Corporate Governance

Before you start (please don’t skip)

Corporate Governance as a practice has been gaining importance ever since the economic turmoil caused by the bursting of the dot com bubble in 2002. Corporate Governance is basically a detailed disclosure of information and an account of an organization’s financial situation, performance, ownership and governance, relationship with shareholders and commitment to business ethics and values. The relevance of corporate governance has increased several times since the concept was introduced. With the introduction of globalization and competition, managing shareholder expectations is no longer the mantra for success. The current economic crisis (2008) is often blamed at poor regulatory and check mechanisms for the business, which has led to ramifications which are far reaching both geographically and socially.

A corporation is created to address objectives which are much more than creating products and services, it has to serve the larger purpose of satisfying multilevel needs of the society. Healthy corporate governance practices are no longer the need of the law but have become essential for the very survival of the organizations, the last economic crisis has proven that beyond doubts.

The corporations have always faced the tug of war of protecting the interests of the shareholders (the legal owners) or the stakeholders which includes suppliers, creditors, government and communities.

It would be interesting to note that the definition of corporate governance changes in different cultural contexts, for e.g. let us study a definition provided by the Center of European Policy Studies or CEPS as it is called. CEPS defines corporate governance
as the whole system of rights, processes and controls established internally and externally over the management of the business entity with the objective of protecting the interests of the stakeholders. Contrasting to this, the **Anglo American defines** it with an emphasis on creating the shareholder value. Let us also look at the definition provided by OECD or Organization for Economic Corporation and Development, which brings together different democratic governments which are committed to sustainable growth and improving the living standards of the communities.

OECD defines corporate governance as Corporate Governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants of the corporation such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.

The biggest incident which shook the world and questioned the existing corporate governance practices was the Enron debacle in the USA. The doctored accounts which flouted all the established norms of the accountancy practices, false financial statements and the executives who pocketed millions of dollars by selling their share of stocks while laying-off the 20% of the organization’s workforce, painted a grim picture for the investors all across the world.

The fundamental question posed by the Enron crisis was the morality of corporate decisions, embezzlement of funds and the larger interest of all the stakeholders right from employees to society in general. The disturbing aspect was the inability of the external agencies like auditors, credit rating agencies and security analysts to see the real picture. A more recent example is the involvement of Satyam Computers Services Ltd, a reputed software firm of India in multimillion dollar accounting fraud which ultimately led to a huge face loss for the entire Indian IT industry. The involvement of the reputed external agency like PricewaterCoopers (PWC) in the scandal made the
entire episode a nightmare for the regulatory bodies, the government and the employees of the organization.

The objective of the corporate governance is hence the prevention of such scams in the business which have a huge bearing not only on the immediate shareholders but also on the morale of the larger stakeholder groups.

**What is Good Corporate Governance?**

Corporate Governance is the art of directing and controlling the organization by balancing the needs of the various stakeholders. This often involves resolving conflicts of interest between the various stakeholders and ensuring that the organization is managed well, meaning that the processes, procedures and policies are implemented according to the principles of transparency and accountability.

Whenever one speaks about corporate governance, it has to be borne in mind that the organizations have duties and responsibilities towards their shareholders and stakeholders and hence they need to be governed in accordance with the law and keeping in mind the interests of the stakeholders and shareholders.

The next aspect of corporate governance is that the notion of economic efficiency must be followed when directing, managing and controlling organizations. For instance, it is truism that corporations exist to make profits and hence the profitability and revenue generation ought to be the aim for which the corporates must strive for.

Of course, this does not mean that corporates can cut corners in their pursuit of profit and power and hence taken together with the principles in the previous paragraph, corporate governance means that a corporation must strive to generate revenues and make profits in a transparent and accountable manner. What this means is that the way in which corporations are managed and directed have to be done in accordance with standard norms and procedures that apply to ethical and normative conduct.

Corporate Governance has been in the news for the last decade or so following a spate of scandals that engulfed companies like Enron which led to their collapse
because of mismanagement. This prompted regulators all over the world to implement various acts and rules to rein in irresponsible corporate behavior that would mar the prospects of the corporations and cause harm to their shareholders and stakeholders.

Acts like the Sarbanes Oxley were passed to enforce greater oversight over corporations and ensure that they did not overreach themselves in their relentless pursuit of profits. Indeed, it can be said that the Enron debacle was a wakeup call for corporate America to set its house in order. It is unfortunate that some of the lessons learnt during the early years of the last decade were forgotten leading to gross abuse of corporate power in the run up to the global financial crisis.

Broadly speaking, corporate governance can be said to encompass the tenets of rights and equitable treatment of the shareholders and the shareholders and following ethical business behavior along with practice of integrity.

**Good corporate governance means that the processes of disclosure and transparency are followed so as to provide regulators and shareholders as well as the general public with precise and accurate information about the financial, operational and other aspects of the company.** As has been mentioned elsewhere in this article, corporate governance is a term that means many things and the bottom line for good corporate governance is the dual aim of pursuing profits and doing so in a transparent and accountable manner.

**The Morality and Accountability of Corporate Decisions**

**It is always hard to establish the accountability and responsibility of corporate decisions** but does this mean that a corporation can take infinite liberties with the flexible law structure and systems? Is it possible for corporate decisions to be moral with social goals met along with the business ones? Before we dwell deeper into discussing the aspects of corporate decision making, it would be appropriate to understand the expectations of the communities from the corporate.

