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CORPORATE GOVERNANCE

Mr. R.N. Agarwal *

Abstract

Good corporate governance is not a fad; nor is it merely a matter of ethics. It makes excellent business sense. A well-governed company enjoys the trust of investors and society - trust that builds partnerships and allows them to grow and earn more profits. Poorly governed companies may get away with it for a few years. But they invariably lose in the long term.

WHY CORPORATE GOVERNANCE?

Companies need funds to invest in growth opportunities, investors who provide such funds - debt or equity - need to be assured that their investments will be protected and will earn a fair return. Good corporate governance refers to the system of supervision and monitoring that enlightened companies put in place to protect and enhance the trust of the shareholders, creditors, employees, suppliers, customers and society.

Systems of corporate governance vary across countries, depending upon law, the stage of development and the evolution of business ethics. However, there are four key elements to good corporate governance. These are:

- * *Transparency* - commitment of management to run its business transparently and ethically.
- * *Disclosure* - conviction that the company should voluntarily disclose all material financial and non-financial facts to its shareholders.
- * *Fairness* - that all shareholders must be treated fairly, especially minority shareholders.
- * *Independent supervision* - by a professionally competent board of directors on behalf of the shareholders.

Kumar Mangalam Birla Committee Report

A full-scale debate on Corporate Governance has dominated the Indian scene since the submission of its report

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by the Kumar Mangalam Birla Committee constituted by SEBI on May 7'1999. Most of its recommendations were notified by SEBI on February 21'2000 as guidelines for good corporate governance and primarily sought to be enforced through listing agreement. Consequently, Clause 49 of the Listing Agreement has been amended.

Kumar Mangalam Birla Committee has primarily focused its recommendations keeping in view the interests of the shareholders. The Committee, however, recognized that the Corporate Governance does not limit itself to shareholders' interest alone, it has several other claimants which include suppliers, customers, creditors, bankers, the employees of the company, the Government and the society at large.

The Companies seeking listing for the first time have to comply with the same at the time of listing itself.

Birla Committee divided its recommendations into:

- I. Mandatory
- II. Non-mandatory

Mandatory Recommendations relate to the composition of Board of Directors, appointment and structure of Audit Committee, remuneration of directors, board procedures, additional information regarding management, discussion and analysis as part of the annual report, disclosure of directors, interest, shareholders' rights, and disclosures regarding compliance level of Corporate Governance in the annual report.

Non-mandatory recommendations include issues concerning chairman of the Board, setting up of remuneration committee, half yearly information to the shareholders, use of postal ballots in certain key decisions, appointment of

Nominee Directors and obligations of Institutional shareholders.

A. Composition of the Board of Directors.

The compositions of the Board of Directors is critical to the independent functioning of the Board. The composition of the Board is important in as much as it determines the ability of the Board to collectively provide the leadership and to ensure that no one individual or group is able to dominate the Board. The executive directors (like director-finance, director-personnel) are involved in the day-to-day management of the companies. The Board comprises of following executive directors, a part of whom are independent. A conscious distinction has been made by the committee between two classes of non executive directors, namely those who are independent and those who are not.

Among the non-executive directors are independent directors, who have a key role in the entire mosaic of corporate governance. Independent directors are those who apart from receiving director's remuneration do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, while in the judgement. Further, all pecuniary relationships or transactions of the non-executive directors should be disclosed in the annual report

The Committee has recommended the Board to comprise of an optimum combination of executive and non-executive directors, with not less than fifty percent of the Board comprising the non-executive directors if the chairman is an executive. But, in case a company has a non executive chairman, at least one-third of Board should comprise of independent directors.

B. Audit Committee

A sub-group comprising of at least three non-executive directors (the majority being independent) and at least one of them having financial and accounting knowledge should be formed to constitute an audit committee (maximum number of the committees is not specified). The role of the audit committee shall not be to prepare financial statements or to engage itself in decisions relating to preparation of those statements. It shall act as a bridge between the board internal auditor and statutory auditor.

C. Remuneration of Non-Executive Directors.

The Board of directors should decide the remuneration of non-executive directors.

D. Disclosure of Remuneration Package

All elements of remuneration package of all the directors, i.e. salary, benefits, bonuses, stock options, pension, etc., details of fixed component and performance linked incentives, along with the performance criteria, service contract, notice period, severance fees, stock option details, if any, and whether issued at a discount, as well as, the period over which accrued and over which exercisable.

