Business Law for Managers
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Module-2: Corporate Governance

Lecture – 10
Corporate Governance a Way Forward

Good evening. Model 2, lecture 10 Corporate Governance a way forward.

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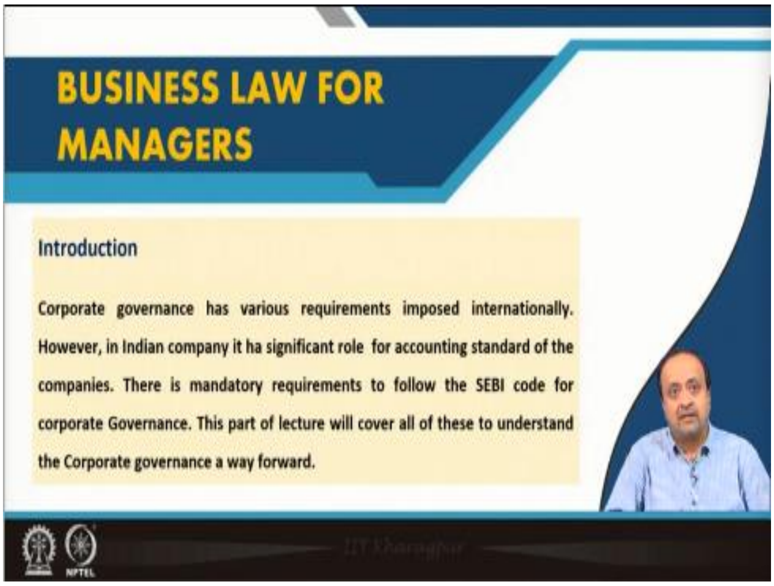

Corporate governance is always a way forward. It is something of a journey for any organisation, for any corporate or a wider thing for a corporate organisation for any country. There is literally no end to this journey. And in case of India also, we have come a long way from the days of voting at remote places for annual general meeting, where the shareholders cannot go, just because the shareholders cannot go, you have your registered office.

And remotest of remote part of the country were hardly out of total 50,000 shareholders in a company, 50 shareholders even cannot reach and out of which 49 belongs to a particular majority shareholders and maybe 1 or 2 straight shareholders living nearby can approach and all decisions passed within minutes, because shareholders cannot reach there. This was the practice in India.

Even 10 years back, have your registered office at the remotest place? So, that annual general meeting, the only meeting where shareholders can participate and take a performance appraisal of the management, the owners who are in control of the management, including the directors, the auditors, statutory auditors cannot even reach that place. And votes are only cast those who could reach.

So, out of 10,000, 50,000 shareholders only 50 shareholders, 100 shareholders used to come, vote and all resolutions got passed in 5 to 10 minutes. Today, even in the remotest place, if a shareholder is there, he can if he wishes too that is a different concept, whether he wishes or not, but today he has the option to vote for or against a resolution; exercises is your choice.

And therefore, today, we are hearing and we are seeing literally resolution of resolution supported by the majority shareholders are getting defeated in the hands of the minority shareholders. Why is it happening? Because, you have allowed them to vote. You have done a mechanism of voting which is e-voting, electronic voting because you have made them aware by the various disclosures as you have done in the stock exchanges, which everybody is privy.

Everybody can see in the public domain. Because, you have brought out results in 3 months which used to come out in 1 year. Now, in 3 months, you are getting the results of a company; every quarter, you are finding what the company is doing. Because you have been built in a system of monitoring by independent directors, audit committees, risk management committees, various committees you have created of the board largely of directors who are not connected with the promoter shareholders, large shareholders.

All these have enabled the investors to be a little aware of still a long, long way to go but today still, with this small progress, we can see the results coming. Not one, quite a few. Resolutions supported by majority shareholders even holding 60% shares getting defeated even to the extent of shareholders, resolutions proposed by management supported resolutions proposed by majority shareholders sent to the shareholders for approval.