Community members want jobs which would give them descent income or wage as well as which challenges ingenuity and creativity, they need goods and services which
are of a descent quality and a safe and healthy work environment. Community members also want their share of interest in the corporation either as an employee, shareholders, suppliers, creditors or just as neighbours. There is a certain level of trust and agreement whether written or otherwise which exists between the corporation and these constituents. These agreements are sometimes between the corporation and its employees, suppliers, creditors and while some other agreements are imposable by the legislature.

The public law provides a platform on which the corporations can decide their transaction with these constituents while also providing them the flexibility to expand and contextualize them as per their needs. The legislature is to ensure that the objectives of the corporation are beneficial for the society as a whole and there is no conflict of interests.

Another significant aspect of this discussion is that both the government and the business have always influenced each other liberally. So a senior corporate chief who makes political contribution with an open heart may have a strong impact on the laws created by the government regarding the competition. The ideal state or the corporate is the free market where there is minimum interference from the government. But, the recent economic crisis has brought the question of whether to have a free market or not, once again into the foray of discussions. However, the governments have always been rather proactive in making accommodation for the business where the long term societal needs and financial implications are overlooked.

Above all, the biggest factor which influences, directs and redirects the decisions of the corporate is the market itself. With the corporations spreading across the globe, it is difficult to determine their domicile and therefore the need to have a more congruent corporate governance structure arises. It is also important that corporations base their decisions on long term strategic and financial planning rather than engaging in short term profits and gains. The impact of corporate decisions are huge not just on economies but on the lives of the common man as well.
To go by the directions provided by the World Bank for the emerging economies, the three points have been identified:

- Transparency
- Independent Oversight
- Accountability

In order to maintain its legitimacy and credibility the corporate would have to base their decisions keeping the above parameters in consideration. The selfregulation by corporate remain a distant possibility in the near future, especially in the wake of the current economic crisis, the role of legislature and government becomes paramount in ensuring that the larger interests are not compromised.

**The Significance and Impact of Corporate Behaviour**

The corporate behaviour tends to have a direct or sometimes an indirect impact on the economic state of the countries and communities they operate in. The very recent examples was the economic crisis in US, Brazil and Asia in 1998 and hard to forget ever continuing financial meltdown of the current times. **Any lack or deficiency in the corporate governance structures has a potential to threat the stability of financial structures globally.**

The most important objective of a corporation is to serve social and economic goals however simple it may sound, in practice it's the economic goals that prevail. Can there be a process to make corporation accountable for its actions and decisions. For e.g. hundreds of people lost their livelihood after the Lehman Brothers debacle and the financial crisis that followed, but who was to be held accountable for it? A corporation also needs to act within the limit of the law, however it is interesting to observe the converse; that if there is no compliance and a corporation engages in criminal activities, there is no body to be prosecuted and punished.

It is essential to understand that corporate tend to engage in criminal behaviour because the benefits outweigh the risk and the resulting costs which are enormous are borne elsewhere. And it’s the shareholders who feel the brunt from all sides, as
members of the community they pay the cost of the crime itself, as taxpayer they pay for the cost of prosecution and ultimately as a shareholder they pay the cost of defence and penalties.

It is sad to note that the white collar crimes as these are not treated at par with criminal offences while the cost factor involved is much higher in the former category of offence. The corporate managers involved, rarely ever lose their jobs and the companies pay the hefty fines and legal fees. Also, since there is no clearly established system of accountability for corporate which can be acceptable by shareholders, employees, suppliers, government; the kind of punishment for corporate crimes remains a difficult area even for the legal experts. It seems that a certain level of corporate crime is just accepted as a way of doing business.

During the recent times it has been observed that there is a direct impact of financial systems on growth and removing poverty. The development of banking systems and market finance drives economic growth as does the role of legal foundations for financial market development; external financing and the quality of investments which bear an impact on the growth of the economy. In such a scenario, the importance and relevance of having a good corporate governance structure in place goes a long way in ensuring a better lifestyle, economic growth and prosperity for the members of the community. To prevent the financial crisis of the current times and to make corporate behavior responsible and accountable, it is necessary that a thorough system of checks be established. The initiative is to be taken by the government, the corporate and the legal structure of the countries in which the corporate operate and the approach should be to create a standardized structure acceptable everywhere in the world.

Corporate Governance and Financial Crisis (this text was written in 2009)

The ongoing financial crisis has proved that Corporate America and the Corporates in other countries around the world have exhibited behaviour that can be described as mismanagement and not keeping in tenets of good corporate governance. In this respect, some of the criticism that has been directed at corporate leaders and the
bankers in particular appears to be justified given the excesses that have been on display from them. For instance, excessive CEO compensation is a hot topic in the aftermath of the global financial crisis.

Studies have shown that the CEO’s of some companies like Wal-Mart and GM along with Wall Street Banks take home pay that is 100 to 150 times the average pay of the working class. This is indeed a fact that speaks volumes about the blatant disregard for fair compensation and reflects the skewed priorities of the corporate leaders. After all, what can possibly justify this huge imbalance even after taking into consideration the fact that CEO’s and Bankers are engaged in activities that are cerebral and visionary in nature?

