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(AN M. DAMODARAN INITIATIVE)

Expert Expressions
Corporate Governance Demystified

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FOULS, PENALTIES AND GOALS

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It is time for stocktaking. Some shenanigans surfaced during the year. With lessons learned, we look forward with hope.

At the outset, we at Excellence Enablers wish you and your loved ones a very happy, healthy, peaceful and enriching New Year.

Omar Khayyam in his Rubaiyat propounded the philosophy "Unborn tomorrow, dead yesterday, why fret when today be sweet". Many modern Gurus have also counselled their followers that one must "live in the moment", and not spend too much time on what has already transpired, and what is likely to happen, going forward. While this view might receive approbation from those unwilling to take note of the past and the future, this is an approach that ignores, at its peril, knowledge from the past.

2022, the year of the World Cup, witnessed, in the corporate arena, a number of fouls, penalties and goals (scored by the Regulator). The lessons therefrom are extremely useful in looking at what lies ahead in the corporate universe. In a calendar year crowded with controversies, some clearly stood out.

In quick succession, Independent Directors (IDs) of the finance subsidiary of a public sector undertaking resigned from their Board positions. Shortly thereafter, one witnessed resignations from the Board of the parent company. The attitude of the management was dismissive, to the say the least. Unlike in the case of many other companies, the departing Directors chose to record, in considerable detail, the reasons why they were leaving. Briefly stated, the management made it difficult for them to continue to stay on the Board with self-respect, and the feeling that they could contribute to the performance and growth of the company, while respecting governance norms and practices.

The standoff between the management and the Board was a fairly common phenomenon in the year gone by. In one case, the Founder and his wife were accused of cheating and embezzlement. Their response has been to blame

themselves for induction of the “wrong” (inconvenient?) person as Director, and then as Chairman. Needless to state, the days ahead will witness even more dirty linen being washed in public.

One company which had a very successful public issue, decided to issue bonus shares, at a time when the share prices had tanked. Questions have been raised as to whether the IDs failed in looking at governance matters relating to the bonus issue.

While these were instances of the existence of Directors not being tolerated, one company appointed at least 15 employees as Directors, and made them shareholders of shell companies. Interestingly, some former employees were inducted as Directors by using their digital signatures, after they had left their jobs. Whose graves will these digital signatures dig?

CEOs were also in the spotlight for the wrong reasons. The shareholders of one private bank filed a requisition to conduct an Extraordinary General Meeting to curb the spending powers of the CEO. Yet another company fired its Co-founder, following an independent forensic audit into allegations of serious financial irregularities. There was of course the celebrated case of one MD and CEO being guided by an alleged Yogi, with the Himalayan ranges as his last known address.

Auditors were also in the news for the wrong reasons. The most recent instances are the sanctions being imposed on two of the Big 4 by the USA’s Public Company Accounting Oversight Board (PCAOB) and UK’s Financial Reporting Council (FRC) respectively, with the Indian media largely ignoring this finding by overseas Regulators. Nearer home, the National Financial Reporting Authority (NFRA) has questioned the professionalism and the independence of audit partners in large firms, and levied penalties, including, but not limited to, their not being allowed to practice for specified periods.

What do these instances portend? As long as greed influences human conduct and decision-making, there will be transgressions, and even very obvious violations of laws and regulations. It is of utmost importance that in such cases, the delinquents should be quickly identified, and given exemplary punishment. This would in turn require the strengthening of regulatory capacity, both in terms of numbers, as well as in terms of skillsets of contemporary relevance. Is this something that can be looked forward to in 2023? There is always the hope, but expectations, based on experience, do not measure up.

2022 also saw many changes and additions to regulations, initiated by the Regulators, especially the securities markets Regulators. Consultation papers flew thick and fast, leaving it to market participants and others involved to quickly respond to proposed changes in regulations that might, going forward, adversely impact them. While in most cases, a consultative process was followed, there is no clarity as to how many suggestions were received, and how many of them were considered, and either accepted or not agreed to. An empty consultative process is, to put it bluntly, a waste of time for all concerned. Twists and turns are also not unknown in the regulated space. For example, with great fanfare, SEBI put out a two-stage approval process for the appointment of IDs. There was expectedly some pushback, with corporates contending that the new process would add to expenditure, without any significant benefits being gained therefrom. The two-stage process was abandoned during the consultation process, but following the maxim “what you lose on the swings, you gain on the roundabout”, SEBI came up with a single stage approval process, however, involving approval by 75% of the shareholders. This revised approval structure has been in place for only a few months. Meanwhile, SEBI has proposed to go back to a modified two-stage approval process on the lines initially suggested. Was this a case of “regulate in haste, and revise at leisure?”

