CORPORATE GOVERNANCE IN INDIA – VITAL ISSUES

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"Corporate Governance contemplates fairness, transparency, responsibility and accountability in functioning of the board of directors." N.R. Narayana Murthy.

INTRODUCTION

Corporate sector plays an important role in economic development by creating wealth for the nation. With the liberalization and globalization of the economy, the thrust of the Government of India has been on better corporate governance to make India globally competitive. Consequently, the Kumar Mangalam Birla Committee, Naresh Chandra Committee and Narayana Murthy Committee in their reports have recommended several legal and regulatory measures for improving the standards of corporate governance. Some of these recommendations have been incorporated by way of amendments in the Companies Act, 1956, and, Clause 49 in the Listing Agreement of Stock Exchanges. However, to cope up with the need of emerging scenario, company law requires simplification and rationalization. The Government of India has, therefore, brought out a concept paper to meet the needs of modern business. Recently Dr. Jamshed J. Irani Committee has also submitted its report on the new Companies Act, which covers provisions for better corporate governance in line with the global management practices. In this context, an attempt is made to review the legal, regulatory and institutional framework of corporate governance with particular reference to the role of the board of directors and audit committee.

CONCEPT

There is no universally accepted definition of "Corporate Governance" due to different legal, regulatory and institutional practices followed in different countries. However, for practical purposes, corporate governance refers to maximizing long-term shareholders' value by following high standards of corporate management, disclosure of financial information and investor democracy. It is the system by which companies are directed and controlled in the best interest of stakeholders.

Good corporate governance means establishing legal and regulatory framework that promotes credible and effective governance practices for the benefit of economy, stakeholders and society as a whole. It is the process by which the board of directors directs, supervise and control affairs of companies in the best interest of stakeholders.

The ICSI defines the concept in a comprehensive manner as under:

> "Corporate Governance is the application of best management practices, compliance of law 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."

Thus principles of Corporate Governance as envisaged in ICSI definition include –

- Sustainable development of all stakeholders – to ensure growth of all individual associated with or affected by the enterprise on sustainable basis.
- Effective management and distribution of wealth – to ensure that enterprise creates maximum wealth and uses judiciously the wealth so created for providing maximum benefit to all stakeholders and enhancing as wealth creation capabilities.
- Discharge of social responsibility – to ensure that enterprise is acceptable to the society in which it is functioning.
- Application of best management practices – to ensure excellence in functioning of enterprise and optimum creation of wealth.
- Compliance of law in letter and spirit – to ensure minimum return / benefits to all stakeholders guaranteed by the law for maintaining socio-economic balance.

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- Adherence to ethical standards – to ensure integrity, transparency, independence and accountability in dealings with all stakeholders.

LEGAL, REGULATORY AND INSTITUTIONAL FRAMEWORK

In India, the legal and regulatory framework of corporate governance is broadly contained in the Companies Act, 1956, and Clause 49 of the Listing Agreement of Stock Exchanges.

Companies Act, 1956

The Companies Act is applicable to all companies. It contains elaborate provisions about the functioning of companies and appointment, role, position, responsibilities and liabilities of board of directors as well as protection of interest of investors.

The salient features of corporate governance under the Companies Act include: –

- Shareholders appoint board of directors (comprising executive as well as non-executive directors) to run the company on their behalf. Executive directors are employee of the company whereas non-executive directors only attend board meetings to advise on policy and strategy matters of the company.
- The board of directors is collectively responsible for the direction, management and control of the affairs of their company.
- Every public company and a private company with paid up capital of Rs.5 crore or more has to appoint a managing director. Managing director enjoys substantial powers of management and is responsible for the day-to-day management of company. He exercises the substantial powers subject to the superintendence, control and direction of the board of directors.
- Board of Directors comprises executive and non-executive directors. Directors are also trustees of company's money and its property. They, being in a fiduciary position, must act bona fide in the best interest of the company. They must not exercise their powers for any collateral purpose and avoid conflict of their personal interest with company's interest.
- Directors, being agents of the company, must act diligently and exercise reasonable care and skill expected of a person of their knowledge, skill and experience.
- Criminal Liability fastens on the directors who are in charge of and responsible for the conduct of business of the company at the time when the offence was committed.
- Board of Directors must make a true and fair disclosure of financial and other information about the company.