The answer from corporate chieftains is that while these levels of gap between the CEO pay and the average pay are indeed troubling, there is no need to panic since the trickle down economics that they rely on means that the wealth eventually finds its way to the bottom. It is another fact that this has not happened so far in practice and what we have instead is a rising inequality gap. The reason for pointing this aspect is to highlight the kind of corporate governance practices that have seeped into corporates around the world. The point here is that one reason why the global financial crisis happened was because of the failure of the very vision and direction as well as misplaced faith in markets for which these CEO’s and Bankers were being paid such humungous amounts. Hence, the notion that this aspect reflects good corporate governance has fallen flat on the face.

Another aspect of corporate governance that underlines the ongoing financial crisis is that there were serious issues of transparency and accountability concerning the behaviour of the corporate leaders. When they overwhelmingly make the rules that benefit them at the expense of the shareholders and the stakeholders, then there is something wrong with the kind of corporate governance being performed. The fact that the employees in these companies and banks along with the shareholders had to pay the price for the mismanagement of the corporate
leaders indicates that there is an urgent need to clean up the stables of corporate governance before it is too late.

Finally, the issues related to pursuit of profits at the expense of social and environmental concerns points to another malaise of the current systems of corporate governance. Hence, taken together these aspects reflect the fact that the current models of corporate governance need a rethink especially when one considers the fact that the global financial crisis was brought about due to excessive greed and reckless risk taking. The bottom line is that corporate leaders must be answerable to the regulators and the shareholders along with the stakeholders and only when there are effective checks and balances to keep the corporate governance on track can we avoid crises like the ongoing global financial crisis.
Part II

Governance- is concerned with the intrinsic nature, purpose, integrity and identity of an organization with primary focus on the entity’s relevance, continuity and fiduciary aspects.

The root of the word Governance is from ‘gubernate’, which means to steer. Corporate governance would mean to steer an organization in the desired direction. The responsibility to steer lies with the board of directors/ governing board. Corporate or a Corporation is derived from the Latin term “corpus” which means a “body”. Governance means administering the processes and systems placed for satisfying stakeholder expectation. When combined, Corporate Governance means a set of systems, procedures, policies, practices, standards put in place by a corporate to ensure that relationship with various stakeholders is maintained in transparent and honest manner.

Noble laureate Milton Friedman defined Corporate Governance as “the conduct of business in accordance with shareholders’ desires, which generally is to make as much money as possible, while conforming to the basic rules of the society embodied in law and local customs.

The heart of corporate governance is transparency, disclosure, accountability and integrity. It is to be borne in mind that mere legislation does not ensure good governance. Good governance flows from ethical business practices even when there is no legislation.

Definitions of Corporate Governance

There is no universal definition of corporate governance. Some good definitions are given hereunder for your better understanding:-

"Corporate Governance is concerned with the way corporate entities are governed, as distinct from the way business within those companies are managed. Corporate governance addresses the issues facing Board of Directors, such as the interaction
with top management and relationships with the owners and others interested in the affairs of the company” - **Robert Ian (Bob) Tricker** (who introduced the words corporate governance for the first time in his book in 1984)

“Corporate Governance is about promoting corporate fairness, transparency and accountability”. James D. Wolfensohn (Ninth President World Bank)

“A system by which business Corporations are directed and controlled”- Corporate governance structure specifies the distribution of rights and responsibilities among different participants in the company such as board, management, shareholders and other stakeholders; and spells out the rules and procedures for corporate decision-making. By doing this, it provides the structure through which the company’s objectives are set along with the means of attaining these objectives as well as for monitoring performance.- **by OECD**

“(It is) the system by which companies are directed and controlled”.

Corporate Governance is a system of structuring, operating and controlling a company with the following specific aims:— (i) Fulfilling long-term strategic goals of owners; (ii) Taking care of the interests of employees; (iii) A consideration for the environment and local community; (iv) Maintaining excellent relations with customers and suppliers; (v) Proper compliance with all the applicable legal and regulatory requirements.- **by Cadbury Committee, U.K.**

Good corporate governance is about 'intellectual honesty' and not just sticking to rules and regulations, capital flowed towards companies that practiced this type of good governance." **Mervyn King (Chairman: King Report)**

“Strong corporate governance is indispensable to resilient and vibrant capital markets and is an important instrument of investor protection. It is the blood that fills the veins of transparent corporate disclosure and high quality accounting practices. It is the muscle that moves a viable and accessible financial reporting structure.”
Report of Kumar Mangalam Birla Committee on Corporate Governance constituted by SEBI (1999)

“Corporate Governance is the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the management of a company.” Report of N.R. Narayana Murthy Committee on Corporate Governance constituted by SEBI (2003)

NEED FOR CORPORATE GOVERNANCE

Corporate Governance is needed to create a corporate culture of transparency, accountability and disclosure. It refers to compliance with all the moral & ethical values, legal framework and voluntarily adopted practices.

(a) Corporate Performance: Improved governance structures and processes ensure quality decision-making, encourage effective succession planning for senior management and enhance the long-term prosperity of companies, independent of the type of company and its sources of finance. This can be linked with improved corporate performance- either in terms of share price or profitability.

