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Module-2: Corporate Governance

Lecture – 6
Concept, Definition and Features of Corporate Governance

Good evening. This is the model 2, lecture 6 concept definition and features of corporate governance.

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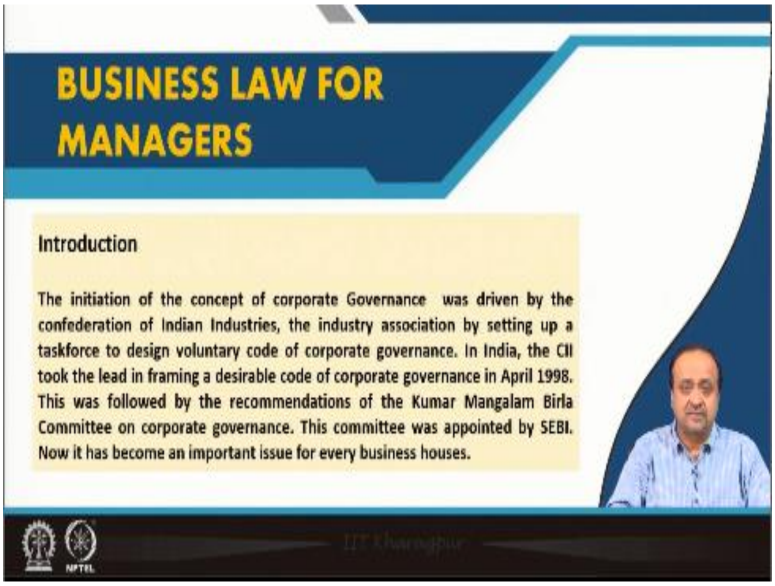

Corporate governance is a buzzword today. Why today? I mean for last 10 years and it is more like why do you need a corporate governance by the way? Are corporate not governed or were it not governed? Why do we have to spell out governance for corporates? Well, there is definitely a reason for it. The reason being, as I think rightly very correctly guided by Kumara Mangalam Birla committee on corporate governance that yes corporates are governed well.

However, there is a need to be a guideline for that. You need a lighthouse; you need an objective; you need a focus; you need a direction for further improvement of corporate governance. Why the need? Question still remains; the basic question why the need?

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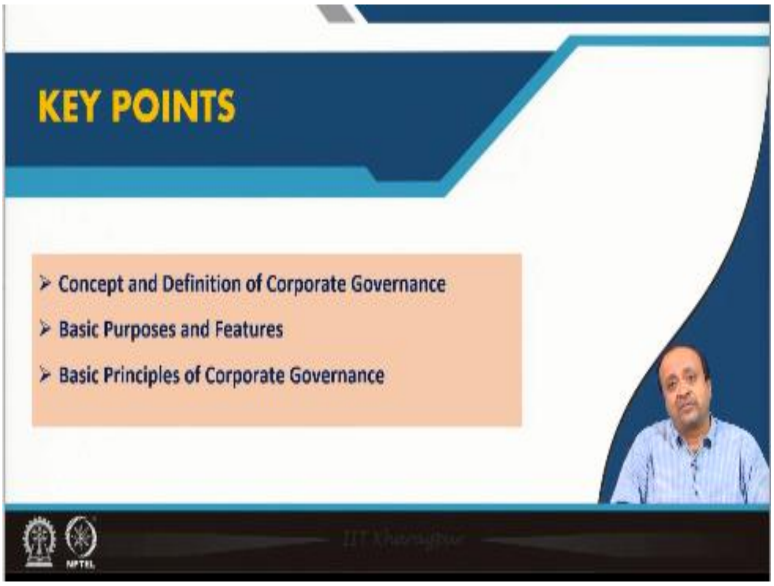

The basic question addressed again by the committee is a corporate is owned by shareholders, managed by board of directors for the interest of both majority and minority shareholders. So, corporate owned by shareholders, largely controlled by majority shareholders; owned by shareholders, largely controlled by majority shareholders, managed by board of directors, largely appointed by majority shareholders for the benefit of all stakeholders including minority shareholders.

So, a proper balancing is required, very much required. So, that control the majority control does not lead to exclusive benefit of the majority holders. Because, though there is separation of ownership and management in corporates, but there is a huge shaded area. The shaded area might look quantitatively less but quality is very high. What we are talking is a company has shareholders and who holds shares in the company, supposing a company has 100 shares held by 99 + 1 shareholders.