The Companies Act is administered by the Ministry of Company Affairs and the offices of Registrar of Companies (ROCs).

Clause 49 of the Listing Agreement

Clause 49 of the Listing Agreement (Clause 49) with stock exchanges, largely derived from the S&O Act, is applicable to only listed companies. The Securities and Exchange Board of India (SEBI) issued Clause 49 in February 2000, was amended in October 2004, with effect from January 1, 2006.

The main objects of Clause 49 are - to improve the quality of corporate governance by ensuring appointment of independent directors; strengthening the role of audit committee; and disclosure and transparency in financial reporting. It makes the CEO and CFO responsible for putting in place risk management and internal control system in critical areas of operations of their companies.

The qualification criteria for independent directors have been made stricter. It disqualifies material suppliers and customers from being independent directors. It also disallows a shareholder with more than two per cent stake in the company from being an independent director as well as a former executive who left the company less than three years ago. Further, partners of current legal, audit, and consulting firms, as well as partners of such firms that had worked in the company in the preceding three years cannot be independent directors.

A relative of a promoter, or an executive director or a senior executive one level below an executive director, too, cannot be an independent director.

Nominees of banks and financial institutions, who have invested or lent money to the company, are deemed to be independent directors.

The discretionary powers of the board of directors to decide whether a materially significant relationship between a director and the company affected his independence have been taken away.

The gap between the two board meetings has been reduced from four months to three months.

The amended Clause 49 also contains the following new provisions :

- The Board to lay down a code of conduct for all board members and senior management of the company to be compulsorily followed.
- The Chief Executive Officers (CEO) and Chief Finance Officer (CFO) to certify the financial statements and cash flow statements of the company.
- At least one independent director of the holding company to be a member of the board of a material non-listed subsidiary. The Audit Committee of the listed company to review the financial statements of the unlisted subsidiary, particularly its investment.
- If the company, while preparing financial statements, follows a treatment that is different from the prescribed accounting standard, it must disclose this in the financial statements. Further, the management should provide an explanation for doing so in the corporate governance part of the annual report.
- The company to lay down procedures for informing the board members about the risk management and minimization procedures.
- The company, where money is raised through public / rights issues, to disclose the uses / applications of funds, according to major categories (capital expenditure, working capital, marketing costs etc) as part of quarterly disclosure of financial statements.
- The company to prepare annually a statement of funds utilized for purposes other than those specified in the offer document / prospectus and places it before the audit committee.
- The company to publish its criteria for making its payments to non-executive directors in its annual report.
- The onus of ensuring legal compliance is with the board and not of independent directors.
- Whistle blowing policy is voluntary.

The provisions of Clause 49 are administered by the SEBI and Stock Exchanges. The SEBI has made it clear that there would be no extension of the given date and listed companies would face stiff penalties, including de-listing from the stock exchanges, if they do not comply with Clause 49 requirements.

INDEPENDENT DIRECTOR

The term 'independent' or 'non-executive director' means those directors who are not employees of the company and do not participate in the day-to-day management. The role of "independent director" has assumed significant importance, particularly in family managed companies in India. The Concept Paper on the New Company Law and JJ Irani Committee Report thereon has highlighted the role of independent directors as 'conscious keeper of the board of directors'.

PROVISIONS UNDER CLAUSE 49

Clause 49(I)(A) provides that the board of directors of the company shall have an optimum combination of executive and non-executive directors. The number of independent directors would depend whether the Chairman is executive or non-executive. In case of a non-executive chairman, at least one-third of board should comprise of independent directors and in case of an executive chairman, at least half of board should comprise of independent directors.

The explanation to Clause 49(I)(A) states that 'independent directors' means: "directors who apart from receiving director's remuneration, do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the judgment of the board may affect independence of judgment of directors. Institutional directors on the board of companies should be considered as independent directors whether the institutions is an investing institution or a lending institution."