(b) Enhanced Investor Trust: Investors consider corporate governance as important as financial performance when evaluating companies for investment. Investors who are provided with high levels of disclosure and transparency are likely to invest openly in those companies. The consulting firm McKinsey surveyed and determined that global institutional investors are prepared to pay a premium of upto 40 percent for shares in companies with superior corporate governance practices.
(c) Better Access To Global Market: Good corporate governance systems attracts investment from global investors, which subsequently leads to greater efficiencies in the financial sector.

(d) Combating Corruption: Companies that are transparent, and have sound system that provide full disclosure of accounting and auditing procedures, allow transparency in all business transactions, provide environment where corruption would certainly fade out. Corporate Governance enables a corporation to compete more efficiently and prevent fraud and malpractices within the organization.

(e) Easy Finance From Institutions: Several structural changes like increased role of financial intermediaries and institutional investors, size of the enterprises, investment choices available to investors, increased competition, and increased risk exposure have made monitoring the use of capital more complex thereby increasing the need of Good Corporate Governance. Evidences indicate that well-governed companies receive higher market valuations. The credit worthiness of a company can be trusted on the basis of corporate governance practiced in the company.

(f) Enhancing Enterprise Valuation: Improved management accountability and operational transparency fulfill investors’ expectations and confidence on management and corporations, and in return, increase the value of corporations.

(g) Reduced Risk of Corporate Crisis and Scandals: Effective Corporate Governance ensures efficient risk mitigation system in place. A transparent and accountable system makes the Board of a company aware of the majority of the mask risks involved in a particular strategy, thereby, placing various control systems in place to facilitate the monitoring of the related issues.

(h) Accountability: Investor relations are essential part of good corporate governance. Investors directly/ indirectly entrust management of the company to create enhanced value for their investment. The company is hence obliged to make timely disclosures on regular basis to all its shareholders in
Corporate Governance is managing, monitoring and overseeing various corporate systems in such a manner that corporate reliability, reputation are not put at stake. Corporate Governance pillars on transparency and fairness in action satisfying accountability and responsibility towards the stakeholders.

The long term performance of a corporate is judged by a wide constituency of stakeholders. Various stakeholders affected by the governance practices of the company:

Corporate Governance Developments in India
The initiatives taken by Government of India in 1991, aimed at economic liberalization, privatization and globalisation of the domestic economy, led India to initiate reform process in order to suitably respond to the developments taking place world over. On account of the interest generated by Cadbury Committee Report, the Confederation of Indian Industry (CII), the Associated Chambers of Commerce and Industry (ASSOCHAM) and, the Securities and Exchange Board of India (SEBI) constituted Committees to recommend initiatives in Corporate Governance.


CII took a special initiative on Corporate Governance, the first institution initiative in Indian Industry. The objective was to develop and promote a code for Corporate Governance to be adopted and followed by Indian companies, whether in the Private Sector, the Public Sector, Banks or Financial Institutions, all of which are corporate entities. The final draft of the said Code was widely circulated in 1997. In April 1998, the Code was released. It was called Desirable Corporate Governance: A Code.

A brief summary (not important from the exam point of view) of the Desirable Corporate Governance Code is reproduced hereunder:

Recommendation I — Frequency of Board Meetings The full board should meet a minimum of six times a year, preferably at an interval of two months, and each meeting should have agenda items that require at least half a day's discussion.

Recommendation II — Board Composition Any listed company with a turnover of Rs.100 crores and above should have professionally competent, independent, non-executive directors, who should constitute:

• at least 30 per cent of the board if the Chairman of the company is a non-executive director, or

• at least 50 per cent of the board if the Chairman and Managing Director is the same person.
Recommendation III — Number of Directorships
No single person should hold directorships in more than 10 listed companies. This ceiling excludes directorships in subsidiaries (where the group has over 50 per cent equity stake) or associate companies (where the group has over 25 per cent but no more than 50 per cent equity stake).

Recommendation IV — Role, Responsibilities, Qualifications of Non-Executive Directors
For non-executive directors to play a material role in corporate decision making and maximising long term shareholder value, they need to:

• become active participants in boards, not passive advisors;
• have clearly defined responsibilities within the board such as the Audit Committee; and
• know how to read a balance sheet, profit and loss account, cash flow statements and financial ratios and have some knowledge of various company laws. This, of course, excludes those who are invited to join boards as experts in other fields such as science and technology.

Recommendation V — Non-Executive Directors
To secure better effort from non-executive directors companies should:

• Pay a commission over and above the sitting fees for the use of the professional inputs. The present commission of 1% of net profits (if the company has a managing director), or 3% (if there is no managing director) is sufficient.
• Consider offering stock options, so as to relate rewards to performance. Commissions are rewards on current profits. Stock options are rewards contingent upon future appreciation of corporate value. An appropriate mix of the two can align a non-executive director towards keeping an eye on short term profits as well as longer term shareholder value.

Recommendation VI — Disclosure of attendance record for re-appointment
While re-appointing members of the board, companies should give the attendance record of the concerned directors. If a director has not been present (absent with or without leave)
for 50 per cent or more meetings, then this should be explicitly stated in the resolution that is put to vote.

