GOOD CORPORATE GOVERNANCE: TOWARDS GREATER EFFECTIVENESS

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INTRODUCTION

Simply stated, Good Corporate Governance is a duty which a company owes to its stake-holders. It is both a moral and legal imperative. A new regulatory framework emerging all over the world, in measure, large or small, makes it obligatory for the companies to subserve their stakeholders. Time has gone when promoters could presume that the company was only theirs, even to the detriment of the stakeholders. The focus has now shifted from the owners to shareholders and other interested parties of the company. This fundamental shift of last few years is rapidly becoming more pronounced day after day.

Secondly, good corporate governance is a *line qua non* not only for success but even survival of any company, in the current situation of heightened awareness and expectations of its stake-holders, concerned public and more sensitised and stringent regulators. Even ignoring such outside considerations, as a long term internalised commonsensical policy, a company committed to certain basic principles and concerned with the maximization of its stakeholders' value, alone is likely to last in the present competitive environment. While these realizations are dawning on die promoters and managements of companies, their actual implementations vary in degrees. While some enlightened organization give effect to them sincerely and wholeheartedly, others adhere to them only symbolically and formally and that too because of legal compulsions. The issue, therefore is, how to extend the application of good corporate govemarfce to larger

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number of companies in a smooth and normal manner?

One basic way to implement the principles of corporate governance is to have a strong legal code of conduct. A leading industries association in India came out with a voluntary code of conduct in the belief that self-regulation is the best one. While it is true that moral conviction plays an important part in actualising the principles, a parallel legal system is equally important. A crime could be both a sin and a legal aberration to be dealt with at the levels of ethics and law.

For the above-mentioned reasons, the London Stock Exchange was the first to take the initiative on the subject in the world and, appointed Lord Cadbury to evolve a Code of Conduct for Corporate Governance. The report of Cadbury was a seminal work. The London Stock Exchange implemented the report by amending the listing agreement between the listed companies and the exchange and making it obligatory for the companies to observe the new conditions. It was not the most ideal way of giving legal effect to the recommendations but it did set new norms, methodology and pace for the rest of the world.

2. THE SEBFS INITIATIVE

In India, SEBI took the lead and appointed the Kumar Manglam Birla Committee in 1999 to recommend the system of Corporate Governance. The Committee had the advantage of reference to the Cadbury. Committee Report on Corporate Governance of the UK, the OECD Committee Report and other reports of the USA. The report of SEBI was described by Lord Cadbury, the pioneer in the field of Corporate Governance, as one of the most comprehensive reports on Corporate Governance in the world. The report was adopted by SEBI by issuing a notification for amending clause 49 of the Listing Agreements between the stock exchanges and the listed companies. Its main features are as under:

1. The boards of the companies should be made independent with at least 50 percent independent directors.

2. Since many companies did not have a system of bringing all the important matters before their boards, enabling their promoters to take decisions without the knowledge of directors and shareholders, it was stipulated that it would be mandatory for certain important matters to be brought before the boards which by and large are independent.

3. The board would appoint several committees; the most important of these is the Audit Committee, which has to comprise three independent directors. This, committee lays down the accounting policies, reviews them, recommends the appointment of statutory auditors and also considers the audit report. The other significant committee is for deciding remunerations.

4. The adherence of the new accounting norms has been made compulsory. The companies are expected to have consolidation of accounts of the holdings and the subsidiary companies. Companies, having several divisions, have to have segment reporting. Accounting norms are prescribed as to how to deal with related party transactions and deferred tax payment liabilities etc.

5. The concept of postal ballot.

6. All covered listed companies are required to submit a quarterly compliance report to the stock exchanges within 15 days from the end of the financial reporting quarter. The report has to be submitted either by the compliance officer or by Chief Executive Officer of the company in a format prescribed by SEBI.

7. Statutory auditors of the company will have to certify the compliance of the Corporate Governance Code by the companies.