E. Board Meetings

The Committee has recommended at least four meetings of the Board in a year with a maximum gap of four months between two meetings (shall require amendment of section 285 of the Companies Act 1956)

F. Membership of the Committees of the Board

To ensure that the members of the board give due importance and commitment to the meetings of the board and its committees, there should be a ceiling on the maximum number of committees across all companies in which a director could be a member or could act as chairman. The committee recommends that director should not be a member in more than ten committees or act as chairman of more than five committee across all companies in which he is a director. Furthermore, it should be a mandatory annual requirement for every director to inform the company about the committee positions he occupies in other companies and notify changes as and when they take place.

G. Disclosure of Interest by Management to the Board.

Good corporate governance casts an obligation on the management in respect of disclosures. The committee, therefore, recommends that disclosures must be made by the management to the board relating to all material, financial and commercial transactions; where they have personal interest, that may have a potential conflict with the interest of the company at large (e.g dealing in company shares, commercial dealings with bodies which have shareholding of management and their relatives etc.)

H. Rights of Shareholders

The basic rights of the shareholders include right to registration and transfer of shares, obtaining relevant information about the company on a timely and regular basis, participating and voting in shareholder meetings, electing members of the board and sharing in the residual profits of the corporation.

The Committee, therefore, recommends that as shareholders have a right to participate in, and be sufficiently informed on decisions concerning fundamental corporate changes, they should not only be provided information as under the Companies Act, but also in respect of other decisions relating to material changes such as takeovers, sale of assets or divisions of the company and changes in capital structure which will lead to change in control; or may result in certain shareholders obtaining control disproportionate to the equity ownership.

The committee recommends that information like quarterly results, presentation made by the companies or analysis may be put on company's web-site or may be sent in such a form so as to enable the stock exchange on which the company is listed to put it up on its own web-site.

I. Director's Report

As a part of the directors' report or as an addition thereto, a management discussion and analysis report should form part of the annual report to the shareholders. This management discussion and analysis should include discussion on the following matters within the limits set by the company's competitive position.

- * Industry structure and developments.
- * Opportunities and Threats.
- * Segment-wise or product-wise performance.
- * Outlook.
- * Risks and concerns
- * Internal control systems and their adequacy
- * Discussion on financial performance with respect to operational performance.
- * Material developments in Human Resource/Industrial Relations front, including number of people employed.

J. Redressal Committee

A board committee under the chairmanship of a non-executive director should be formed to specifically look into the redressing of shareholder's complaints like transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends etc. The committee believes that the formation of such a committee will help focus the attention of the company on shareholders' grievances and sensitize the management to redressal of their grievances.

K. Share - Transfer Agents

To expedite the process of share transfers, the board of

the company should delegate the power of share transfer to an officer, or a committee or to the registrar and share transfer formalities should be conducted at least once in a fortnight.

L. Compliance Report

Auditor shall certify compliance with mandatory requirements. The said certificate shall be sent to members along with the annual report. A copy of the same must also be sent to the concerned stock exchange(s).

NON-MANDATORY RECOMMENDATIONS INCLUDE:

1. Role of the Chairman of the Board

The Committee believes that the role of the chairman is to ensure that the Board meetings are conducted in a manner which secures the effective participation of all directors, executive and non-executive alike, and encourages all to make an effective contribution, maintain a balance of power in the Board, make certain that all directors look beyond their executive duties and accept full share of the responsibilities of governance. The committee is of the view that the chairman's role should in principle be different from that of the chief executive, though the same individual may perform both the roles.

2. Remuneration Committee

The committee has recommended the constitution of a Remuneration Committee which would determine the remuneration packages of the executive directors. It should comprise of at least three directors, all of whom should be non-executive directors, the chairman of committee being an independent director.

The committee further recommended that the remuneration of directors be fixed at a meeting of the committee in which all members are present.

The chairman of the remuneration committee should be present at the Annual General Meeting to answer the shareholder queries. However, it would be up to the chairman to decide who should answer the queries.

3. Consolidation of Accounts of Subsidiaries.

- * Committee felt that ICAI be requested to issue a standard on the subject expeditiously.
- * It is felt that the companies should be required to give consolidated accounts in respect of all the subsidiaries in which they hold 51% or more of the share capital.