The term 'material pecuniary relationship or transactions' used in clause 49(I)(A), is not defined under the Companies Act or other allied legislation. However, for practical purpose, `pecuniary' means concerning or consisting of money or monetary consideration. The scope of the expression `pecuniary relationship or transactions vis-a-vis the company' is very wide. It indicates any relationship or transaction of a director with the company, which gives him any monetary benefit, remuneration, reward, or remuneration (including remuneration for directorship, whether salary, fees, commission, fees for professional services, sitting fees, whether exempt under the Companies Act for the purpose of computation of managerial remuneration or not) and needs to be disclosed.

Simply stated, according to the new Clause 49, an independent director is one who does not have any financial or service transaction with the company. However, nominees of banks and financial institutions, who have invested or lent money to the company, are also deemed to be independent director.

In fact, truly respected and valued independent directors are those who are competent, committed and have an independent 'state of mind' to challenge and ask the right / uncomfortable questions. In fact, they govern the functioning of the board with long-term vision and perspective of the company.

Independent directors bring in independent thinking and rich experience in their respective fields. They represent divergent viewpoints on issues brought before them. They bring in an element of objectivity to company board process in the general interest of the company and to the benefit of all stakeholders, including minority and small shareholders.

Independent directors are independent in their judgment on the issues of strategy, performance and resources, including key appointments and standards of conduct. They also ensure that proper, efficient and effective monitoring system exists in the company. In fact, their role becomes critical in determining the composition and functioning of board of directors.

"Independence" of board of directors and its members lies in the quality of the Board – whether members are encouraged to express their independent views without fear or favour on controversial issues. What is important is the ability of board members in asserting what they believes is in the best for the company, particularly when there is a conflict of interest and difference of opinion.

Independent directors are capable of resisting the influence, the pulls and pressures of the company on the one hand and the particular group of shareholders who appointed them, on the other hand. Moreover, they justify and take responsibility for their decisions.

CONCEPT PAPER ON COMPANY LAW

Presently the concept of "independent director" is applicable only to listed companies under Clause 49. However, the concept paper proposes to make appointment of independent director mandatory to such public companies having the prescribed paid up share capital or turnover. These companies would also be required to have a minimum of seven directors. In addition, the number of independent directors would be 50 per cent of the board and the attributes of them will be prescribed by the Central Government and not laid down in the Act.

According to the first provision of the proposed section 63(1) : "Every public company having paid-up share capital or turnover of such amounts as may be prescribed shall have a minimum of seven directors, out of which, not less than three or such number as near to 50% of the strength of the board, whichever is higher, shall be independent director as defined by section 2(45) and possessing such attributes necessary for being appointed as independent director, as may be prescribed."

The second provision of proposed section 63(1) states that companies existing before the commencement of this Act shall have a minimum number of directors; maximum number of directors, independent directors, in accordance with the provisions of this section, within such period and in such manner as may be prescribed.

The provisions of the proposed section 2(45) state that term "independent director" means a non-executive director of a company, who, apart from receiving director's remuneration, does not have any material pecuniary relationship or transactions of such amount as may be prescribed, with the company, its promoters, managing director, whole-time director, other directors, manager or its holding company and its subsidiaries, apart from possessing such attributes for being treated as an independent director as may be prescribed by the Central Government from time to time."

The concept paper also states that non-executive directors and employees earning remuneration greater than that of the Managing Director and simultaneously holding more than two per cent stake in a company can be held responsible for any default. The non-executive directors shall be held responsible only if they are found to be directly or indirectly involved with a default.

It further provides that non-executive directors shall be held in default where any contravention has taken place with their neglect / connivance or consent. Simply stated, to prosecute a non-executive director, a prima case has to be made out that the contravention of the provisions of the Companies Act has taken with the negligence or consent of the concerned director.

IRANI COMMITTEE RECOMMENDATIONS

According to the JJ Irani Committee (Committee) "independent director" means a non-executive director of the company who apart from receiving director's remuneration, should not have any material pecuniary relationship or transaction with the company, its promoters, directors, senior management or holding, subsidiary and associate companies, which may affect his independence. Moreover, an

independent director or his relative should not have served or been linked with the company in the immediately preceding year.

As far as the mode of appointment of independent directors is concerned, the Committee has suggested that appointment should be made by the company from persons who are of integrity and having relevant expertise and experience and satisfy the criteria of independence.