**Recommendation VII** — Key information to the Board Key information that must be reported to, and placed before, the board must contain:

- Annual operating plans and budgets, together with up-dated long term plans.
- Capital budgets, manpower and overhead budgets.
- Quarterly results for the company as a whole and its operating divisions or business segments.
- Internal audit reports, including cases of theft and dishonesty of a material nature.
- Show cause, demand and prosecution notices received from revenue authorities which are considered to be materially important (Material nature if any exposure that exceeds 1 per cent of the company’s net worth).
- Default in payment of interest or non-payment of the principal on any public deposit and/or to any secured creditor or financial institution.
- Fatal or serious accidents, dangerous occurrences, and any effluent or pollution problems.
- Defaults such as non-payment of inter-corporate deposits by or to the company, or materially substantial non-payment for goods sold by the company.
- Any issue which involves possible public or product liability claims of a substantial nature, including any judgment or order which may have either passed strictures on the conduct of the company, or taken an adverse view regarding another enterprise that can have negative implications for the company.
- Details of any joint venture or collaboration agreement.
- Transactions that involve substantial payment towards goodwill, brand equity, or intellectual property.
• Recruitment and remuneration of senior officers just below the board level, including appointment or removal of the Chief Financial Officer and the Company Secretary.

• Labour problems and their proposed solutions.

• Quarterly details of foreign exchange exposure and the steps taken by management to limit the risks of adverse exchange rate movement, if material. Recommendation

VIII — Audit Committee

• Listed companies with either a turnover of over Rs.100 crores or a paid-up capital of Rs. 20 crores should set up Audit Committees within two years.

• Composition: at least three members, all drawn from a company’s non-executive directors, who should have adequate knowledge of finance, accounts and basic elements of company law.

• To be effective, the Audit Committees should have clearly defined Terms of Reference and its members must be willing to spend more time on the company’s work vis-à-vis other non-executive directors.

• Audit Committees should assist the board in fulfilling its functions relating to corporate accounting and reporting practices, financial and accounting controls, and financial statements and proposals that accompany the public issue of any security - and thus provide effective supervision of the financial reporting process.

• Audit Committees should periodically interact with the statutory auditors and the internal auditors to ascertain the quality and veracity of the company’s accounts as well as the capability of the auditors themselves.

• For Audit Committees to discharge their fiduciary responsibilities with due diligence, it must be incumbent upon management to ensure that members of the committee have full access to financial data of the company, its subsidiary and associated companies, including data on contingent liabilities, debt exposure, current liabilities, loans and investments.
• By the fiscal year 1998-99, listed companies satisfying criterion (1) should have in place a strong internal audit department, or an external auditor to do internal audits.

**Recommendation IX — Disclosure on shareholders information**

Under “Additional Shareholder’s Information”, listed companies should give data on:

• High and low monthly averages of share prices in a major Stock Exchange where the company is listed for the reporting year.

• Statement on value added, which is total income minus the cost of all inputs and administrative expenses.

• Greater detail on business segments, up to 10% of turnover, giving share in sales revenue, review of operations, analysis of markets and future prospects.

**Recommendation X — Consolidated Accounts**

Consolidation of Group Accounts should be optional and subject to:

• The FIs allowing companies to leverage on the basis of the group’s assets, and

• The Income-tax Department using the group concept in assessing corporate income-tax.

• If a company chooses to voluntarily consolidate, it should not be necessary to annex the accounts of its subsidiary companies under Section 212 of the Companies Act.

• However, if a company consolidates, then the definition of “group” should include the parent company and its subsidiaries (where the reporting company owns over 50% of voting stake).

**Recommendation XI — Compliance Certificate**

Major Indian stock exchanges should gradually insist upon a compliance certificate, signed by the CEO and the CFO, which clearly states that:

• The management is responsible for the preparation, integrity and fair presentation of the financial statements and other information in the Annual Report, and which also suggest that the company will continue in business in the course of the following year.
• The accounting policies and principles conform to standard practice, and where they do not, full disclosure has been made of any material departures.

• The board has overseen the company’s system of internal accounting and administrative controls systems either through its Audit Committee (for companies with a turnover of Rs.100 crores or paid up capital of Rs. 20 crores) or directly.

Recommendation XII ─ Disclosure relating to GDRs For all companies with paid-up capital of Rs. 20 crores or more, the quality and quantity of disclosure that accompanies a GDR issue should be the norm for any domestic issue. Recommendation XIII ─ Funding The Government must allow far greater funding to the corporate sector against the security of shares and other paper.

Recommendation XIV ─ Nominee Director It would be desirable for FIs as pure creditors to re-write their covenants to eliminate having nominee directors except:

• in the event of serious and systematic debt default; and

• in case of the debtor company not providing six-monthly or quarterly operational data to the concerned FI(s).

Recommendation XV ─ Disclosure of Ratings

• If any company goes to more than one credit rating agency, then it must divulge in the prospectus and issue document the rating of all the agencies that did such an exercise.

• It is not enough to state the ratings. These must be given in a tabular format that shows where the company stands relative to higher and lower ranking. It makes considerable difference to an investor to know whether the rating agency or agencies placed the company in the top slots or in the middle or in the bottom.

• It is essential that we look at the quantity and quality of disclosures that accompany the issue of company bonds, debentures, and fixed deposits in the USA and Britain - if only to learn what more can be done to inspire confidence and create an environment of transparency.
Companies which are making foreign debt issues cannot have two sets of disclosure norms: an exhaustive one for the foreigners, and a relatively minuscule one for Indian investors.