8. Rules regarding the prevention of insider trading have been introduced so that the promoters, senior executives and other insiders do not get undue advantage because of the confidential information available to them. This aspect was dealt with the second report of Kumaramangalam Birla Committee.

9. The Code has been introduced in a phased manner.

The reason for SEBI going through the indirect and circuitous route of amendment in the Listing Agreement between a stock exchange and a company needs to be commented on. It was because the power of amending the Companies Act did not lie with SEBI and in any case, the procedure to do so was too cumbersome and time consuming. A word is also needed to clarify the position regarding the accounting standards. SEBI has no direct powers to prescribe these; it is the Institute of Chartered Accountants of India (ICAI), which is legally authorized to lay down these standards. Thus, SEBI sought the support of ICAI in this matter. SEBI worked in tandem with ICAI and had latter issued Accounting Standards for consolidation of account; of the holding and subsidiary companies, segment reporting, related party transactions, deferred tax payment liabilities etc. In fact an organic link was established between SEBI and ICAI by making its President the permanent member of the SEBI's Standing Committee on Accoutring Standards headed by Y H Malegam and also the member of Kumarmangalam Birla Committee. By adopting this approach, SEBI could get the new norms of ICAI issued expeditiously. With these changes, the Indian accounting norms now comply with the International Accounting Standards, followed by large number of developed countries barring the USA, which follows the rival accounting system of the GAAP.

There is yet another aspect. The approach of SEBI was one o gradualism. The belief was that initially the large and the leading companies should adopt the Code of Corporate Governance an others could follow them over time. This was in contrast to th view of many of our theoretical reformers, who often rush t" reforms. They do not have any specialization in Manageme

Science and have little idea of managing the change. It is also interesting to observe that not many of our experts talked of Corporate Governance till SEBI started the process. Even those who recognized the importance of the concept ended up by suggesting a voluntary code which was virtually ineffective but had the merit of keeping the industrialists pleased with the suggested system which gave them the freedom to implement the provisions or not to do so

3. THE SECOND PHASE: NARAYAN MURTHY COMMITTEE

Recognizing that process of reforms is an on-going one. The SEBI appointed Narayana Murthy Committee on Corporate Governance. Accordingly the Committee reviewed the progress and made further recommendations. The covering letter of the Chairman of the Committee who gave the report to SEBI sums aptly the rationale of the corporate governance:

> Corporations pool capital from a large investor base both in the domestic and in the international capital markets. In this context, investment is ultimately an act of faith in the ability of a corporation' s management. When an investor invests money in a corporation, he expects the board and the management to act as trustees and ensure the safety of the capital and also earn a rate of return that is higher than the cost of capital. In this regard, investor expects management to act in their best interests at all times and adopt good corporate governance practices.
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> 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.

The Narayana Murthy Committee noted the following level of compliance of the Corporate Governance code as reported by 1026 companies of BSE and 595 companies of NSE:

- The compliance level in respect of requirements relating to Board of Directors, Audit Committee, Shareholders Grievance Committee, and Shareholders is very high;

- Many companies are yet to comply with the requirements relating to Remuneration *Committee* (which is not mandatory), board procedures, management and Report on Corporate Governance; and

- Few companies have submitted that the provisions relating to management and board procedures are not applicable.

The Narayana Murthy Committee also obtained SEBI's observations on the compliance of the Corporate Governance Code. The views of the SEBI as reported by the *Committee* are worth repeating:

> SEBI observed that the compliance with the requirements in clause 49 of the listing agreement is, by and large, satisfactory; however, an analysis of the financial statements of companies and the Report on Corporate Governance discloses that their quality is not uniform. This is observed on parameters such as the nature of qualifications in audit reports, the quality of the Corporate Governance. Report itself (which is often perfunctory in nature), and the business transacted and the duration of audit committee meetings. Variations in the quality of annual reports, including disclosures, raises the question whether compliance is in form or in substance; and emphasizes the need to ensure that the laws, rules and regulations do not reduce corporate governance to a mere ritual. This question has come under close scrutiny in recent

times.

