CORPORATE GOVERNANCE: Legal and Institutional Framework©

Vinod Dhall
Member and Actg Chairman
COMPETITION COMMISSION OF INDIA

at

Masterclass for Directors

25 November 2007

Corporate Governance

- Has grown enormously in recent years:
- Conceptually
- Geographically

- Cadbury: in a short time has moved extraordinarily from obscurity to ubiquity

"Corporate Governance is .... Holding the <u>balance</u> between economic and social goals and between individual and communal goals. The Governance framework is there for the <u>efficient use of resources</u> and equally to require <u>accountability</u> for the stewardship of those resources. The aim is to <u>align as nearly as possible</u> the <u>interests of individuals, corporations and society</u>. The incentive to corporations is to achieve their corporate aims and to attract investment. The incentive for states is to strengthen their economies and discourage fraud and mismanagement".

Sir Adrian Cadbury

Why Corporate Governance?

- Corporate failures
- Expanding scale/size of businesses
- Increasing numbers of stakeholders
- Globalisation
- Privatization of Government entities
- M&As, strategic alliances
- Regulatory requirements/expectations
- Societal concerns, social audit, CSR

Global Initiatives

Several Committees/organisations have studied CG Issues-

- Sir Adrian Cadbury Committee on Financial Aspects of Corporate Governance (1992),**UK-*Effective Board, Independent Directors, Audit Committee, Remuneration Committee.* (Comply or Explain)**
- Mervyn E. King's Committee on Corporate Governance(1994),**South Africa-*similar issues***
- Greenbury Committee on Directors' Remuneration (1995),**UK-*Full disclosure, robust policy on compensation commitments***.
- California Public Employees Retirement System - Global Corporate Governance Principles (1996),**USA**-***Accountability***
- Business Round Table (BRT) Statement on Corporate Governance (1997),**USA-*No one size fits all, substance important, independence of directors***

Global Initiatives (Contd.)

- Hampel Committee on Corporate Governance (1998), UK –***not merely prescriptive, but substance; combined code comprising 17 main principles, 26 supporting principles, and 47 provisions; adopted by Listing Authority though not yet compulsory but companies must state why not followed.***
- Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (1999),USA-***independence of audit committee, independent directors, detailed Directors' Report.***
- Commonwealth Association for Corporate Governance Principles for Corporate Governance in Commonwealth (1999)-***15 general principles***
- Higgs Review of the Role and Effectiveness of Non Executive Directors (2002), **UK**-***half independent directors, separate Chairman and CEO, nominations committee, induction training for independent directors***.
- OECD Principles of Corporate Governance (2004)
- World Bank ***-GFCG***

India- reviews by committees

- CII Code of Desirable Corporate Governance, 1998 *-first effort, max 10 companies, audit committee*
- Kumar Mangalam Birla Committee on Corporate Governance,2000, SEBI *-half NEDs, audit committee, remuneration committee, consolidated a/c*
- N R Narayana Murthy Committee on Corporate Governance, SEBI- *ethical dimension, training of directors, code of conduct, risk management, directors' report, whistle blower*
- Naresh Chandra Committee on Audit and Governance, *MCA*
- Dr. J J Irani Committee on New Company Law, *MCA*

Naresh Chandra Committee

- IDs-at least half
- IDs-criteria (9 yrs, shareholding, past employment, etc)
- Audit committee charter
- Auditor independence-criteria: non audit work, material dependence on company, rotation
- Auditor–disciplinary process
- Video/audio conferencing

Irani Committee on Board Governance

- Board to exercise strategic oversight
- Emphasised role of IDs
- Min one-third IDs, excl nominee directors
- Suggested attributes of IDs
- No more than 15 directorships
- Disclosure of remuneration
- Audit committee: majority IDs, chairman also ID
- Shareholders' Committee; Remuneration Comm.
- Include basic duties of Director in law

CII Code

First private institutional effort

- Be adopted by Board
- Emphasizes fiduciary responsibilities
- Professional NEDs, be active participants, not passive advisors
- Clear responsibilities, eg audit committees
- Legal compliance

CII- model code

- Act honestly, fairly, ethically and with integrity
- No improper advantage
- Deal fairly with all stakeholders
- Not use company position for personal gain
- Not accept/ give gifts
- Act in good faith

CII Code (Contd.)

- Not to misuse information
- Enhance company reputation
- Disclose personal interest
- Abstain in case of conflict of interest
- Respect confidentiality
- Create culture of ethical conduct

GOI Measures

- 1999 amendments-*IEPF, unpaid dividend a/c, nomination of shares*
- 2000 amendments:*big leap-audit committee, postal ballot, directors' responsibility statement, disqualification of directors*
- Vanishing companies' prosecution
- Serious Fraud Investigation Office; investigations by CAs
- E-Governance

SEBI Measures

- SEBI introduced through Listing Agreement Clause 49
- Revised existing Clause 49 in Oct,2004
- Revised Clause came into effect from January 1, 2006

Highlights of revised Clause 49

Applicability

- Clause 49 applicable to:

(a) Entitles seeking listing for first time, at time of seeking in-principle approval for listing.