Withdrawn, withdrawn taken back, knowing fully well that this will get defeated, but at the same time of sending, they were not aware. In 10 days, 15 days, they came to know that these resolutions will get defeated, but by that time, the field has come from the market that the overall feeling is, this resolution does not require to be supported. So, a long way has, we have come in this journey of corporate governance.

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The way forward is going to be very interesting. It is to be seen how the majority shareholder run companies discipline themselves. Yes, there are quite a few of them who are doing everything possible to do the best of governance. They have changed their mindset. They have allowed directors of repute to be inducted in the board as independent directors. They are opening up the board for discussion.

The board was closed for discussion. Now, the board has opened up for discussion. Board meetings which were for 10, 15, 20, half an hour. Now, going for 1 hour, one and a half hours, 2 hours. Meetings before the board audit committees, majority independent directors, chairman independent as rounds for few hours much more than what the board meeting time consumes is almost 2 to 2 and a half times the board meeting time.

Quite a few mindsets of the promoters are now even talking of environment, society, governance, which were not the words earlier because it does not add to the bottom line. Now, the bottom line has been replaced by the word called health line. It is not bottom line only. It is not profit only. It is the health of the organisation which the promoters are talking off. Earlier, they used to talk of bottom line and top line.

Top line means revenue; bottom lines meet net profit. In between, they were not concerned. Today, that talking of in between which is the health of an organisation. So, health line is becoming important, not for all, but at quite a few of the promoters. They have felt that going forward, way forward, the only way is allowed, open, disclose, dialogue. There is a distinct change of mindset and that is a very positive sign for corporate India.

Rules and regulations are all a welcome but mindset change is finally what is required. And that has happened for quite a few promoters. Corporate governance in India, it surely is surely on the upper path. It is very encouraging to see the way forward also looks extremely encouraging, extremely interesting and exciting as well. A lot of facilitators are there in this journey. We have taken by one by one.

Accounting standards are nothing but the guidelines for a statutory auditor to be followed while auditing the accounts of the company. The statutory auditors are basically the persons who go through what is given to them. Now, what is given to them is not what they should go through. They should look for evidence which is not given to them but which are significant and that is their expertise of an auditor, studying the business and knowing the business, understanding the business is very important.

Accounting standards gives various kinds of guidance notes in understanding this. One of the very important aspects of accounting standard which has helped corporate governance, improvisation; corporate governance disciplining, very important is related party transactions. We call it RPT. No one spoke of related party transactions before 10 years. Last 5 Years, they are all discussions. Now, it has become rigid.

For them, it is becoming rigid from next 3 months just down the line January 2002. Every quarter you have to know disclose your related party transactions. Corporate India never thought off; initially, no discussion at all. What is related party transactions? Now, related party transaction means a promoter driven company or a promoter largely promoter hold, held company, all companies are basically owned by a large shareholder.

Now that large shareholder as is holding as well as margin management control to its representatives. Now that large shareholder is not shareholding only this company or having control on this company, he has also a plethora of other companies in which he has got control. Many times, what happens? Business is done between these 2 companies, nothing wrong; nothing wrong.

You can do company business with various companies including the companies in which he is also a majority shareholder in that company also. So, supposing X company majority shareholder, Mr. A, also is a majority shareholder in Y company. Now, X and Y companies entered into transactions. Both the decisions are taken by these 2 companies board of directors in which he has influenced, significant influence being the majority shareholder.

Ideally, when this decision is taken, law is very clear you have to abstain from voting. You will not be counted in that. Legally, that is recorded, but actually what happens that is something to be known. Though he is not voting, but his presence is always there in the mind of the board that this is a company in which majority shareholder has a stake.

So, board might be influenced by that and might take a decision in favour of that. Now, if that happens, then that is a wrong decision. There is a break of corporate governance culture, because you are considering influence; you are not considering merit. Although he is not voting, the majority shareholder is not voting, but the shadow of the majority shareholder is looming large in it. So, what did SEBI do?

