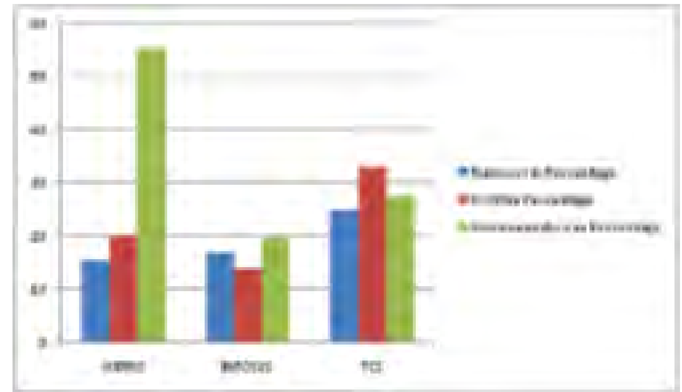
Further study in respect of 3 Sensex Companies having no Remuneration Committee reveals as under:



Source: Annual Reports of the Companies

It is seen from the above chart that in the absence of Remuneration Committee, the managerial remuneration has exceeded the profits.

Further study in respect of 3 Sensex Tech Companies which includes WIPRO, INFOSYS and Tata Consultancy - the remuneration has increased despite reduction in average turnover over 3 year period - 2009-10, 2010-11 and 2011-12.



Source: Annual Reports of the Companies

In the case of WIPRO for the financial year2012-13 top brass get handsome hike in difficult year. The company has more than doubled the Chairman's annual remuneration, while that of Chief Executive Officer and Chief Financial Officer's remuneration went up by 19.5% and 28.4 %, respectively.

(Source: Business Line 5th July, 2013 and Annual Report of the Company)

Under the Companies Act, 2013 the listed companies shall disclose in the Board Report, ratio of the remuneration of each director to the median employees' remuneration and such other details as may be prescribed.

Further one of the criteria for approving the remuneration by the Nomination and Remuneration Committee is that the committee be in a position to bring about objectivity in determining the remuneration package while striking balance between the interests of the company and shareholders.

In alignment to the Companies Act, 2013 regarding Corporate Governance, Securities and Exchange Board of India (SEBI) has brought out a Consultative Paper on Managerial Remuneration. SEBI has proposed that listed companies constitute a remuneration and nomination committee consisting of atleast three non executive directors having at least half as independent directors.

This committee will be responsible for identifying candidates for board appointments based on selection criteria, and evaluating performance of board members. The committee will ensure that remuneration of directors is aligned with proper performance benchmarks and company's goals, and sufficient balance exists between fixed and variable pay of all directors.

The Institutional Investor Advisory Services' (IIAS) views on SEBI's Consultative paper on Managerial Remuneration are as under:

IIAS favours appointing a remuneration and stakeholder committee in line with the Companies Act. The formation of the remuneration committee must be made mandatory and should comprise of

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atleast 50% independent directors. IIAS has observed instances in Indian Companies where the absence of a remuneration committee has led to abuse of high remuneration to controlling shareholders.

Though clause 49 lists the disclosures on directors' remuneration, IIAS finds the current disclosures regarding compensation inadequate. These are open-ended with regard to both the value of perks, as well as bonus payments. As bonus cannot be decided upfront, being paid for 'performance' IIAS suggests that the fixed salary be decided and voted upfront, while the bonus amount is put to vote, in the subsequent year based on the company performance. This will ensure that the compensation committee makes a well-argued case for the total compensation. IIAS believe compensation details for executive directors (including CEO/ Chairman) should be standardized and disclosed. In case they receive money from an offshore subsidiary/ associate firm, whether as salary or consultancy fees or under any other head, this too should be disclosed.

A study conducted by FE (Financial Express) Research Bureau reveals that, during 2008-09, there was an overall hike of 9.96% in the salary of 323 top Companies' CEOs. This was despite, a fall of 8.3% recorded in net profits of these companies during the same period.

The debate was more intensified when some prominent persons opined over the issue. Prime Minister Manmohan Singh held that CEOs earn indecent salary and this needs to be moderated.

Over the past few years the concept of stakeholders' constituency has widened. In the early days only stakeholders were shareholders. With the growth of the business the constituency has encompassed employees, suppliers and consumers to ensure long term sustainability of companies' operations. In the current phase the community members where the company's plant is located also become the stakeholders. The Companies Act, 2013 has also mandated compliance with Corporate Social Responsibility objectives for the specified listed companies.

In India, there are no judicial pronouncements in matters of excessive remuneration to managerial persons. In case the managerial remuneration is not in accordance with the conditions specified in schedule XIII, Central Government approval is required. The Central Government has power not to accord its approval for appointment of managerial personnel on two counts :-

1. If the person is found not to be fit and proper person and the appointment is not in public interest; or

2. Terms and Conditions of the appointment are not fair and reasonable.

In case of non-approval, the appointee is required to refund the remuneration to the company.

In conclusion, the Remuneration Committees hence forth shall have to consider following factors among other things, while approving managerial remuneration:

1. Linkage between company's performance and managerial remuneration.

2. Ratio between the remuneration of each director with median employee's remuneration.

3. Long term sustainability of company's business.

4. Frame and disclose Remuneration policy of the company in the Annual Report.