**Recommendation XVI** — Default on fixed deposits by company

Companies that default on fixed deposits should not be permitted to:

- accept further deposits and make inter-corporate loans or investments until the default is made good; and
- declare dividends until the default is made good.


The Securities and Exchange Board of India (SEBI) had set up a Committee on May 7, 1999 under the Chairmanship of Kumar Mangalam Birla to promote and raise standards of corporate governance. The Report of the committee was the first formal and comprehensive attempt to evolve a Code of Corporate Governance, in the context of prevailing conditions of governance in Indian companies, as well as the state of capital markets at that time. The recommendations of the Report, led to inclusion of Clause 49 in the Listing Agreement in the year 2000. These recommendations, aimed at improving the standards of Corporate Governance, are divided into mandatory and non-mandatory recommendations. The said recommendations have been made applicable to all listed companies with the paid-up capital of Rs. 3 crores and above or net worth of Rs. 25 crores or more at any time in the history of the company. The ultimate responsibility for putting the recommendations into practice lies directly with the Board of Directors and the management of the company.

**TASK FORCE ON CORPORATE EXCELLENCE THROUGH GOVERNANCE**

In May 2000, the Department of Company Affairs [now Ministry of Corporate Affairs (MCA)] formed a broad-based study group under the chairmanship of Dr. P.L. Sanjeev Reddy, Secretary, DCA. The group was given the ambitious task of examining ways
to “operationalise the concept of corporate excellence on a sustained basis”, so as to “sharpen India’s global competitive edge and to further develop corporate culture in the country”. In November 2000, a Task Force on Corporate Excellence set up by the group produced a report containing a range of recommendations for raising governance standards among all companies in India. It also suggested the setting up of a Centre for Corporate Excellence.

NARESH CHANDRA COMMITTEE (2002)

The Enron debacle of 2001 involving the hand-in-glove relationship between the auditor and the corporate client, the scams involving the fall of the corporate giants in the U.S. like the WorldCom, Qwest, Global Crossing, Xerox and the consequent enactment of the stringent Sarbanes Oxley Act in the U.S. were some important factors which led the Indian Government to wake up and in the year 2002, Naresh Chandra Committee was appointed to examine and recommend inter alia amendments to the law involving the auditor-client relationships and the role of independent directors.


In the year 2002, SEBI analyzed the statistics of compliance with the clause 49 by listed companies and felt that there was a need to look beyond the mere systems and procedures if corporate governance was to be made effective in protecting the interest of investors. SEBI therefore constituted a Committee under the Chairmanship of Shri N.R. Narayana Murthy, for reviewing implementation of the corporate governance code by listed companies and for issue of revised clause 49 based on its recommendations.

Corporate Governance Under Companies Act, 2013

The Companies Act, 2013 enacted on August 30, 2013 envisages radical changes in the sphere of Corporate Governance in India. It is set to provide a major overhaul in Corporate Governance norms and have far-reaching implications on the manner in
which corporate operates in India. Some of the Provisions of Companies Act, 2013 related to Corporate Governance are:

1. Appointment and maximum tenure of Independent Directors;
2. Appointment of Woman Director;
3. Appointment of Whole time Key Managerial Personnel;
4. Performance Evaluation of the Directors and Board as a whole;
5. Enhanced disclosures and assertions in Board Report, Annual Return and Directors’ Report with regard to Managerial Remuneration, risk management, internal control for financial reporting, legal compliance, Related Party Transactions, Corporate Social Responsibility, shareholding pattern, public money lying unutilised, etc.
6. Stricter yet forward-looking procedural requirements for Secretarial compliances and ICSI Secretarial Standards made mandatory;
7. Enhanced compliances of Related Party Transactions and introduction of concept of arm’s length pricing;
8. Enhanced restrictions on appointment of Auditors and mandatory rotation of Auditors;
9. Separation of role of Chairperson and Chief Executive Officer;
10. Mandatory provisions regarding vigil mechanism;
11. Constitution of Nomination and Remuneration Committee;
12. Constitution of CSR Committee with minimum one Independent Director and formulation of CSR policy to spend 2% of average Net Profits during the three immediately preceding financial years in pursuance of CSR policy;
13. Secretarial Audit for the bigger companies.
MECHANISM OF CORPORATE GOVERNANCE

Some of the important elements of good corporate governance are discussed as under:

1. **Role and powers of Board** Good governance is decisively the manifestation of personal beliefs and values which configure the organizational values, beliefs and actions of its Board. The Board as a main functionary is primary responsible to ensure value creation for its stakeholders. The absence of clearly designated role and powers of Board weakens accountability mechanism and threatens the achievement of organizational goals. Therefore, the foremost requirement of good governance is the clear identification of powers, roles, responsibilities and accountability of the Board, CEO, and the Chairman of the Board. The role of the Board should be clearly documented in a Board Charter.

2. **Legislation** Clear and unambiguous legislation and regulations are fundamental to effective corporate governance. Legislation that requires continuing legal interpretation or is difficult to interpret on a day-to-day basis can be subject to deliberate manipulation or inadvertent misinterpretation.

