CORPORATE GOVERNANCE
- A Study in Indian Context

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In this study my aim is to analysis the origin, implementation and to conclude as to whether the steps taken in India are enough to ensure a good Corporate Governance System in place or not. Naturally such a study will cascade to the issue as to what other steps has to be taken to improve the existing system sought to be put in place. This study will also cover the existing legal frame work to know whether the existing system is good enough to punish the erring corporate or whether there is a need to revamp the existing legal systems in place. This study will also touch upon the most debated subject as to how Independent are the so called Independent directors or whether we need to have a system in place by which the failure of an independent director to blow the whistle needs to be acted upon by sanctions on the said director apart from proceeding against the corporate in question.

What is Corporate Governance :

The word Corporate Governance has no clear cut standard definition nor can it have such definitions because the needs of corporate governance may differ from nation to nation. However, it can lay down the parameters of such Corporate Governance taking into consideration the national or local conditions. In a growing and developing economy it becomes all the more important to adopt a set of best practices adopted globally to ensure that investors feel comfortable. It is also to be noted that the system needs to be the vamped at frequent intervals.

[1] Notwithstanding what is stated above, Corporate Governance can be defined as the system by which business entities are monitored, managed, and controlled. It is generally understood as the framework of rules, relationships, systems and processes within and by which authority is exercised. At one end of the spectrum are the shareholders as owners of the business entity since they provide the ultimate risk capital. At the other end are the ‘managers’ or the executive directors of the company who are in control of day-to-day affairs. As the elected representatives

of the shareholders it is the responsibility of the entire board of directors to direct operations of the company. As the owners of business the shareholders are expected to monitor and evaluate operations of the company as well as the performance of the entire board of directors and in particular the effectiveness of the full time or executive directors. A good structure of Corporate Governance is one that encourages symbiotic relationship among shareholders, executive directors and the board of directors so that the company is managed efficiently and the rewards are equitably shared among shareholders and stakeholders.

The fundamental Principle to be noted is that Corporate Governance mechanisms differ between different countries. The governance mechanism in each country is shaped by the political, economic and social history as also by its legal framework. The governance practices adopted in any country reflect national ethos and value systems adopted in that country over a long period of time. For most of the countries the corporate form of organization did not evolve and emerge through a natural business process. It has been an alien concept transplanted from another soil. In the beginning most of the countries found the company to be merely a convenient form of organization and enabled entrepreneurs to raise money from a large number of investors for funding their growing business or new ventures especially if they are large.

Given the differing social and business value systems of individual countries, assimilation process of the philosophy of the corporate form of organization was not necessarily similar in different countries. Interestingly, however, in most of the countries, current managements of business entities generally enjoy a special status vis-à-vis the shareholder community. Most of the common shareholders also do not revolt immediately if the existing management tries to perpetuate its control over a business entity so long as the management does not grossly mismanage it. Shareholders start agitating only when they perceive that the company is being highly mismanaged and that the shareholder value is getting destroyed.

To trace the implementation of Corporate Governance in India broadly the route taken by SEBI as a regulator was as under:

Beginning in the late 1990s, SEBI formed a number of committee to help formulate corporate governance standards for publicly listed Indian companies. This was necessitated with the opening up of our Economy in the 1990's and with the Flow of Foreign investments to India. After lobbying by large firms and a governance code proposed by a leading industry group, in 2000, SEBI introduced unprecedented corporate governance reforms via clause 49 of the Listing Agreement. Clause 49, which has been described as a major event in Indian corporate governance, the said clause 49 established a number of requirements with a focus on the role and structure of corporate boards, internal controls and disclosure to shareholders. As noted by several scholars, many of the provisions – such as a minimum number of independent directors and independent audit committees – were derived from governance reforms adopted in developed countries, especially those in the United States and the United Kingdom. The clause 49 reforms were phased in over several years, applying at first to larger entities and eventually to smaller listed companies. Eventually thousands of listed Indian public companies were required to comply with a new corporate governance regime. The fundamental flow in implementation arose out of the fact that the regulator adopted different standards for implementation at different level and this caused confusion in the minds of the investors especially Private sector Vs Public sector companies listed in stock exchanges.

However, the entire castle built by SEBI as a robust system to usher in the best and world class system in India proved a paper tiger with the Satyam episode. As the facts are well-known, I am not venturing into the factual details and as to what really went wrong. However, the irony is that founder of Satyam was honoured for having the best of best practices under the Corporate Governance system.

The very fact that eventhough almost two years have lapsed since the Satyam episode and the fact no one involved leave alone stands punished, but even charge sheeted proves that we in India does not have a quick and simple effective legal system method to punish the wrong doers. This particular case in my view has eroded to a great extent the faith of foreign investors investing in Indian companies as a long term player or a long term investor and has proved a question mark to our legal system as well as our investigating method.

We now deal with the best practices implemented and their weakness.

