

CORPORATE GOVERNANCE – RESTORING THE BALANCE

2nd August, 2019

Mumbai

SUMMARY OF DISCUSSIONS

Backgrounder

It is no one's case that Corporate Governance is past its sell-by-date. With increasing allegations of investor-unfriendly behaviour by managements, promoters and so-called professional leadership, there has never before been such a crying need for sound Corporate Governance policies and practices to be put in place pronto.

At the same time, the instruments of Corporate Governance seem more than a little frayed. Audit Committees (ACs), Independent Directors (IDs), auditors and credit rating agencies (CRAs) have been the pillars on which the grand edifice of Corporate Governance has been constructed. The pillars have developed cracks that need to be fixed. Plastering the cracks will not do. Supporting structures have to be thought of. What form and shape will they take? And can it be done quickly and effectively, before IDs and auditors exit in large numbers, and CRAs think of shutting shop?

Objective of Discussions

- What exists today in the corporate world needs improvement since *inter alia* the current system is suffering from distrust. The relationship that society shares with business is premised on distrust.
- Over a period of time, to address concerns around business and Corporate Governance, certain institutional responses were thought of and implemented, so that business can be made accountable to various stakeholders. These *inter alia* included the institutions of IDs, auditors, CRAs and the like.
 - IDs were thought to be important because they were supposed to protect the interest of shareholders, especially minority shareholders.
 - Auditors were thought to be important since they would help outsiders know whether the company was financially sound.
 - CRAs too gave confidence about the soundness of financials to outsiders, and in turn helped lenders take their decisions on whether or not to lend to a company.
- There is an urgent need to strengthen and/or restore the confidence in, and credibility of, these institutions before IDs and auditors exit in large numbers, and CRAs think of shutting shop. In case that does not seem feasible, there is an urgent need for another set of responses since these institutions would seem to have failed to live up to expectations. A third alternative could be complete *laissez-faire*.
- At present, there does not seem to be a holistic solution to the issues.

DISCUSSIONS

Expectation Mismatch

Present

- There is a complete mismatch in the expectations, from IDs, auditors and CRAs, that stakeholders have, and what is supposed to be their role or what they perceive their role to be.
 - IDs are perceived by some stakeholders as bloodhounds. However, their role is to help finalise the strategy, and give a sense of direction to management.
 - Auditors are expected to uncover all possible frauds, but they have to only provide an opinion on numbers.
 - CRAs too are expected to provide an opinion about the future of the company and its instrument(s), but their role is to provide ratings on the basis of data provided to them, and the rating is ultimately a judgement.

- Unlike for IDs, the opinion of an auditor and a CRA comes with a caveat/ disclaimer stating that it is based on the information provided by the management.

Way forward

- Roles of IDs, auditors and CRAs should be properly defined so that the expectation gap can be reduced, if not eliminated.

Distrust

- A number of Indian promoters resort to cutting corners, or adopting the 'chalta hai' attitude.
- Most IDs, auditors and CRAs are aware of this. Persons and firms of the right quality and with good conscience will not associate with such companies. However, there are enough persons and firms who would be more than happy to associate with such companies. They may often explain later that they did not know about the promoter or her intentions earlier.
- Even if some good IDs and auditors are not averse to be associated with such promoters, they too can do so only with a limited number of companies since caps are imposed by law.
- Confidence has to be given to various institutions of governance for them to perform properly.

Structural Issues

- There are some structural issues in the governance framework, owing to certain laws and regulations.
- IDs in bank Boards are required to clear credit proposals. This is an executive role.
- ACs, comprising Non-Executive Directors, have to approve Related Party Transactions, which are individual transactions.
- Once CRAs are allowed to list on stock exchanges, revenue becomes important for them. As a result, they market their products, and shopping for ratings may happen. This could adversely impact on the independence of the process.
 - Similar issues exist with stock exchanges too. Stock exchange is the first level Regulator. If they list, they too have a business to run and so there could be a conflict. On paper, the regulatory side of the stock exchange reports to the Chief Executive Officer (CEO) through a dotted line relationship, but a situation of conflict cannot be avoided.

Flow of Information

Present

- Information asymmetry between management and other stakeholders was, is, and will continue to be, a huge problem.
- Information flow to the Board depends on the management.
- In some companies, managements do not provide adequate information to the Board. In such companies, even after repeated requests, if the information is not provided to the Board members, their functioning is adversely impacted. Boards must also know what to ask for.
- In some other companies, managements can resort to information overload. This too does not solve any constructive purpose, since this can be used to distract from issues that need to be discussed.
- Bringing only numbers or raw data to the Board, does not solve any purpose. They should be analysed and presented. For instance, in the absence of a proper briefing to the AC, it is difficult for the committee to understand huge spreadsheets that might be presented to it in the name of financials.