SEBI said, accounting standard said, let that be disclosed, nothing else. Let that be disclosed in the annual report initially. Now, it says let that be disclosed every quarter, the quarter related transaction which has happened and disclose it to the stock exchange, so that the whole world comes to know pan India, pan world is good in the institutional investors come to know that this company has entered into a transaction with another company, which are related parties.

Now, supposing I sell my goods to a related party transaction holder company, right fine, fair enough. You can sell. You can sell to anybody you want. But if you have sold, then you disclose that. When you disclose that, you disclose the quantum you have sold and the price you have done. The moment you disclose the price, the world comes to know whether you have done at an arm’s length price or not at an arm’s length price.

Arm’s length mean, whether on an independent basis has the decision taken on merit or not. That is a huge disclosure requirement. And what has happened? This has stopped related party transactions to a large extent. This has stopped another related party transaction. Selling of goods is not what is the thing to be looked into; what is to be looked into is loans we are giving to related party.

The investments, you are making to that related party. The buying of shares, you are doing of the related party. And why are you buying shares? What amount of money is going to that company? What is the purpose of buying that share? How much dividend you will get from that share? What is the worth of those shares? How do you do the market evaluation of those shares? Are those companies listed?

Are their shares traded? Or is it a private company? Or is a non-listed company? All these questions will open up the basic purpose of investment in related parties. Though the time and inter-corporate deposits used to be given random to associate companies, companies having significant influence at very low rate of interest or even at no rate of interest. Today, all those have stopped.

All related party transactions getting captured each and every, even to the extent of managing director remuneration related party transactions. Company paying salary to the managing director is also getting disclosed verbatim. Any loan to the managing director, even in the ordinary course of business has to be disclosed. Any loan to the KMP even in the ordinary course of business are; not ordinary course of business in.

As per the company policy, he is an employee, he is entitled to get some loan house-building, provident fund, whatever it is, children education that is to be disclosed. How much known has been given to the managing director and what is the interest rate, how much loan has been given to the KMP? So, accounting standards have brought in a lot of disclosure requirements, one of the primary important related party disclosure requirements which has made corporate governance which different level.

And I would also say cleaned up a lot of mess in corporates; cleaned up the balance sheet of corporates is the related party transactions.

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There is another meeting which happens about the independent directors, is that the independent directors they meet have to meet at least once in a year without the other directors, meaning there will be no chairman, there will be no non-executive, non-management directors, only the independent directors, closed door meeting, nobody else is invited, not even the company secretary, not even the CFO, no one, only independent auditors.

What they will do? They will discuss among themselves, whether they are getting enough flow of information from the company they will record that. And all this will be taken by SEBI and other enforcement authorities investing authorities when there is a crisis in that company. Did the independent director record in their meetings that they were not getting any information?

And what steps did you take? Did they take to get that information? Did any of the independent directors in their meeting recorded that? No. If not, they kind of later on blame that we are not privy to information. If yes, recorded and what action you are taking to get that information. So, very little room is there now to play around for the exit route. If you are not doing your due diligence, so independent directors have to be very careful.

They are now responsible, they are having, you are meeting your own independent directors, your body, your team, your team members, nobody else is there. You tell whether you are privy to all the information, number 1. Number 2, you read the performance of the managing director, evaluate the performance of the managing director. Most importantly, you evaluate the performance of the chairman.

The chairman's performance has to be evaluated by the independent directors in their meeting only. The chairman will not even come to know. They might say, the chairman does not need to listen to us. They might say, the chairman always forces us to listen to him. Or they might say, the chairman does not give him the scope to read. I mean, allow us to speak. If the right, what action they are taking?

In the next meeting, they have to say what action they have taken. Have they brought up before the chairman? Have the disclosures to the chairman? Have the shared this with the chairman? And what are the views of the chairman? And is there any improvement? And if they say no, we are fantastic. Our chairman is brilliant. We are getting all information. Chairman is so good, fine.