[2] The Clause 49 of the Listing Agreement lists some basic Corporate Governance practices which brought in number of changes in governance and disclosures by Indian Companies. It specifies the minimum number of independent directors required on the board of a company, the setting up of an Audit committee, Shareholders' Grievance committee, inclusion of Management's Discussion and Analysis (MD&A) section and the Report on Corporate Governance in the Annual Report, and disclosures of fees paid to non-executive directors. It requires the board of directors, audit committee, senior management, and company secretary to comply with the all provisions listed in the clause.

The revised Clause 49, which has incorporated certain provisions of the Sarbanes-Oxley Act prevalent in the US, requires the CEO and the CFO to certify to the board that the annual financial statements are in the prescribed format and that the establishment of internal control systems and processes are in place. CEOs and CFOs are, thus, accountable for putting in place robust risk management and internal control systems in their organizations.

As per the clause 49, for a company with an Executive Chairman, at least 50 per cent of the board should comprise independent directors. In the case of a company with a non-executive Chairman, at least one-third of the board should be independent directors. The clause clearly lists down requirements for a non executive director to become an independent director such as the directors should not have, apart from receiving director's remuneration, any other material pecuniary relationship of transactions with the company, its promoters, its management or its subsidiaries, which in the judgment of the Board may affect independence of judgment of the director. But in reality the corporate world, he or she is selected by the promoters group comprising 55 family run undertakings and who still holds 90% of assets of the corporate sector. There are no checks and balances available to really "Test" the independence of such Independent directors so picked up by the family Run understandings.

If the purpose or objective of having a specified number of independent directors on the boards of listed companies is to ensure that boards are not packed with 'yes-man' or to ensure

constructive criticism one needs to ponder how many independent directors can freely raise questions at board meetings. As there is no effective board meetings, however only few persons who are eminent in their own fields may ask right questions , even if they look inconvenient, at board meeting but the majority may not muster enough courage to do so. It may therefore appear that no amount of regulation can ensure how an independent director should behave at board meetings. After all independent directors is a matter of attitude and a director who is conscious about his responsibilities, will always raise right questions at board meetings, whether or not holds the independent status. He should take part and should possess initiative, intelligence, integrity and impartibility at the board meeting.

The growing trend which we notice is that a Pack of Retired Bankers, Beurocrates and governments officials are seen picked up by the companies to fulfill this regulatory requirement. Most of them consider this as a Pre Retirement benefit and as an act of kindness conferred upon them by the companies. This puts big question mark on their Independence.
The audit committee has oversight of the financial information to ensure that financial statement is correct, sufficient and credible.

Disclosure clause has been introduced to strengthen the corporate governance and transparency in the present business environment for the sake of investor protection. Disclosure such as Basis of related party transactions, Disclosure of Accounting Treatment, statement of funds utilized for purposes other than those stated in the offer document/prospectus/notice and place it before the audit committee.

The company must lay down procedures to inform the board about the risk assessment and minimization procedures, which shall be periodically reviewed to ensure that executive management controls risk through a properly defined framework.
A management discussion and analysis report must form part of the annual report which included discussion on matters such as internal controls and their adequacy.
The key managerial persons of the company need to certify that they accept responsibility for establishing and maintaining internal controls that they have evaluated the effectiveness of the

company control systems and they have disclosed to the auditors in the designs or operation of internal controls and steps for deficiencies.

As per clause the company is also required to submit quarterly compliance report to stock exchanges within 15 days from the close of quarter ended that is duly signed by the compliance officer and need to obtain Certificate from the auditors or from practicing company secretary stating compliances of conditions of corporate governance.

[3] SKS Microfinance shocked the corporate world by sacking its CEO. One of the main reasons for SKS's damaged public image is that the company's board of directors and the glittering list of SKS shareholders have chosen to maintain a stunning silence over the way the CEO was sacked and also the swirling rumours regarding how the company was run. The silence of SKS Microfinance presents an interesting case study about perceptions of governance and accountability at the board level. While there is no indication of a financial scam like Satyam, this is case, where neither a glittering list of internationally renowned corporate achievers (Vinod Khosla, NR Narayana Murthy) and top funds such as Sequoia as shareholders nor a board packed by representatives of private-equity funds, has been able to prevent controversial and confrontationist action without explanation. This again proves as a systematic failure on the part of the regulator in implementation of the best practices of Corproate Governance. This issue needs to be examined at lengthen.

The next big issue to be considered is about Insider Trading. Insider Trading is the buying , selling or dealing in securities of a listed company by a director , member of management , employee of the company , or by any other person such as internal auditor , advisor , consultant , analyst etc, who has knowledge of material inside information which is not available to general public. “Insider trading” can also mean the perfectly legal buying and selling of stock by a company’s corporate insiders. Insider trading is legal when these corporate insiders trade stock of their own company and report these trades to the SEBI. That way the insider trading is not kept a secret and anyone can find out a corporate insider’s opinion of his or her company. Insider

trading is only illegal when a person bases their trade of stocks in a public company on information that the public does not know.