(b) Existing listed entitles having paid-up share capital of Rs. 3 crores and above or net worth of Rs. 25 crores or more at any time in history of company.

- For other listed entities, which are not companies, but body corporates (e.g. private and public sector banks, financial institutions, insurance companies, etc.) incorporated under statutes other than Companies Act, 1956, revised clause will apply to extent it does not violate respective statutes, guidelines or directives issued by relevant regulatory authorities.
- Clause not applicable to mutual funds.

Composition of Board

- Board to have optimum combination of executive and non-executive directors
- Not less than fifty per cent of Board should comprise non-executive directors
- In case Chairman is executive, at least half of Board should comprise of independent directors
- In case Chairman is non-executive, at least one-third of Board should comprise of independent directors

Independent Director

Independent Director has been defined:

- Non-executive director who apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates, which may affect the independence of the director
- is not related to promoters or persons occupying management positions at board level or one level below board;
- has not been an executive of the company in immediately preceding three financial years;

Independent Director (contd.)

- is not a partner or an executive or was not partner or an executive during the preceding three years, of any of the following:
  - the statutory audit firm or the internal audit firm that is associated with the company;
  - the legal firm(s) and consulting firm(s) that have a material association with the company.
- is not a material supplier, service provider or customer or a lessor or lessee of the company which may affect independence of director; and
- is not a substantial shareholder of company, i.e. owning two percent or more of block of voting shares.
- Nominee directors appointed by institution which has invested in or lent to the company to be deemed independent directors.

Additional Definitions

- Definitions of Associate, Senior Management, Relative have been incorporated. These definitions are as under:
- "Associate" shall mean a company which is an "associate" as defined in Accounting Standard (AS) 23 - "Accounting for Investments in Associates in Consolidated Financial Statements", issued by the Institute of Chartered Accountants of India.

Additional Definitions (Contd.)

- ”Senior management” shall mean personnel of the company who are members of its core management team excluding Board of Directors. Normally, this would comprise all members of management one level below the executive directors, including all functional head.
- Relative shall mean “relative” as defined in section 2(41) and section 6 read with Schedule IA of the Companies Act, 1956.

Non executive directors' Compensation and Disclosures

- All fees/compensation, if any paid to non-executive directors, including independent directors, required to be fixed by Board;
- Requires previous approval of shareholders in general meeting; unless sitting fee within limits prescribed under Companies Act.

Code of Conduct

- Board shall lay down Code of Conduct for Board Members and Senior Management.
- Board members and senior management required to affirm compliance with the Code on annual basis.
- Annual Report of the company required to contain declaration to this effect signed by CEO.

Board Meetings

- At least four meetings in a year
- Maximum time gap of four months between any two meetings.

Audit Committee

- Board to lay down TOR of Audit Committee.
- Two thirds of members of audit committee must be independent directors.
- All members of audit committee should be financially literate; term "financially literate" defined.
- At least one member shall have accounting or related financial management expertise.

Audit Committee (contd.)

- At least four meetings in a year
- Not more than four months shall elapse between two meetings.
- Quorum: either two members or one third of members, whichever is greater; but minimum of two independent members.

Audit Committee-Role

Includes:

1. Oversight of company's financial reporting process and disclosure of its financial information to ensure that financial statement is correct, sufficient and credible.
2. Recommending to Board: appointment, re-appointment and, if required, replacement or removal of statutory auditor and fixation of audit fees.
3. Approval of payment to statutory auditors for any other services rendered.
4. Reviewing, with management, annual financial statements before submission to board, with particular reference to:

Audit Committee Role(Contd.)

a) Matters required to be included in Director's Responsibility Statement
b) Changes, if any, in accounting policies and practices and reasons for same
c) Major accounting entries involving estimates based on exercise of judgment by management
d) Significant adjustments made in financial statements arising out of audit findings
e) Compliance with listing and other legal requirements relating to financial statements
f) Disclosure of any related party transactions
g) Qualifications in draft audit report.

Audit Committee Role (Contd.)

5. Reviewing, with management, quarterly financial statements before submission to the board for approval
6. Reviewing, with management, performance of statutory and internal auditors, adequacy of internal control systems.
7. Reviewing adequacy of internal audit function, if any, including structure of internal audit department, staffing and seniority of official heading the department, reporting structure, coverage and frequency of internal audit.
8. Discussion with internal auditors any significant findings and follow up.

Audit Committee Role(Contd.)

9. Reviewing findings of any internal investigations by internal auditors into matters where there is suspected fraud or irregularity or failure of internal control systems of material nature and reporting matter to board.
10. Discussion with statutory auditors before audit commences, about nature and scope of audit as well as post-audit discussion to ascertain any area of concern.
11. To look into reasons for substantial defaults in payment to depositors, debenture holders, shareholders (in case of non payment of declared dividends) and creditors.
12. To review functioning of the Whistle Blower mechanism, in case the same is existing.
13. Carrying out any other function as is mentioned in TOR of Audit Committee.