Then later on, if something happens, do not tell us the chairman has allowed you to hear your views. So, this is the purpose of the independent directors meeting, no escape route. Very strong due diligence now.

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And there is the reason you find; independent directors are no longer much demand. Only if you are sure of an organisation one joints as an independent director, otherwise not.

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These are basically to deal with the rights of the shareholders, audit committee, related party transactions. This is most important. Prompters of the company cannot vote related resolution for related party transactions. No, you cannot vote. Moreover, there is a threshold limit. Beyond which, if any transaction goes 10% of the net worth of the company, then shareholder's approval is required.

What approval? Shareholder's approval that too the number of shareholders voting in favour shall be more than the number voting against however the promoter shareholders will not be considered. Now, what will happen then? Supposing, there are 100 is the total number of shares, 60% is held by the promoters and 40% is held by the others. Now, 60% will not vote at all.

In that resolution, only 40% will vote and in that 40% voting, if you take it as 40 shares, then 21 must be in favour and 19 against, then only it will get past, minimum 21. So, promoters influence totally gone; it is only non-promoter shareholders who are going to decide whether this related party transaction will pass or not. Therefore, no promoter will go knowing fully well, it will not pass in on related party transaction exceeding that network, for sure.

So, this is another very, very important move which has been done. Within the network, if it does not contain the network of the company, in that case, fine. You can take a decision related party but you disclose everything to the stock exchange and the public. The moment it crosses that limit of 10%, shareholder approval will be required but the promoters cannot vote.

Other than the disclosure in the in the stock exchange and all, over and above this resolution cannot be passed at all unless it is approved by the shareholders where the promoter will not be able to vote. If the promoter does not vote, the straight away his shareholding goes, supposing he holds 60%, 60% goes, out 100, 60 shares goes, only 40 shares remain and in those 40 shares, 21 must be in favour which is a tall, tall task.

No one will vote for that resolution, which has got related party transactions. People normally shy away from those resolutions and institutional investors if the right not to vote, no one will vote for that. This will go for an absolute loss. I mean it will fail from day 0. Therefore, none of the promoters will take the resolution to the shareholders for passing.

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And the prohibition which has been made mandatory by SEBI is a whistleblower provision, very important. Corporate governance to a large extent depends on a proper whistleblower mechanism in an organisation. It should allow employees on a no name basis to blow the whistle. Sometimes wrong whistles are blown. It is true. Some cases, actually are done for a purpose.

However, for that reason, you cannot stop a very good mechanism like we should blow on. It has its pitfalls. It has its pitfalls; it has its challenges, but a mature committee which controls this kind of mechanism which screens, that kind of whistleblower mechanism. I mean, the complaints that come in, can jolly well find out whether it is time to take cognizance of those complaints or not.

Sometimes, these also are placed before the audit committee of the board and sometimes before the risk management committee of the board because both consisting of independent directors. So, there might be a case where it has to be placed before the audit committee take a decision. A certain whistleblower has raised a question of corruption or certain whistleblower has raised a question of certain kinds of risks, it can be raised before the risk management also, but it is a very good mechanism. It has its pitfalls as well.

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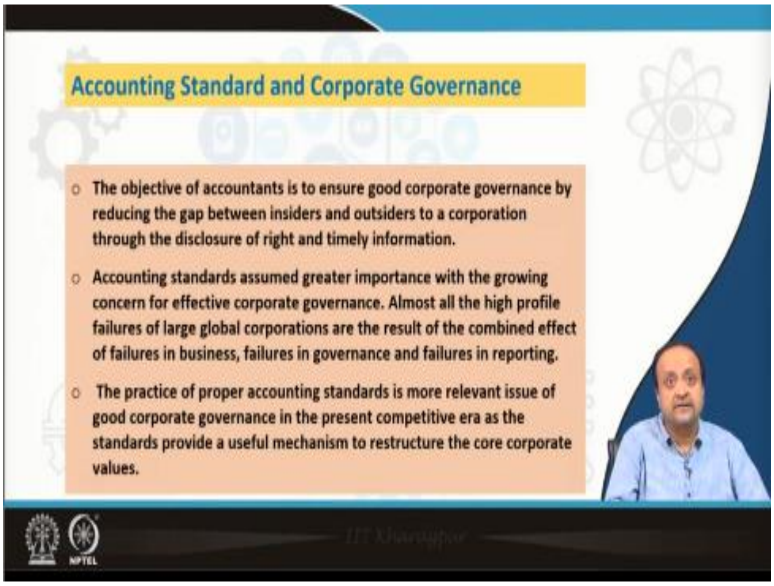