3. **Management environment:** Management environment includes setting-up of clear objectives and appropriate ethical framework, establishing due processes, providing for transparency and clear enunciation of responsibility and accountability, implementing sound business planning, encouraging business risk assessment, having right people and right skill for the jobs, establishing clear boundaries for acceptable behaviour, establishing performance evaluation measures and evaluating performance and sufficiently recognizing individual and group contribution.

4. **Board skills** To be able to undertake its functions efficiently and effectively, the Board must possess the necessary blend of qualities, skills, knowledge and experience. Each of the directors should make quality contribution. A Board should have a mix of the following skills,
knowledge and experience: → Operational or technical expertise, commitment to establish leadership; → Financial skills; → Legal skills; and → Knowledge of Government and regulatory requirement.

5. **Board appointments** To ensure that the most competent people are appointed in the Board, the Board positions should be filled through the process of extensive search. A well-defined and open procedure must be in place for reappointments as well as for appointment of new directors. Appointment mechanism should satisfy all statutory and administrative requirements. High on the priority should be an understanding of skill requirements of the Board particularly at the time of making a choice for appointing a new director. All new directors should be provided with a letter of appointment setting out in detail their duties and responsibilities.

6. **Board induction and training** Directors must have a broad understanding of the area of operation of the company’s business, corporate strategy and challenges being faced by the Board. Attendance at continuing education and professional development programmes is essential to ensure that directors remain abreast of all developments, which are or may impact on their corporate governance and other related duties.

7. **Board independence** Independent Board is essential for sound corporate governance. This goal may be achieved by associating sufficient number of independent directors with the Board. Independence of directors would ensure that there are no actual or perceived conflicts of interest. It also ensures that the Board is effective in supervising and, where necessary, challenging the activities of management. The Board needs to be capable of assessing the performance of managers with an objective perspective. Accordingly, the majority of Board members should be independent of both the management team and any commercial dealings with the company.

8. **Board meetings** Directors must devote sufficient time and give due attention to meet their obligations. Attending Board meetings regularly and preparing thoroughly before entering the Boardroom increases the quality of interaction at Board meetings. Board meetings are the forums for Board decision-making. These meetings enable directors to discharge their responsibilities. The effectiveness of Board meetings is
dependent on carefully planned agendas and providing relevant papers and materials to directors sufficiently prior to Board meetings.

9. **Code of conduct** It is essential that the organization’s explicitly prescribed norms of ethical practices and code of conduct are communicated to all stakeholders and are clearly understood and followed by each member of the organization. Systems should be in place to periodically measure, evaluate and if possible recognise the adherence to code of conduct.

10. **Strategy setting** The objectives of the company must be clearly documented in a long-term corporate strategy including an annual business plan together with achievable and measurable performance targets and milestones.

11. **Business and community obligations** Though basic activity of a business entity is inherently commercial yet it must also take care of community’s obligations. Commercial objectives and community service obligations should be clearly documented after approval by the Board. The stakeholders must be informed about the proposed and on going initiatives taken to meet the community obligations.

12. **Financial and operational reporting** The Board requires comprehensive, regular, reliable, timely, correct and relevant information in a form and of a quality that is appropriate to discharge its function of monitoring corporate performance. For this purpose, clearly defined performance measures - financial and non-financial should be prescribed which would add to the efficiency and effectiveness of the organisation. The reports and information provided by the management must be comprehensive but not so extensive and detailed as to hamper comprehension of the key issues. The reports should be available to Board members well in advance to allow informed decision-making. Reporting should include status report about the state of implementation to facilitate the monitoring of the progress of all significant Board approved initiatives.

13. **Monitoring the Board performance** The Board must monitor and evaluate its combined performance and also that of individual directors at periodic intervals, using key performance indicators besides peer review. The Board should establish an
appropriate mechanism for reporting the results of Board’s performance evaluation results.

14. Audit Committees The Audit Committee is inter alia responsible for liaison with the management; internal and statutory auditors, reviewing the adequacy of internal control and compliance with significant policies and procedures, reporting to the Board on the key issues. The quality of Audit Committee significantly contributes to the governance of the company.

15. Risk management Risk is an important element of corporate functioning and governance. There should be a clearly established process of identifying, analysing and treating risks, which could prevent the company from effectively achieving its objectives. It also involves establishing a link between risk-return and resourcing priorities. Appropriate control procedures in the form of a risk management plan must be put in place to manage risk throughout the organization. The plan should cover activities as diverse as review of operating performance, effective use of information technology, contracting out and outsourcing. The Board has the ultimate responsibility for identifying major risks to the organization, setting acceptable levels of risk and ensuring that senior management takes steps to detect, monitor and control these risks. The Board must satisfy itself that appropriate risk management systems and procedure are in place to identify and manage risks. For this purpose the company should subject itself to periodic external and internal risk reviews.

Mechanism of Corporate Governance- Governance through Committees

With the globalization and the blurring of the borders, the demands on the board have increased tremendously. The regulatory requirements are complex and the onus on the Board is immense. In this scenario, the need to delegate oversight of certain areas to a specialist board committee has become imperative. However, it is to be remembered that even though the board delegates some of the responsibilities to a committee, the ultimate responsibility lies with the board. Board committees with formally established terms of reference, criteria for appointment, life span, role and function constitute an important element of the governance process and should be established with clearly
agreed reporting procedures and a written scope of authority. Committees enable better management of the board’s time and allow in-depth scrutiny and focused attention.

