Making Corporate Governance Work

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The global financial crisis exposed the inherent weaknesses in the way corporates functioned and highlighted the urgent need to strengthen the Board oversight. The excesses committed during the pre-crisis period could only be attributed to the lack of adequate oversight by the Board and their lack of basic understanding of business the financial institutions had got into.

Most listed companies follow the regulatory requirements as regards number of independent directors on a company board and various Board committees.What is missing is the real independence amongst independent directors. These directors get re-elected year after year, over-stay and there is no rotation policy for such directors. This comfortable "old boys club" does not restrain very ambitious CEOs from venturing into very risky businesses that either destroy companies or threaten its very existence. It is time boards got truly independent directors, who take a principled stand on issues.

There is anecdotal evidence that companies that adopt good corporate governance practices are:

- more successful than competition
- respected by society
- courted by investors
- liked by employees, and
- last longer.

A disciplined and voluntary self-governance approach can be adopted by any company, but voluntary action alone is not adequate to protect the interests of vast number of stakeholders. Regulators need to provide that strong deterrent by constantly updating various legislations and we also need shareholders, especially the institutional shareholders, given their clout, to actively engage with management of the company.

I have listed various ways in whichkey custodians i.e. a) independent directors, b) Institutional shareholders and c) regulators can add significant value to improve corporate governance standards.

Role of Independent Directors

The need for Independent Directors at publicly-listed companies arises from the need to be fair to all categories of shareholders. Independent Directors are expected to act in the best interest of the company and not in the best interest of one set of shareholders, especially the promoters. They can add significant value to a company by ensuring that the following issues are discussed and deliberated in a Board meeting regularly:

Risk Management

We see many examples of companies presenting a number of pages on risk management in their Annual Reports but when you take a little deeper look, you realise that it is purely an academic exercise. Companies that do not ingrain risk management approach in operating units / entities and use it as a mere lip service can face enormous trouble when the economic environment in which it operates suddenly changes, which is not uncommon.

Risk assessment and mitigation should top the Board agenda. Board should ensure that the entire risk management process is institutionalized by setting up of a separate risk committee of the Board and appointment of one of the senior management members as a Chief Risk Officer. The independent members of the Board should ask searching questions on all aspects of business and Board should insist on regular review of all critical risks including those concerning company's reputation.

Mergers and acquisitions (M&A)

The Board should review all M&A proposals in great detail as it is a common knowledge that most of the M&A transactions destroy company value. Without second guessing the management on the need for M&A, it should assess whether the company has a documented approach to M&A, clearly defined roles and responsibilities pre and post-acquisition, set key time bound milestones for the new business and fixed accountability by appointing a CXO level / senior management member for successful integration of new business.

The Board should ask the executive management to present a summary of all acquisitions including projections made and actual results, every quarter. This review would help the Board to assess the ability of the senior management team to plan and forecast, which in turn would help in evaluating new M&A proposals.

Board's self-assessment

While a competent Board is critical to company's success, its effectiveness can be further enhanced by instituting a process of Board's self-assessment. The Board and its committees should evaluate its performance against the charter and should also review the attendance record of independent directors, time spent by them outside meetings on company matters, contribution made / value added in deliberations etc. This annual evaluation should be done jointly by the lead independent director and the senior most executive director.

Audit Committee- Audit committee members need to follow the steps given below, at a minimum, to ensure accuracy of financial statements

a) Independent discussions with auditors and CFO, separately

Audit committee members, through their independent discussions with statutory and internal auditors, should specifically get an assurance that the promoter group and / or the executive management team have not fraudulently tried to divert company resources for personal gain. They should also meet the CFO / senior most finance member of the company independently to get similar feedback. Even though the regulations around related party transactions have been tightened over the years, this continues to be the most abused area. Audit committee should ask the company management to present all related party transaction details every quarter with adequate justifications.

b) Accounting policies and estimates

Audit committee members need to critically assess the accounting treatment in cases where two or more positions could be taken and be comfortable with the appropriateness of the final decision. It is also important to review the consistency in application of accounting policies and estimates as well as the need and justification for any changes proposed in the current year.

c) Positive assurance from executive management team

As company businesses are growing rapidly and becoming extremely complex it is important that the audit committee seeks positive written assurance not only from the CEO & CFO but also from people responsible for running various business units that they are not aware of any financial / accounting irregularities. This will help avoid negative surprises in future. Companies should also establish a whistle blower policy andpublicize that at regular intervals.

d) Independent confirmation of cash and bank balance

While proper accounting and control of cash and bank balances / investment of surplus funds is a very basic requirement, one should remember that a number of high materiality frauds have been detected in this area. Audit committee members should instruct statutory auditors to seek direct independent confirmation of balances from all banks and mutual funds, without fail, every quarterand communicate that to the committee.

e) Compliance with statutory regulations

Audit committee should seek a confirmation from management and auditors that the company is complying with statutory regulations in India and all overseas markets, where the company operates. It should insist on setting up of a proper compliance framework and seek regular updates on violation / penalties, if any.