4. Disclosure and Treatment of Related Party Transactions.

Transactions of material nature with subsidiaries, promoters/ management or their relatives. An exposure draft to this effect has already been issued by ICAI.

5. Deferred Tax Liability

Again, the committee has recommended that ICAI be requested to issue a standard on deferred tax liability at an early date.

6. Role of Management

The management comprises the Chief Executive, Executive -directors and the key managers of the company, involved in day-to -day activities of the company.

The committee believes that the management should carry out the following functions.

- * Assisting the board in its decision making process in respect of the company's strategy, policies, code of conduct and performance targets, by providing necessary inputs.
- * Implementing the policies and code of conduct of the board.
- * Managing the day-to-day affairs of the company to best achieve the targets and goals set by the board, and to maximize the shareholder's value.
- * Providing timely, accurate, substantive and material information, including financial matters and exceptions, to the board, the board committees and the shareholders.
- * Ensuring compliance of all regulations and laws.
- * Ensuring timely and efficient service to the shareholders and to protect shareholder's rights and interests.
- * Setting up and implementing effective internal control systems, commensurate with the business requirements.
- * Implementing and complying with the code of Conduct as laid down by the board.
- * Co-operating and facilitating efficient working of board committees.

7. Responsibilities of Shareholders

The effectiveness of the board is determined by the quality of the directors and the quality of the financial information is dependent to an extent on the efficiency with which the auditors carry on their duties. The shareholders

must show a grater degree of interest and involvement in the appointment of the directors and the auditors. Indeed, they should demand complete information that in case of the appointment of new director or re-appointment of a director the shareholders must be provided with the following information.

- * A brief resume of the director.
- * Nature of his expertise in specific functional areas; and
- * Names of companies in which the person also holds the directorship and the membership of committees of the board.
- * The half-yearly declaration of financial performance including summary of the significant events in last six months, should be sent to each of share holders' household.

8. Role of Institutional Investors

The institutional shareholders:

- * Take active interest in the composition of the Board of Directors, be vigilant
- * Maintain regular and systematic contact at senior level for exchange of views on management, strategy, performance and the quality of the management.
- * Ensure that the voting intentions are translated into practice.
- * Evaluate the corporate governance performance of the company.

9. Postal Ballot

Currently, although the formality of holding the general meeting is gone through, in actual practice only a small fraction of the shareholders of that company do or can really participate therein. This virtually makes the concept of corporate democracy illusory. It is imperative that this situation which has lasted too long needs an early correction. In this context, for shareholders who are unable to attend the meetings, there should be a requirement which will enable them to vote by postal ballot for key decisions. Some of the critical matters, which should be decided by postal ballot, are given below;

- a. Matters relating to alternation in the memorandum of association of the company like changes in name; objects; address of registered office; etc
- b. Sale of whole or substantial share of the undertaking.
- c. Sale of investment in the companies, where the

shareholding of the voting right of the company exceeds 25%:

- d. Making a further issue of shares through preferential allotment or private placement basis;
- e. Corporate restructuring;
- f. Entering a new business area not germane to the existing business of the company;
- g. Variation in the rights attached to class of securities;
- h. Matters related to change in management.

Role of Chartered Accountants

The role of chartered accountants in this new scenario of increased concern for good corporate governance may be grouped under the following two heads:

1. As a body.
2. As an individual/firm

As a Body

- * Setting up of accounting/auditing standards.

- * Defining technical terms and expressions so as to lend a uniform meaning and treatment (e.g. free reserves).
- * Offering expert advice on complicated matters through the existing network of expert advisory committee, taxation committee, corporate law committee, etc.
- * Helping evolve legislation relating to corporate laws and fiscal matters.

As an Individual/ Firm

- * To help evolve an effective internal check/control system.
- * Assist the audit committee as internal auditor.
- * Work in collaboration with audit committee as statutory auditor.

Conclusion

Good corporate governance is not a fad; nor is it merely a matter of ethics. It makes excellent business sense. A well-governed company enjoys the trust of investors and society - trust that builds partnerships and allows them to grow and earn more profits. Poorly governed companies may get away with it for a few years. But they invariably lose in the long term.