The Committee has suggested that the nominees of financial institutions and banks on the board of their assisted companies should not be deemed to be independent directors. The Committee has stated: 'Nominee directors appointed by any institution or in pursuance of any agreement or government appointees representing government shareholding should not be deemed to be independent directors'. Such nominee directors represent specific interest and, therefore, could not be called independent. The suggestion is particularly significant for companies with high level of debt-equity ratio.

The Committee has also suggested that independent directors should not be held responsible for any default made by their company, if they are not aware of it.

The Committee has made a significant recommendation to keeps the number of independent directors at one-third of the total size of the board - 'One-third of total directors as independent directors should be adequate for a company having significant public interest, irrespective of whether the chairman is executive or non-executive, independent or not.

To avoid conflict with the provisions of Clause 49, the Committee has recommended that the directions of other regulators for companies within their domain may prevail, if they are at variance with its recommendations on the subject.

Independent Directors in Government Companies

The administrative ministries or departments in consultation with the Department of Public Enterprises (DPE) appoint directors on the boards of PSUs. The DPE and Standing Conference on Public Enterprises (SCOPE) maintain a panel of competent candidates on the basis of the criteria, who can be appointed as independent directors on boards of PSUs.

A Search Committee comprising the Chairman of the Public Enterprises Selection Board, Secretary of the DPE, Secretary of the administrative ministry or department and four-non-official members appoint non-official directors on the boards of 'Navratnas' and 'Mini-ratnas' PSUs .

Recently the Government has reviewed the eligibility criteria for the appointment of independent directors after the controversy over appointment of politicians / bureaucrats on the boards of Navratna companies. Now persons of eminence with proven tract record from industry, business or agriculture are eligible for appointment as independent directors on the boards of PSUs.

The SEBI has clarified that government officials cannot be treated as independent directors and all listed PSUs have to comply with the provisions of Clause 49 by December 31,2005 or face penal consequences.

AUDIT COMMITTEE

"Audit Committee" plays an important role in overseeing the company's financial reporting process and the disclosure of its financial information. The independence of Audit Committee is of vital importance in discharge of the functions of the Board.

The regulatory framework of Audit Committee is prescribed under the provisions of Section 292A of the Companies Act, 1956 and Clause 49. However, same audit committee can discharge its functions under the Act and Listing Agreement. Clause 49 provides that if a company has set-up an Audit Committee pursuant to the provisions of the Companies Act, the said committee shall have such additional features / functions as contained in the Listing Agreement.

Companies Act, 1956

The Section 292A is mandatory and provides that every public company and its subsidiary, having paid up capital of Rupees five crore or more have to appoint audit committee. A non-profit company registered under Section 25, being not specifically exempt, attracts the provisions of the Section 292A. Listed companies have to abide by Section 292A as well as Clause 49.

Section 292A states that an "Audit Committee" shall consist of not less than three directors and such number of other directors as the Board may determine of which two-thirds of the total number of members shall be directors, other than managing or whole-time directors.

Simply stated, section 292A of the Act provides that the Audit Committee of a company shall consist of part-time and whole-time directors in the given proportion - two-thirds of the total number of members shall be part-time directors and one-third Managing

or whole-time directors. It may be noted that there is no mention of 'independent director' or the criteria thereof for the purpose of the Audit Committee. What is required is that up to one-third of the total number of members of the Audit Committee shall be out of managing director or whole-time directors.

Provisions under Clause 49

Clause 49 requires that listed companies have to constitute a qualified and independent Audit Committee. The role of the Audit Committee, inter-alia, includes overseeing the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.

The board of directors of a listed company is required to constitute a qualified and independent Audit Committee to enhance the credibility of the financial disclosures. The Audit Committee is to strengthen financial reporting at three levels – the board, internal audit and statutory audit.

The Audit Committee generally comprises both part-time and whole-time directors. Whereas the part-time directors are on the board of the same company and / or other companies in the same group, the whole-time director is one of the senior members of the board of directors. Presence of whole-time director is required because part-time directors may not be quite well conversant with the company's specific business issues and may not have adequate time to devote.