SEBI has analysed a few recently published annual reports of companies to assess the quality of Corporate Governance. These reports could be classified into the following categories:

- Reports where there is no mention about the compliance with Corporate Governance requirements;

- Reports that state that the company is fully compliant with clause 49 of the Listing Agreement, but where independent auditors have made qualifications in their audit reports;

- Reports that mention areas on non-compliance with clause 49 of the Listing Agreement and provide explanation for non-compliance; and

- Reports that mention areas on non-compliance with clause 49 of the Listing Agreement but provide no explanation for auditor's qualification or for reasons for non-compliance.

SEBI also observed that there was a considerable variance in the extent and quality of disclosures made by companies in their annual reports.

4. SIGNIFICANT RAMIFICATION

The Report of the Narayana Murthy Committee has generally tried to fine-tune the recommendations of the earlier Birla Committee Report. For example the role of the audit committee has been slightly clarified or enlarged. Many of the suggestions given by this committee are already inherent in the Birla Committee Report. The Committee also recommended a movement towards the regime of unqualified financial statements. But this raises a much wider issue of reforming the entire system or audit in India. The Committee has dealt with related party transactions Again the Birla Committee already largely covers this. The Committee has further suggested that the board members should be apprised of the risk assessment and its minimization. It is also suggested training of

board members, but this seems to be too theoretical. According to Committee, the Audit Committee should be informed of the utilization of the proceeds from the initial public offering. Already there are some precautions prescribed in this regard. Besides the Committee has recommended that Code of Conduct should be laid down for the board members and senior management. In this matter already the insider trading regulations prescribe various precautions. However, for nominee Directors, the Committee has made significant recommendations with which one may not wholly agree. In the present situation of vast NPAs, the corporate world would undoubtedly be happy if no nominee Directors are appointed by the banks or financial institutions but this would not serve the public interest. Again to say that nominee Directors, if appointed, for the banks and financial institutions or Government should be elected by the shareholders is also a recommendation of similar type. The Committee has dealt with independent Directors as well; it has validly suggested that recommendation of the Naresh Chandra Committee in this regard should be accepted. It may be mentioned here that following the Birla Committee, the issue of defining independent Director was left to the boards of a company mainly because it was felt that a perfect code, if implemented, may give rise to too much resistance. The view was that let this idea of independent Directors be accepted even with this relaxation and after sometime a more stringent definition would be provided.

The two issues on which Narayan Murthy Committee could have probed a little more are relating to subsidiary company and insider trading. According to the formal definition of a subsidiary company, the holding company must have 51 percent shares. There are many companies in India which are very ethical. But there are many others which specialize in taking advantage of the loopholes. There are some very big companies in the country, which have set up hundreds of companies without their own share holding by involving their employees' friends, relatives etc. to do various things including the playing in the stock market. The Report could have addressed itself to this point. For this, the Committee could have recommended the piercing of corporate veil.

Insider trading is one of the major issues on which the governance of corporates depends, but the Committee has not said much on this. In fact, surprisingly, the Committee has stated that there were some practical problems in disclosing the critical business events. This kind of a recommendation may please the corporates, but not the stakeholders or objective analysis. The procedures in this regard are already prescribed by SEBI and Stock Exchanges. The need is to tighten these norms rather than recommending the reference of the matter to SEBI. Already in the advanced markets of the world, stringent provisions in this regard exist.

The ground rules for the corporate governance will need continuous review and updating. The efforts made by Narayan Murthy Committee in this regard are welcome to some extent. SEBI has accepted many of these recommendations in August 2003. Perhaps some more recommendations would be needed. Particularly, on the issue of subsidiaries, discloser of material events and insider trading.