Accounting standards definitely has improved a lot over the years and has become much more demanding from the auditors as well as from the CFO in maintaining the accounts. Large global corporate practices benchmarks have been put in with regard to disclosure requirements, even with regard to valuation of assets, fair value concept has come in. We have been always going into the value of depreciated assets.

Now, fair value concept has come in which is fair in all respects to get the net worth of the company. Many times, deliberately, fair value basis was not taken for income tax gains and purposes. However, now this has been stopped that accounts should be done on a fair value basis.

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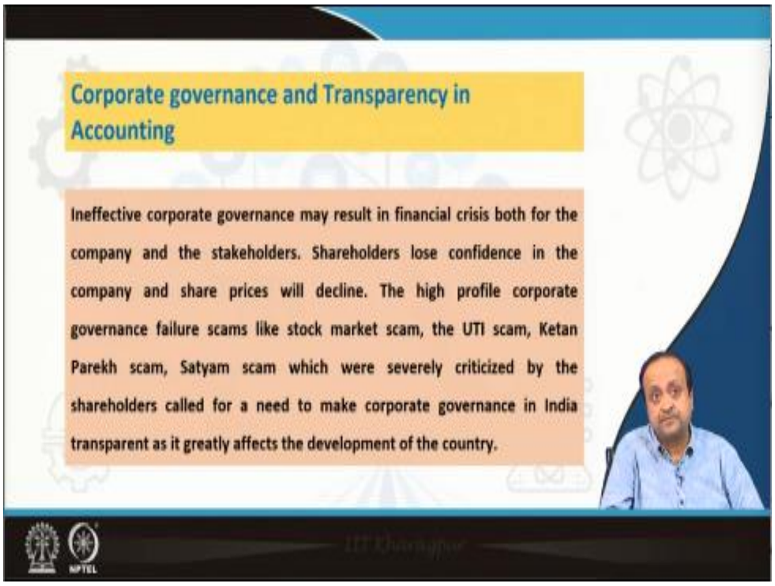

Ineffective corporate governance will always lead to scams. We have seen a plethora of them. I am not for a moment saying these are only the cases. These are just tip of the iceberg. The iceberg is very deep down and quite a huge one. But it is not that all have to be honest, if they are disciplined, even now that is enough. There is no question of unearthing; unearthing those scams are failures, which are there yet to be disclosed.

But what is important is, no one is trying to score a point on this. Everybody is looking for a better environment for corporate governance. And that is happened; that will happen and that is happening. These measures will make those who have still not come in line, fall in line. Quite a few of the majority shareholders has gone through a mindset change, no doubt about that.

But those who have still not come, just sitting and thinking what should be done, should I think are all going to follow this. It is just a matter of time. There is no escape from this.

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SEBI guidelines of corporate governance on transparency, integrity, ethical decision making, mitigate the conflicts of interest between shareholders and promoters basically. Shareholder's promoters mean large shareholders or minority shareholders that are the conflict of interest.

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A lot of right has been given to the minority shareholders to raise their grievances to write to the regulatory authorities, Ministry of Corporate Affairs, Serious Fraud Investigation Office SFIO. If they find anything like that thought, they can on name basis, fine, send it and investigations are done based on that primer facie evidence there, then only real party disclosures.