The salient features of the Audit Committee under Clause 49 are as under :

- There has to be minimum three directors of the audit committee and all the three would be non-executive. Further, in case of larger number, two-third must be independent directors.
- All members of the audit committee should be finance literate and at least one should have financial and accounting or related financial management expertise.
- The chairman of the audit committee should be an independent director and to be present at annual general meeting to answer shareholder queries.
- The audit committee should invite such executives of the company as it may deem fit. The director finance, head of internal audit and representative of external auditor, as and when required, are to be present as invitees at the meeting of the audit committee.
- The Audit Committee of the listed company to review the financial statements of the unlisted subsidiary, particularly its investment.
- The company secretary shall act as secretary to the committee

Audit committee derives its powers from the terms of reference by the board. The powers include investigation, seeking information from any employee, obtaining outside legal / professional advice from external sources and securing attendance of outsiders with relevant expertise.

The functions of the audit committee relate to:

- overseeing company's financial reporting process and disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible;
- recommending appointment / removal of external auditor and matters relating thereto; and
- Reviewing with management annual financial statements before submitting to the board, focusing primarily on (i) changes in accounting policies and practices; (ii) major accounting entries based on exercise of judgment by management; (iii) qualifications in draft audit report; (iv) significant adjustments arising out of audit; (v) the going concern assumption and (vi) compliance with accounting standards.
- Compliance with stock exchange and legal requirements concerning financial statements.
- Examination of any related party transactions i.e., transactions of the company of material nature, with promoters, or the management, their subsidiaries or relatives etc. in conflict with the interest of the company.
- Reviewing the adequacy of internal control systems.
- Reviewing the adequacy of internal audit function, including its structure reporting about the systems in vogue, coverage and frequency of internal audit.
- Discussion with internal auditors of any significant findings and follow-up thereon.
- Reviewing the findings of any internal

investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the board.

– Discussion with external auditors before the audit commences, have the nature and scope of audit and post audit discussion on any area of concern.

– Reviewing the company's financial and risk management policies.

– Looking into the reasons for substantial defaults in the payments to the depositors, debentures holders, shareholders and creditors.

The recommendations of the Audit Committee on any matter relating to financial management, including the audit report, are binding on the Board of directors and consequently on the company. For any reasons, if the recommendations of the Audit Committee are not acceptable by the Board, it has to record reasons for the non-acceptance and communicate the same to the shareholders. The audit committee's recommendations are of mandatory nature to be implemented without dilution in any matter. Moreover, annual reports of companies are required to contain a separate section on corporate governance.

RECENT DEVELOPMENTS

The National Foundation for Corporate Governance (NFCG) jointly set up by the Ministry of Company Affairs, the Industry, ICAI and ICSI to evolve corporate governance principles in three areas – institutional investors, independent directors and auditing. The non-binding principles, in line with the principles developed by the 30-member international policy advocating body, would further foster and develop corporate culture in the country, besides making available adequate number of independent directors for the corporate sector. The NFCG will ensure compliance of corporate governance norms in letter and spirit by the Indian companies.

It is estimated that over 9,000 listed companies require about 30,000 independent directors to comply with the requirements of Clause 49. The PRIME database has created the website "primedirectors.com" to enable listed companies find suitable independent directors for their boards. The main sponsors of the website are the National Stock Exchange of India Limited and Bombay Stock Exchange Limited with the Confederation of Indian Industry as the institutional partner.

In the fast changing business scenario, risk management has acquired top priority. As such, strong and effective corporate governance is no longer a 'nice to have' but a 'must have'. This is the reason why companies, besides restructuring of board of directors, are looking at a more holistic governance model.

Investors are placing high value on those companies, which follow internationally accepted practices of corporate governance. They expect fair return on the investment of their hard earned savings.

Companies have been realizing that it is high time to put their houses in order if investors have to be drawn back to capital markets.