Way forward

- Information provided by management should be complete, to the point, and analysed. This would greatly help constructive deliberations at the Board level, which could lead to decision making. For agenda notes to help in constructive deliberations, they should be balanced and there should not be information overload.

Promoters

- It is assumed that promoter run companies are run only as per the promoter. This may not always be true. In a number of professionally managed companies, the persona of the CEO is larger than life, thereby impacting the true independence and performance of the Board.
- IDs, auditors and CRAs should not be overawed by the promoter/ company. This impacts on their independence.
- If a company has the right kind of institutional investors, they may help in diluting the power exerted by the promoter, and can help in promoting governance. However, while institutional activism is required, institutional adventurism must be avoided.

Different kinds of Boards

- Boards of Public Sector Undertakings (PSUs)
 - Boards of PSUs are very different from Boards of non-PSUs since in PSUs, the government takes decisions on all major items, including on appointment of IDs to such Boards. As a result, many decisions come to the Board merely for noting or for formal approval. This happens largely because the government continues to consider itself to be an owner, and not a majority shareholder.
 - Further, statutory auditors are appointed by Comptroller and Auditor General (CAG) of India, and the compensation for the auditors is very low, and is often decided by tendering process. As a result, the quality of audit is greatly compromised.
- Boards of Multi-National Companies (MNCs)
 - Most decisions for MNCs are taken by the Boards of their foreign holding companies, and the Indian Boards merely ratify or note the decisions.
 - Indian Boards are mostly expected to take care of compliance.

Independent Directors

Present

- Role of IDs
 - An ID is inducted on the Board for her experience and expertise, and not for domain knowledge.
 - The role of an ID should be to ensure that there are sufficient/ adequate checks and balances and internal controls in place within the company. She should periodically review these, but this should not be disruptive for business. She should not be held responsible for transactional matters since execution is the role of management.
 - The institution of IDs, historically, was supposed to have persons who do not have any conflict of interest vis-à-vis the company. This would help ensure that they have an independent view while taking decisions. Their role never was to get into micro details.
 - At present, IDs on many Boards are performing sub-optimally.
- Selection/ induction
 - In the past, in most companies, there was a cozy relationship between promoters, managements and IDs. IDs were chosen from the old boys club, or for their name, or because the promoter had a good relationship with her/him and so knew that she/he would not raise any questions. For IDs, it was a matter of pride to be a Director.
 - However, now times are changing. There is still a huge gap in Board composition that exists at present. This is partly because the company has not identified the skillsets that it wants on its Board.
- Agenda of meetings
 - An ID cannot be expected to perform her role properly if the flow of information to her is inadequate.
 - At present, little thought is given to agenda, agenda notes and information available to IDs, its adequacy, or time available to IDs for reading the agenda papers. Agenda is usually decided by

management or the Regulator (like in the case of banks), and the duration/ frequency of Board meetings does not often do any justice to the agenda.

- If agenda notes are tabled, it makes it impossible for Directors to derive complete benefit from them, and contribute to informed decisions.
- Posterity
 - Investigative agencies have become very active. News of mis-governance is taken very seriously.
 - It is easy to sit in judgement on a decision once it has played out.
 - It is possible that some decisions taken by a Board can go wrong, but it should not make investigative agencies take an extreme view and assume that the ID was conniving with management, and that every wrong decision was *ab initio* malafide.

Way forward

- Appointment of IDs –
 - The current system of promoters or management suggesting the appointment of an ID to shareholders is not working.
 - Government should not appoint IDs, as has been proposed from time to time.
 - Individual agencies being tasked with maintaining database of IDs will also not help, since companies rarely access such websites to identify potential Directors.
 - In the past a suggestion was made that Securities and Exchange Board of India (SEBI) should have a database of IDs from where IDs should be suggested. But this was not accepted since if something goes wrong, SEBI would be considered to have been a part of the problem.
 - There should be a constructive and independent discussion on criteria and/or skillsets that are required at the Board level, before selecting IDs.
- Getting good IDs is a challenge. The risk for them has increased. IDs can be appointed for the first term with an ordinary resolution. In the second term, by which time they have understood the business of the company and can contribute better, it requires a special resolution, and it may not always be possible to get it. As a result, Boards would have newer IDs, who may not understand the business of the company initially.
- IDs need to perform due diligence before accepting a Board position. For this, they could look at the annual report and other such similar documents of the company in public domain. If required, they could also interact with Board members and/or management persons. This should not be delegated as it is a judgement call.
- Currently, there is a huge gap in role clarity of IDs in their own minds, as well as in the minds of others. There is an urgent need for role clarity. IDs need to think about their expectation from themselves when they become an ID. This is largely missing.
 - Regulators and stakeholders should have reasonable expectations from IDs.
- In the absence of an induction programme, IDs do not get any clarity on their role or expectations from them.
 - As a result, a number of IDs do not raise the questions that they should be raising since they do not understand the agenda. In some cases, this is furthered by the fact that managements may not appreciate IDs asking questions.
- Time commitment of IDs too has to be considered. While membership of Boards of 7 listed entities (as mentioned in law) is not a problem, more time is spent in the committees of the Board, and so those should be considered while assessing the time commitment.
- Directors should send in their comments on the minutes since these are records of the meetings.
- IDs should have continual conversations amongst themselves. This need not necessarily be based on the agenda. These days with technology such as WhatsApp, IDs can have their own groups, without the presence of management, where they can communicate regularly about the company.
- Resigning from a Board is not the solution. IDs should ask for information that they require, and should assert this right of theirs.