5. NARESH CHANDRA COMMITTEE

Separately, Naresh Chandra Committee appointed by the Department of Company Affairs made some of the following recommendations on the issue of Corporate Governance:

1. The auditors - company relationship, disqualification for audit assignments because of direct financial interest in audit clients, loans and guarantees and business relationships between the company and the audit firm;

2. List of prohibited non-audited services prescribed;

3. Independence standard for consulting another entities that are affiliated for audited firms;

4. Compulsory audit partner rotation;

5. Auditors' disclosure of continent liabilities;

6. Setting up of independent oversee boards or supervising the work of auditors;

7. Setting up an independent quality review board or auditors;

8. Independent director defined. Apart from the criteria of family pecuniary business relationship, one should also not be director for more than three terms of three years and prescribed that not less than 50 per cent of the board of directors should comprise of independent directors;

9. Minimum boards size prescribed;

10. Provisions regarding the audit committee and its powers;

11. SEBI not to exercise subordinate legislation. Special legislation exist

12. Improving facilities in the DC A bffices

13. Setting up of a serious fraud office in the Department of Company Affairs

Many of these recommendations aroused the ire of the corporate world. For example limiting the term of Directors for nine years has been contested. These recommendations are being questioned on the ground of creating space for micro- management by DCA and SEBI. One get the impression that the corporate world in India and its spokesmen are at best interested in paying lip service to the concept of corporate governance. While they do not want to give up their privileges, they also do not want to appear as bad guys. Many of these recommendations were contained in the Companies (Amendment) Bill 2003 which was not approved by the Cabinet.

One of the problems of the Indian system is the growing clout of the large corporates. Many of them are ethical. They are also creators of wealth. It is also a fact that without the promoters, there would be no impulse for enterprise. The cost of corporate governance and regulation too should not be disproportionate to

advantages. On the other hand, many of the large corporates with increased business profits and association with the powers-that-be do not sincerely believe in corporate governance and would try to subvert this concept by fair and foul means. The inadequate competition law has to help them acquire more power than what is good for the system. The battle of corporate governance is ultimately to be fought against them.

6. UNITY OF DIRECTION

Before closing, it is also necessary to raise one issue. Which is the agency that is the nodal and legal one to deal with the subject of corporate governance? Is it the Department of Company Affairs, as it asserts, or is it SEBI which is charged with the responsibility of protecting the investors? Indeed while on one hand, Narayan Murthy Committee was engaged with the subject on behalf of SEBI, there was another committee headed by Naresh Chandra appointed by Department of Company Affairs. This is an unusual spectacle. The Naresh Chandra Committee strongly pleaded that SEBI should refrain from exercising powers of subordinate legislation in areas where specific legislation exist as in the Companies Act. This will certainly not improve the matters. Further, who regulates the corporate governance of the banking companies? Is it SEBI, RBI or the Department of Company Affairs? In case of non-banking finance companies raising deposits, which is the regulatory agency? One of the major problems in the country is multiplicity of agencies with different perceptions. The interesting point is that in this situation, prone to confusion, different agencies assert when they exercise power but disclaim any responsibility when there is problem. Some day this issue will have to be squarely faced by transcending the institutional, departmental or ministerial turf battles. Even in a country like Pakistan, entire work of the Department of Company Affairs is regulated by the Chairman of the Securities Exchange Commission. In the UK, facing the similar problem, Financial Services Authority has been set up as a lead regulator with powers dealing with the provisions of the Companies Act, securities, laws and other regulatory issues related to ordinary companies, finance companies, non-banking finance companies and banking finance

companies. One wonders when would our system muster the courage and resolve this problem of scattered regulations and responsibilities.

The Birla Committee recommendations accepted by SEBI and described as the most comprehensive report continues to be the basic document on the Corporate Governance. It needs to be revised and updated regularly. But while doing so the basic issue of insider trading, continuous disclosure and piercing the corporate veil will also have to be seriously considered irrespective of some resistance from some corporates not given to the culture of compliance.