SUGGESTIONS

Following suggestions deserve careful consideration for better corporate governance norms:

1. The provisions of corporate governance under the Companies Act and Clause 49 of the Listing Agreement should be harmonized to facilitate easy compliance and economy for companies.
2. Defining independence is necessary but not sufficient to ensure independence of judgment. The criteria has much to do with the choice of directors and the skills that they bring to the board, the conduct of board meetings, the quality and quantity of financial, operational and strategic information supplied by the management to the board; management's appetite for independent evaluation and criticism of strategies and performance; the extent to which promoters and management truly want healthy debate and independent oversight.
3. In practice, however, "independence" of directors lies in the quality of the Board where members are encouraged to express their independent views without fear or favour on controversial issues. Equally important is the ability of board members in asserting what they believes is in the best for the company, particularly when there is a conflict of interest and difference of opinion in the board. To achieve this, Indian corporate sector has to create and promote a culture of professionalism and openness in corporate affairs. The greatest challenge before corporate leaders today is to build and restore trust among stakeholders and improve the credibility in the independence of the board. In the ultimate analysis, what is important is the role of the board rather than the higher number of independent director.
4. Nominee directors of Government in PSUs should promote professionalism and independent functioning of the boards. They should not be allowed to interfere in the normal functioning of the board and day-to-day management of companies. However, government being the

majority shareholder can have veto power in strategic and macro issues.

5. In line with the global experience, directors in Indian company should act in the best interest of their companies rather than acting as rubber-stamp to approve the decisions of the CEO. They should scrutinize the performance of the CEOs and weed out those who fail to meet the targets.

6. The important factors to determine whether a director has "material pecuniary" relations or transactions with the company, its promoters, its management or its subsidiaries should include (a) the professional qualification, designation, duties and responsibilities of the director; (b) besides remuneration, receipt of any other material pecuniary relationship or transactions with the promoters and management; (c) his shareholding structure; (d) the extent of inter-corporate loans and investments under sections 370 to 372A of the Companies Act (e) any relationship of `relative' under section 6, of the Companies Act; and (f) his `disclosure of interest' in a contract or arrangement under section 299 of the Companies Act, in the same, subsidiary or other companies under the same management during the preceding five years.

7. Presently independent and non-executive directors are hauled up for any default committed by a company, whether they are aware of it or not. It is worthwhile to relieve the independent directors from the penal provisions so that eminent persons can come forward for the appointment of independent directors.

8. Effectiveness of board cannot be enforced through legislative and regulatory measures alone because of their inherent limitations. In India, in family managed companies where the management is often the controlling shareholder, the laws can ensure governance in letter, and not in spirit. The emphasis should, therefore, be on business ethics, value system, code of conduct and self-regulation for board of directors to adherence to the high standard of corporate governance.

CONCLUSION

Corporate Governance has assumed vital importance in the wake of increasing competition and globalization. It stipulates parameters of accountability, control and reporting functions of the board of directors. It also encompasses the proper relationship among various participants - the board, management, shareholders, banks, financial institutions, suppliers, creditors and the state – in determining the direction and performance of companies.

Tougher legal and regulatory provisions of corporate governance are required to check and prevent default by companies, but unless these are implemented strictly no useful purpose would be served. So, apart from tough provisions, the larger issue is that of implementation. In the ultimate analysis, what counts is the speed with which the wrongdoers and defaulters are punished. In this context, the greatest challenge before corporate leaders today is to build and restore trust among stakeholders and improve the credibility in the independence of the board.

The message is quite clear and loud - only law cannot ensure good corporate governance without code of conduct and self-regulation. Laws, rules and regulations are required to strike a balance in the objectives sought to be achieved by different interest groups in companies, but the aim of corporate governance is commitment to values, business ethics and distinction between personal money and corporate funds.

For the Indian corporate sector, the urgent need is to fight the 'battle of mind' by ensuring that the decisions of the board are in the best interest of company. What is needed is "conscience keeper" in the board of directors to enlighten the management in their pursuit of goals; rather than committees, reports, rules and regulation. Sooner than later, the realization has to come to the management that they are the trustees of the wealth assigned to them by the shareholders for social good rather than private profit. In the ultimate analysis, it is an inner process of self-realization and enlightenment and not the outward imposed restrictions, code or stringent enforcement of regulatory framework.

It is being increasingly realized that market is the best judge. The market appreciates well-managed companies and rewards them. The management who fails to enhance shareholders' value run the risk of deprivation of capital and become easy takeover targets. On the other hand, high valuation of a company's share deters takeover attempts by providing a shield to the management from raiders.