- Companies are scared of a credible ID resigning and what it would mean for their reputation.
- Directors and Officers (D&O) Liability Insurance policy – IDs should ask for a copy of the policy, and specifically check the exclusions. The quantum of the policy alone is not important. Directors can ask companies to make a presentation in the Board meeting on the specific exclusions.

Key Managerial Personnel (KMP)/ Senior Management Personnel (SMP)

Present

- In a number of companies, managements do not take the suggestions of Board members seriously. This could be because they are perceived as not adding value.
- This could also be because the IDs and management may not share a constructive and healthy relationship.

Way forward

- It is important for management to have trust in IDs. If this happens, half the battle is won. Management will proactively bring issues to IDs if they feel that IDs will add value.
- On the part of IDs, they should be supportive of management, while constructively challenging them.
- The relationship between IDs and KMPs (other than CEO) depends largely on the CEO. KMPs usually have access to IDs at the time of Board meetings. This is not enough. If a CEO does not appreciate other KMPs directly interacting with IDs, it would adversely impact on the relationship between the IDs and KMPs.
 - If the Chief Financial Officer and the Company Secretary were to have dual reporting to the Board and the CEO, this could undermine the position of the CEO, and so this should not be done.
- In such situations, it is for IDs to take the first step so that KMPs have the confidence to reach out to IDs, if required.
 - IDs should proactively engage with management, since management understands the business of the company.
 - In addition to understanding the business, it creates a bond between them. Also, in case IDs understand ground realities, it will help them in understanding the practical challenges that the management may be facing.
- Further, in addition to the CEO, SMP should be encouraged to interact with IDs, both during and outside of Board meetings.
 - Like in United Kingdom, Indian law too should mandate a specific number of days that an ID should spend dealing with the company. This would result in IDs spending more time, beyond only attending Board meetings. This would also help in two-way communication between IDs and SMP.
- Conversations outside boardrooms help, and a number of times, informal conversations can help solve issues which formal communication may not solve.
- However, in all of this, it should not result in an alternate power centre being formed with IDs.

Auditors

Present

- There is a general feeling that if a company fails, it is because its auditor failed in detecting what was wrong with the company. This is not true.
- The auditing standards, as they exist at present, are fairly strong. It must be noted that an auditor has to make a number of judgement calls.
- An auditor is expected to certify on an increasing number of items, which may not be practically possible.
- If an auditor asks too many questions, it is frowned upon by the management and AC.

- To a large extent, the qualification of “going concern” depends *inter alia* on the reputation of the promoter. An auditor may find some major issues in the company or the projections given by the promoter or management, and hence the company being a “going concern” may be questioned.

Way forward

- It is wrong for an auditor to be too formal or too informal with the management. A number of auditors do not ask the right questions or say what needs to be said. This should change.
- Process of appointment of auditors is important. This decision is usually left to the management. A company should have the right pre-decided criteria on the basis of which the auditor should be chosen.
 - The process should be objective.
 - Size of the audit firm is not equivalent to quality. But a number of Boards feel that safety lies in appointing one of the big 4 auditing firms. They fear that if they choose any of the smaller audit firms, and in case of a problem or a failure, they may be questioned about their choice.
 - The selection should not be based on pricing alone. Factors such as integrity and honesty of the firm are very important, and should be given importance.
 - The decision to appoint an auditor should not be with the government, as has sometimes been suggested.

Credit Rating Agencies

Present

- The process for rating a company or its instrument(s) has a number of steps. It is based on discussions with management, past actions of management and documents of the company. But ultimately the rating is a judgement of the CRA.
- If management is not truthful to the CRA, it would be very difficult for the CRA to find it out. Over time, a CRA builds capabilities and could be in a position to call the bluff of management.
- Earlier a company could get a rating, and keep the information to itself if it was not favourable. However, now it is mandatory to make all ratings public.