It is illegal not only to trade on your own stock in a company based on this information but it is also illegal to give someone that information, a tip, so they can trade their stock. Insider Trading Regulations encourages market professionals to trade by restricting competitions from better informed insiders. While SEBI has come out with a Insider Trading regulations and has stipulated that each Corporate draw up a scheme and put the same in place to deal with Insider Trading within the corporate, the fact such scheme need not be filed with SEBI and the fact that there exists no audit on the implementation by SEBI makes it the move easier to circumvent certain provisions of the Insider Trading regulations. It also necessitates Insider Trading to be defined in the Companies Bill.

[4] The requirement to appoint independent directors is a minimum of 33% of the total number of directors. The amended law should therefore, prescribe their mode of appointment, their qualifications, extent of independence from promoters/management, their role and responsibilities as well as their liabilities. In this context, it would be relevant to mention that there is a need to limit the liabilities of Independent Directors, so that they are able to act freely and objectively and are able to share their expertise with the rest of the Board. The amend law may be made for their rotation by restricting their tenure in a company to say, five years.

The Audit Committee as well as the role of Auditors has assumed considerable significance. The Audit Committee is to be the first point of reference for engagement of Auditors, as well as be responsible for the overall risk identification, minimization and management policies of the Company. Audit firms will be subject to five year rotations in engagements, and Audit Partners every three years, with a cooling off of three years. The latter restriction is verges on being onerous – a three year cooling off can actually destroy a bona-fide client advisor relationship irreparably. Joint and individual liability for collusion in corporate offences is envisaged, and while no professional can remain insulated from culpability if facts so warrant, Auditors will demand indemnification and insurance cover effectively escalating audit costs immensely. The role, rights and duties of the auditors defined as to maintain integrity and independence of the

audit process. Consolidation of financial statements of subsidiaries with those of holding companies is proposed to be made mandatory. Even though Satyam had the required proportion of representation of independent persons on its Board including the person who chaired the meeting and were members of the company's Audit Committee. Nonetheless they did nothing to prevent the fraud, or record their protests, demonstrating that the existing safeguards were not adequate. Any one person can be an independent director only in five listed companies and ten public companies against the MCA's seven listed companies and fifteen public companies is also a requirement that these members devote due care and attention to the watchdogs.

The company should not have step down subsidiary company and have only one Investment Company. Companies use subsidiaries and subsidiaries of subsidiaries for mergers and acquisitions, formation of joint ventures, which facilitate business transaction. Easy transition of companies operating under the Companies Act, 1956, to the new framework as also from one type of company to another.

The proposed amendment states that Chief Financial Officer (CFO) has been included as one of the key managerial personnel of a company. But no special qualifications have been prescribed for the CFO; company secretaries and cost accountants are obliged to have the prescribed qualifications.

In my view, in order to achieve best results, the regulator should consider either by statutory sanction and / or by educating and creating awareness amongst the shareholders, which in turn will prompt the promoters cum owners that ownership and management should be separated. The managers of such companies should be left to the professionals. The involvement of promoters or owners in the day to day affairs should be limited to the extent possible. This will create confidence in the minds of the shareholders and investors.

The other suggestion is to do away with the differential treatment given to the Public Sector companies and PSU banks wherein the word corporate governance remains only in paper and wherein even though the companies are listed, many of the provisions and the best practices

adopted by other companies and Banks are not followed at all. This has created a big divide between the Private Sector companies and Banks which religiously follows such practices and the Public Sector Banks and companies who are exempted.

Another issue which needs to be considered in this context is that across the Board whether be it in a Public sector or a Private Sector, especially in the Banking sector, as per the recommendations of Ganguly Committee, the post of Chairman and Managing Director has to be necessarily split and there should only be a Non-Executive Chairman and CEO or a Managing Director and the CEO should alone be empowered to run the company on day to day basis. By doing so, the Government should ensure that in a Public Sector, the said Non-Executive Chairman so appointed does not come from the ranks of the political fraternity.

The need of the hour is to set up a separate investigating agency manned by professionals who have not only adequate knowledge in finance and accounts and Law but it should also be properly qualified in this stream. They alone should be allowed to investigate such cases. As stated by the Hon'ble Chief Justice of India. Commercial courts exclusively dealing in commercial aspects should be set up. Such changes should be multi member body and to the extent possible should be manned by not only the High Court judges but also people who have adequate experience and knowledge about the various practical aspects of the cases which is proposed to be dealt by the said court.

While I do appreciate and take note of the fact that there has been a major change in implementing these issues and policies, much still remains to be done. Any law or best practices which is sought to be implemented, will lose its purpose, if the breach of such policies cannot be investigated and acted upon and guilty punished within shortest possible period.

Unfortunately inspite of the scam, after scan happening, the guilty remain outside and claim to be innocent. This is due to the slow enforcement of the laws and because of lethargies investigating system and slow judiciary. In India, what is lacking is the enforcement of the laws enacted and does not suffer from dearth of laws. This gap has to be filled up immediately unless it is bridged best practices will have no effect.

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1 Report of the Advisory Committee on Corporate Governance dated 24.03.2001

2 Listing Agreements by SEBI

3 SKS Microfinance episode reported from Personal Finance Moneylife Magazine dated 12.10.2010

4 Report of Standing Committee on Companies Bill – August, 2010