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Investment decisions are very important. Investors look into this corporate investment decisions. Today, investors are very foreign portfolio investors do not subscribe to the views of the company as regards investments. Unless and until they are absolutely clear, it is in the same line of business whether it is creating competition or it is further aggravating the situation, whether there is enough players in the market which is already the market is there or you are a new entry.

So, many things they are looking into just because you are making an investment; they are not looking into approving your investment decision. Whether there is a need for going to the market or not, basic question they are asking. Why are coming to the market raise an issue your internal accruals are enough to fund your expansion, diversification or whatever you are doing. Why are we raising this fund?

Then you must be doing something which is other than that, you are telling you are raising for expansion, diversification, but your results are not showing that you required that. You have enough net worth; you have enough reserves; you have enough past profits. Do your expansion and diversification from there. Why you have come to the market to raise funds? There has to be an answer to that.

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These are the major filings which are done in the CG system, annual report filing, corporate reporting, management controls interaction, functional departments, any investor presentation you are making, any meet you are having with the financial institutional investors, you have to give that information to the stock exchange first. And before putting that investor presentation to the investors, you have to share it with the stock exchange.

It must go to the stock exchange that this is what I am presenting to the investors. So, that they are not privy to their information, the whole investor community comes to know what you are doing.

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Basically, key factors that influence the corporate governance system is not only the fact that independent directors, audit committees, minority shareholders, majority influence of the major shareholders, it is also to do with the sustainable business development programmes that a company does. So, there is a provision now of business responsibility reporting, BRR which is again, our practice to improve corporate governance.

There, a lot of disclosure requirements are there which gives basically, the strength and weaknesses of an organisation as well as the risks and opportunities. So, it is one way a balancing thing. What are the strengths of the organisation? What are the weaknesses? So, the shareholders, investors can come and see and evaluate the company because many times, it is not possible for them to find out what exactly are the risks, what exactly are the strengths, what exactly are weaknesses, what exactly are the opportunities?

So, all this is a separate section for listed companies which are called business responsibility reporting. Various inside information are given on that intrinsic inside information, which is made public and this information is a statutory information, not a non-statutory information duly signed by the all directors. So, the board of directors take responsibility for the statement. This is another good disclosure, which has brought in by SEBI for the investors community to understand the corporate well and accordingly made their decisions.

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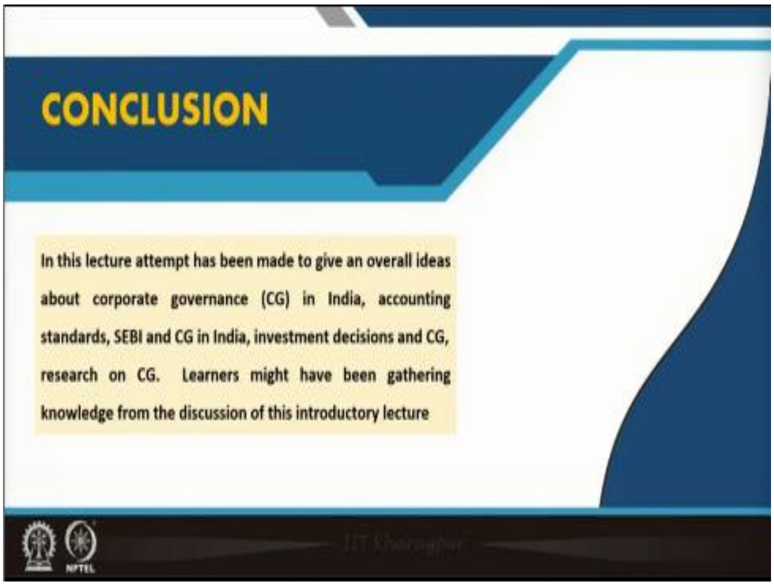

Various references that I have taken, mostly from my experience also, it covers the various aspects of investments, decision making, corporate governance and all. That brings us to the close of this session on lecture. Thank you so much.