Consistent with the philosophy of “Vasudhaiva Kutumbakam”, SEBI expanded the universe of related parties. Resultantly, a new category of Related Party Transactions (RPTs) have come into being. There is more that needs to be taken to the shareholders for approval. Will Boards and Audit Committees become passthrough agents over a period of time?

Not surprisingly, much of the focus of regulations and Regulators remained on IDs. In a recent prescription, SEBI has mandated that when a company is seeking to access the public market, the IDs should pronounce on the appropriateness of the issue price. Pricing of an IPO is a complex issue, and persons without expertise should not be tasked with deciding on such matters. Would it be reasonable to assume that better sense will prevail, and the remit of the IDs would be reduced to what they can, and should, handle? The revolution of rising expectations, consequent on such prescriptions, could deal a death blow to the institution of IDs.

Yet another gem from the Regulator's treasure chest has been the suggestion that corporates should comment on every matter that appears in the print media, and in the social media. It is not unknown that the media, to increase readership, or to gain more eyeballs, sometimes put out sensational news items, which are without any basis. Would it not be preferable to leave it to the corporate to decide what reports to comment on in some detail, and what to brush aside or ignore as baseless? The proposed regulation could lead to a Department of Media Responses being created in the larger companies.

Market Infrastructure Intermediaries (MIIs) also received some attention. As against 50% of the Board comprising IDs, as at present, it has now been suggested that 75% on the Board should be IDs. What additional value this would add is a matter that needs to be clarified. By now, it is recognised that a majority in the Board is often not the best way to determine what is relevant and productive.

Happily, 2022 also witnessed a fair measure of stakeholder activism. Proposals for enhancement of executive compensation did not sail through unchallenged, as they did in the past. With a few resolutions for enhancement of executive compensation being turned down by the shareholders, at least in the first instance, it became abundantly clear to the corporates that unless there is justification spelt out in adequate detail in the resolutions, they should not expect the passing of these resolutions to be a cakewalk.

The year gone by also saw significantly increased attention being paid to the identification of risks, and the management of such risks. Covid-19 has, in some quarters, been given credit for risk becoming centre stage, forcing Boards and managements to look at employee heath and welfare, and the ensuring of business continuity, as important tasks. There has been considerable discussion and debate on the issue of cyber security, and the steps required to identify the systemic weaknesses, and to shore up the defences against any such attacks. As the year wound to a close, India's premier hospital had a massive cyber security attack on its systems. This reportedly affected the smooth functioning of the hospital for at least 2 weeks, and considerable patient information was reportedly compromised. It would be useful to reflect on the possible consequences of such an attack on a large entity in the financial sector, and the damage it could do to the health of the sector.

Adverse commodity prices and supply side shocks were also witnessed by many companies. Consequent on the Russian invasion of Ukraine, companies had to scramble to address these issues. The non-availability of chips was a major setback to the manufacturing sector. The fact that these concerns were addressed, and the ship was kept on even keel, redounds to the credit of managements and Boards.

Sustainability became a part of the active vocabulary of most corporates and stakeholders. Recognition that India needs an ESG approach, that is consistent with its ground realities, is increasingly gaining currency. This too is expected to play out significantly in 2023 and the subsequent years.

A lot of what has transpired, in the year gone by, should lead us to reflect on whether we need to travel down the path of increased prescriptions and micromanagement by Regulators. Would it not be far more value-adding if Boards were appropriately composed, and left to determine what should be done to promote Corporate Governance, while seeking to increase business, and add to the profitability? There are obviously no easy answers. What is clear is that more regulations, which would usher in more processes and disproportionate time invested by senior managements on compliance matters, is not a worthwhile option. At the end of the day, regulations that are clear, written in simple language, and have continuity as a major element, will alone deliver what stakeholders expect from corporate entities. Winter is going. Spring is round the corner.

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