Various Committees of the Board

The following are some of the important committees of the Board: • Audit Committee • Shareholders Grievance Committee • Nomination and remuneration committee Corporate Social Responsibility committee • Stakeholders’ Relationship committee • Corporate Governance Committee • Corporate Compliance Committee.

1. Audit Committee

A key element in the corporate governance process of any organization is its audit committee. The purpose of constitution of this committee is to make it responsible for the oversight of the quality and integrity of the company’s accounting and reporting practices; controls and financial statements; legal and regulatory compliance; the auditors’ qualifications and independence; and the performance of the company’s internal audit function. The committee functions as liaison between the board of directors and the auditors - external & internal.

Regulatory Framework: The Regulatory Framework with regard to Audit Committee is covered under:

- SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015
- Section 177 of Companies Act, 2013

Powers of Audit Committee

The Audit Committee shall have powers, which should include the following:

1. To investigate any activity within its terms of reference.
2. To seek information from any employee.
3. To obtain outside legal or other professional advice.
4. To secure attendance of outsiders with relevant expertise, if it considers necessary.

2. Nomination and Remuneration Committee

The Nomination and Remuneration Committee helps the Board of Directors in the preparation relating to the election of members of the Board of Directors, and in handling matters within its scope of responsibility that relate to the conditions of employment and remuneration of senior management, and to management’s and personnel’s remuneration and incentive
schemes. The responsibilities of the Remuneration and Nomination Committee are defined in its policy document.

3. **Corporate Social Responsibility Committee**

   Companies Act 2013 provides for constitution of CSR Committee of the Board to formulate and monitor the CSR Policy of a company for certain specified companies.
Part III

Recent development and RBI Rules regarding Corporate Governance

1. PJ Nayak Committee

Public Sector Banks are in need of a complete reboot. PSBs comprise about 70% assets of the Indian Banking sector which necessitate introducing some quick reforms which are able to revive bank lending and private investment. A Panel headed by PJ Nayak who was ex-Chairman of Axis Bank suggested that governance in PSBs was ridden with constraints imposed on them externally largely due to dual regulations by the Ministry of Finance and RBI along with agencies like CVC, CAG etc. All these had accrued due to the government stakes in these banks more than 50%. Furthermore, the Bank Nationalisation Acts of 1970 and 1980 together with SBI Act and SBI (Subsidiary Banks) Act had further weakened the governance structures of PSBs.

PSBs are faced with three prime issues viz.

Governance: Board composition and functioning
Management: CEO selection procedure
Operations: The burgeoning NPA and capital infusion in the banks

The recommendations of PJ Nayak Committee and implications are as follows:

It had suggested separating the roles of chairman and managing director in a three-phase process. Later will give enough time to the PSBs for required autonomy and power to appoint the chairman and other directors. However, the government has taken steps to separate the roles of chairman and managing director (CMD) in all Public Sector Banks except in State Bank of India in one go as an initial measure. The Chairman will be selected by a panel which will be led by the governor of RBI. Despite the move, there are possibilities of governmental influence to continue on the chairman after appointment which may come in conflict with the strategy of CEO and thus cripple the whole
organisation. Thus, it was imperative to forward the separation of roles till the bank boards had effectively learnt to run under independent directors.

The Panel had been gravely critical of the selection process of bank board and stated that the bank boards were not independent at all. The strengthening of bank boards has become even more important after the separation of roles stated above. In the same light, the government is deciding to set up Bank Boards Bureau comprising three former bankers, two distinguished professionals and Secretary of Department of Financial Services. Bank Chairmen, CEO and other independent directors will be selected by this Board.

2. Guidelines on Corporate Governance to NBFCs (Refer Para 9)
3. Master Circular on Board of Directors – UCBs
4. Basel Committee of Banking Supervision: Corporate governance principles for banks
   - Effective corporate governance is critical to the proper functioning of the banking sector and the economy as a whole. While there is no single approach to good corporate governance, the Basel Committee’s revised principles provide a framework within which banks and supervisors should operate to achieve robust and transparent risk management and decision-making and, in doing so, promote public confidence and uphold the safety and soundness of the banking system.
   - The Committee’s revised set of principles supersedes guidance published by the Committee in 2010. The revised guidance emphasises the critical importance of effective corporate governance for the safe and sound functioning of banks. It stresses the importance of risk governance as part of a bank’s overall corporate governance framework and promotes the value of strong boards and board committees together with effective control functions. More specifically, the revised principles:
     - expand the guidance on the role of the board of directors in overseeing the implementation of effective risk management systems;
• emphasise the importance of the board's collective competence as well as the obligation of individual board members to dedicate sufficient time to their mandates and to keep abreast of developments in banking;
• strengthen the guidance on risk governance, including the risk management roles played by business units, risk management teams, and internal audit and control functions (the three lines of defence), as well as underline the importance of a sound risk culture to drive risk management within a bank;
• provide guidance for bank supervisors in evaluating the processes used by banks to select board members and senior management; and
• recognise that compensation systems form a key component of the governance and incentive structure through which the board and senior management of a bank convey acceptable risk-taking behaviour and reinforce the bank's operating and risk culture.