Way forward

- Kneejerk reactions by Regulators is harming CRAs.
 - The proposal to have a SEBI appointed nominee Director on the Board of every CRA is wrong. Boards of CRAs do not deal with individual ratings. Such appointment would also undermine the existing IDs on the Board.
 - There is also a proposal that if CRAs give AAA rating to a company, it should certify that the company would not default for at least 2 years. However, it is unrealistic for a CRA to certify this. It is understood that such a requirement does not exist in other countries.

Regulators

Present

- More Rules and Regulations are not the answer. If all stakeholders act in the interest of the company, change will happen.
 - Companies/ persons who want to find a way around law or regulations, will almost always find a way.
- In the current environment, regulators have been making frequent changes to law and regulations. These are seen as kneejerk reactions, as responses to specific cases.
 - For instance, AC certifying on cyber security seems to be unreasonable, since it is beyond the competence of the committee.
- Exiting from the company should be the last resort for IDs, auditors or CRAs. But at the same time, they should not be made to feel that exiting a company, in case the situation warrants, would be near impossible (as is currently being contemplated).

Way forward

- Instead, a holistic solution should be attempted to address the problems. Regulators should focus on solving problems/ issues. It should not be about persons, but about problems.
- Regulators have a social responsibility too, and they should not impose Regulations without considering their implications, including cost implications, in totality.
- There is an urgent need for a regulatory impact assessment for the existing laws and regulations, before newer ones are introduced.

Whistleblower mechanism

- Genuine whistleblowers are a great help. However, whistleblowers will have to be provided safety and security, else the mechanism would not succeed. As of now, only a few companies have functional whistleblower mechanisms.

Video Recording of Board Meetings

- All Board meetings should be video recorded, with timestamp.
- This would help in transparency and would help in protecting Board members.
- It would also promote more serious and focussed discussions in meetings.
- It is possible that some Board members may speak only to be recorded. In such situations, the Chair of the meeting will have to exercise her powers to prevent such persons from holding forth endlessly.
- Such recordings will have to be kept confidential and safe.
- However, companies will have to be careful about the items being considered in the meeting since the legal framework requires the company to disclose any major move being contemplated by the company. Also, with restrictions on unpublished price sensitive information (UPSI), companies would have to be additionally careful.
- Going forward, this could also aid in Board evaluation, to differentiate between performing and non-performing Directors.

Board Portals

- There should be a backup for information available on Board portals since the access to it is restricted once a Director resigns from a Board. She could ask the company, but there would be a time lag in receiving the information.

Culture

- The role of culture in promoting the right environment, which promotes Corporate Governance, cannot be undermined.
- Importance has to be given to building the right culture in the company.
- Tone set at the top has to travel throughout the company, and has to become the DNA of the company. Corporate Governance cannot flow only from the Board, through its quarterly Board meetings.
- Ability to ask the right questions, even at the lowest levels in the company, requires a huge cultural change. It can happen only over time. Asking the right questions does not seem to come naturally.

Role of Chairperson

- The deliberations in Board meetings depends on the Chairperson.
- Capability and quality of the Chairperson is very important and has a huge impact on the functioning of the Board.
- The stature of the Chairperson or the size of the company can prevent IDs from talking to each other/ raising the right questions. The Chairperson has a huge role to ensure that this does not happen.
- The Companies Act, 2013 has a provision whereby the Chairperson is given the right to decide what should / should not be included in the minutes of the meeting, if it not in the interest of the company. If this provision is misused, this can have far reaching consequences.

Governance Premium

- In India, there is no/ limited correlation between the market capitalisation of a company and the quality of its Board.
- While there is some proof that a governance premium exists in India, it is not as much as it is in some other countries.

Environment Social and Governance (ESG)

- Corporate Governance alone is not important.
- Companies should focus on the ecosystem in which they exist. Society and sustainability should be important considerations while taking decisions.

EXCELLENCE ENABLERS

CORPORATE GOVERNANCE SPECIALISTS
ADDING VALUE, NOT TICKING BOXES

EXCELLENCE ENABLERS PRIVATE LIMITED

Excellence Enablers Private Limited (EEPL) is an initiative that focuses on implementation of better corporate governance practices, improvement of Board performance, including audit and evaluation, training of directors and engagement with stakeholders of governance. It is founded on the firm belief that the gap between performance and potential can, and must, be bridged. Consistent with that belief, all our offerings are tailor-made to the specific needs of the organisation or the individuals concerned.

Given that our founder, Mr. M. Damodaran, introduced Clause 49 of the Listing Agreement, dealing with corporate governance in India, and has been a part of both public sector and private sector Boards, as well as performing and underperforming Boards, we offer experience based consultancy and courses on the journey from compliance through governance to performance. Further, given his success in turning around organisations that had been written off, we are uniquely positioned to offer courses on leadership, organisational transformation, and building winning teams.

EEPL has a number of highly experienced and renowned consultants and faculty members who have helped, and continue to help, us deliver programmes that have been well received.

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