Audit Committee-Review of Information

Audit Committee shall mandatorily review following:

- Management discussion and analysis of financial condition and results of operations;
- Statement of significant related party transactions (as defined by the audit committee), submitted by management

Audit Committee-Review of Information (Contd.)

- Management letters / letters of internal control weaknesses issued by statutory auditors
- Internal audit reports relating to internal control weaknesses
- Appointment, removal and terms of remuneration of chief internal auditor.

Subsidiary Company

- At least one independent director on Board of Directors of holding company should be a director on Board of material non-listed Indian subsidiary company.
- Audit Committee of holding company should review financial statements, in particular investments made by unlisted subsidiary company.
- Minutes of Board meetings of unlisted subsidiary company required to be placed at Board meeting of holding company.

Subsidiary Company (Contd.)

- Management should periodically bring to attention of Board of holding company, statement of all significant transactions and arrangements entered into by unlisted subsidiary company.
- “Significant transaction or arrangement” defined.
- Where listed holding company has listed subsidiary which is itself a holding company, above provisions also apply to listed subsidiary insofar as its subsidiaries are concerned.

Disclosures

Following additional disclosures required under revised clause:

- Basis of Related Party Transactions
- Disclosure of Accounting Treatment
- Risk Management
- Proceeds from public issues, rights issues, preferential issues, etc.
- Remuneration of Directors

CEO/CFO Certification

- CEO, i.e. Managing Director or Manager appointed in terms of Companies Act, 1956 and CFO i.e. whole-time Finance Director or any other person heading finance function or discharging that function required to give certification that -

  (a) They have reviewed financial statements and cash flow statement and that to the best of their knowledge and belief :

CEO/CFO Certification (Contd.)

- these statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading;
- these statements together present a true and fair view of the company's affairs and are in compliance with existing accounting standards, applicable laws and regulations.

CEO/CFO Certification (Contd.)

(b) There are, to the best of their knowledge and belief, no transactions entered into by the company during the year which are fraudulent, illegal or violative of company's code of conduct.

(c) They accept responsibility for establishing and maintaining internal controls for financial reporting and that they have evaluated the effectiveness of internal control systems pertaining to financial reporting and they have disclosed to auditors and the Audit Committee, deficiencies in the design or operation of internal controls, if any, of which they are aware and the steps they have taken or propose to take to rectify these deficiencies.

CEO/CFO Certification (Contd.)

(d) They have indicated to the auditors and the Audit committee —

- significant changes in internal control over financial reporting during the year;
- significant changes in accounting policies during year and that the same have been disclosed in notes to the financial statements; and
- instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or an employee having a significant role in the company's internal control system over financial reporting

Compliance Certificate

- Company required to obtain certificate from either auditors or practising company secretaries regarding compliance of conditions of corporate governance as stipulated in this clause.
- Certificate required to be annexed with directors' report.
- Same certificate required to be sent to Stock Exchanges along with the annual report.

Quarterly Compliance Report

- Companies required to submit quarterly compliance report to stock exchanges within 15 days from the close of quarter in prescribed format.
- Report required to be signed either by the Compliance Officer or by CEO.

Non Mandatory Requirements

Tenure of Independent Directors

- Independent Directors may have tenure not exceeding, in the aggregate, period of nine years on the Board.
- Company may move towards a regime of unqualified financial statements.

Remuneration Committee

i. Board may set up a remuneration committee to determine on their behalf and on behalf of shareholders with agreed TOR, the company's policy on specific remuneration packages for executive directors including pension rights and any compensation payment.

ii. To avoid conflicts of interest, remuneration committee may comprise of at least three directors, all of whom should be non-executive directors, the Chairman of committee being an independent director.

Remuneration Committee (Contd.)

i. All members of remuneration committee could be present at the meeting.
ii. Chairman of remuneration committee could be present at AGM, to answer shareholder queries. However, it would be up to Chairman to decide who should answer queries.

Training of Board Members

- A company may train its Board members in the business model of company as well as risk profile of its business parameters, their responsibilities as directors, and best ways to discharge them.

Mechanism for evaluating non-executive Board Members

- Performance evaluation of non-executive directors could be done by a peer group comprising entire Board, excluding director being evaluated and Peer Group evaluation could be mechanism to determine whether to extend / continue terms of non-executive directors.

Whistle Blower Policy

- Company may establish mechanism for employees to report to management concerns about unethical behaviour, actual or suspected fraud or violation of company’s code of conduct or ethics policy.
- Mechanism could also provide for adequate safeguards against victimization of whistle blower, and also provide for direct access to Chairman of Audit Committee in exceptional cases.
- Once established, existence of mechanism may be appropriately communicated within organization.

REPORT ON CORPORATE GOVERNANCE

- There shall be a separate section on Corporate Governance in Annual Report, with detailed Compliance Report.
- Non Compliance of any mandatory requirement of Clause 49 with reasons thereof should be highlighted.
- Extent to which non-mandatory requirements have been adopted should also be highlighted in Report.

THANK YOU