Compensation Committee–

Members of the compensation committee have the onerous task of ensuring that executive directors and key officers' compensation is competitive and it is benchmarked correctly. There is a growing trend to pay astronomical compensation to promoters who are also actively involved in managing business.

We have a number of examples in Indian corporate world such as, the promoter of a leading Television network got a compensation of over Rs. 65 crores and the compensation of all family members of the promoter group at a leading automobile company is over Rs.100 crores. Such large compensation payouts to promoter directors are not fair compared to compensation paid to professional managers.

In principle, founders / promoters have to take as much compensation as any other professional manager would. Also, the promoters should largely be rewarded through dividends, which is equitable to all shareholders

The remuneration paid to the independent directors and their reappointment is also a point of great debate. The independent directors should not compromise their position / independence by seeking higher remuneration and ensure that a proper benchmarking exercise is done before their remuneration is fixed. They should also recuse themselves from any discussion in this regard and not take higher increases than what has been awarded to the senior professional executive management team. As regards their reappointment, dominant shareholders' vote should not be counted to ensure real independence.

The promoter directors and independent directors can really set the bar high by disclosing compensation details as well as the rationale for determining their compensation.

Role of Institutional shareholders

Indian institutional investors need to collaborate and take a principled stand on many issues. Institutional investors should collaborate in raising their voice against bad behavior by companies. There should be positive engagement between companies and institutional investors to bring about change.

Global long-only investors - pension funds, mutual funds, endowments, foundations, etc. - have detailed guidelines and send annual letters to companies on what they expect of their investee companies from a corporate governance perspective. Indian institutional investors also need to adopt such best practices. Also, Indian institutional investors need to recognize that adopting good corporate governance practices is not such a series of "events" or just shareholder meetings of their investee companies, but is a regular day-to-day risk management for their entire portfolio. Needless to say, corporate governance score should be an integral part of their investment decision making.

As a part of their fiduciary responsibility to their investors and to the capital markets, they should work with regulators to streamline infrastructure bottlenecks in the voting process and bring about change in regulations. Isn't it a surprise that the Adi Godrej committee set up by the MCA to arrive at a comprehensive policy framework to enable corporate governance of highest quality in all classes of companies without impinging on their internal autonomy doesn't have any representation from the institutional investors?

Role of Regulators

Regulators should adopt global best practices. The Companies Bill 2011 is still not an Act, and has gone through many rounds of consultations. The Companies Bill 2011, while bringing out much needed change, will still fall short on many counts like rotation of auditors, streamlining of voting process, differential classes of shares etc.

SEBI and the exchanges need to work on many counts to make Indian capital markets investor-friendly and punish errant companies. SEBI and the exchanges need to enforce regulations zealously.

Insider trading is one large area that needs attention by SEBI. In the US, the SEC makes examples of high-profile executives so that it acts as a deterrent to other executives and insiders.

Disclosures by companies are still sketchy. During restructurings, companies should clearly disclose all aspects of the transaction envisaged: the detailed financial statements of all involved entities, the consideration paid/received, the party involved in the transaction, the timing of the transaction, the valuation report, etc. Taking refuge in the Companies Act, and asking shareholders to come and inspect the financial statements at the registered office, isn't an investor-friendly practice. In this day and age, these documents should be in electronic format, prominently displayed on the company website and accessible to investors at large.

Notices and agendas are the key documents for any shareholder meeting. Many companies don't make these documents available in electronic format, nor are stock exchanges rigorously censuring companies for not putting out the notices and agenda as a corporate announcement at least 21 days ahead of the meeting. Even large institutional investors - with all their resources - find it hard to obtain meeting agendas much ahead of the meeting.

Independent directors, Institutional investors and regulators should work towards espousing better corporate governance practices, which in turn, will contribute to widening and deepening the Indian capital markets.