A company has 100 shares held by 99 + 1 shares shareholders. Now, that one shareholder holds 60% shares; there is 60 shares. One shareholder holds 60 shares, balance 40 shares are held by 99 shareholders perhaps not possible, because half shares cannot be held. So, I reduce the number 99 to 40. I revisit the whole thing by saying, there are 100 shares in a company and 40 + 1 shareholders for ease of understanding of all; 40 + 1 shareholders.

So, 41 shareholders holding 100 shares; out of which one shareholder holds 60 shares and balance 40 is held by 40 shareholders. How are decisions taken in a corporate? Majority decisions are taken by majority shareholders. Who are the majority? Anything above 50% is majority for ordinary cases, ordinary resolutions and special resolutions more than 75%. So, one particular shareholder holding 6 shares, he will take care of his own interest and get everything passed about 50.

Other 40 shareholders holding 40 shares will be at the mercy of that 60 shareholder; 60 shareholder holding one shareholder. So, one shareholder holding 60 shares actually will override the decision of 40 shareholders holding 40 shares. Moreover, when it comes to 75% +, you might say or might ask, how is that decision getting passed; if we understand our 50% is getting passed, because he is holding 60 shares, because decision is taken based on shares, not by number of heads by number of shares.

Now, the beauty of the whole thing is, these 40 shareholders are not known to each other; they are scattered all over the country. They do not know what the other is doing, whereas the single shareholder holding 60 shares is everything. So, when a 75% recording is required, information is sent to 41 shareholders 1 + 40; out of 40, 30 do not vote even, not interested in voting, only 10 votes. Supposing, these 10 votes against, then what happens?

Nothing happens because the 30 has not voted, the effective bodies 60 + 10 70 and that 10 has voted against worst case scenario, even then, out of 70, he manages 60 which is much more than 75% of 70. This is exactly the scenario in India. Majority shareholders or promoters' shareholders or owner shareholders do not hold more than 55 to 60% shares in any company. Balance 40% shares are held by scattered shareholders who do not have any understanding or bonding or knowing what is happening.

Invariably 20 to 25% of them are indifferent, unaware of; refuses to be aware of; do not even vote. Therefore, this has been the practice, not that I am saying something which has not been the practice. This has been the practice in Indian corporates. Therefore, we find minority shareholders enthusiasm. Therefore, we find institutional investors coming up. Therefore, we find SEBI coming for monitoring, Securities and Exchange Board of India.

And finally, this word corporate governance formulated so, that this 60% does not run the company at its whims, totally ignoring the 40 shareholders holding 40 shares. That is the basic requirement of corporate governance particularly in Indian context. In the west, it is a little different, because shareholders are aware of. Out of these 40 largely held by institutional investors in the west.

An institutional investor, they are all extremely aware of what is happening and they move in a cloud; they both in the group; they take decisions jointly unlike in India. We are in India; it is moving now gradually towards that, as we call it, minority shareholders activism. It is happening. It is showing up; we are seeing lots of corporates who is managing directors' remuneration and getting defeated.

Even the owner, his remuneration has been defeated by shareholders. Expansion plans have been shelved, because minority shareholders and institutional investors voted against. Company shying away from passing resolutions. Even after sending the notice, withdrawing the notice at the AGM saying that we are not proposing this resolution, knowing fully well the resolution will get defeated; for the image of the company will get tarnished.

Taking back resolutions never heard of big companies. Why? Institutional investors have been able to generate enough interest in the scattered 40 to come to the terms and make them at least 2022. So, when those 60 finds 2022 already there to vote against and it is a question of margin now 75 And the stake of the company would be; image of the company would be lost.

The market cap will take a nosedive shied away from the resolution; took back the resolution that is a corporate governance win. That is where corporate governance own but that will take a lot of time, a lot of time because it will not happen like that and therefore, we need stock strong corporate governance norms and that is a welcome step and it is going absolutely in the right direction and the pace is also somewhat good. It is happening.

So, that is perhaps I wanted to make corporate governance need and understanding clear that what is the need of this word buzzword corporate governance.

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It is basically a kind of commitment towards all stakeholders and good corporate governance and good business go hand in hand. If a corporate governance norm is strong, if you follow very ethical code of conduct and governance in letter and in spirit, then business is definitely going to do well and be sustainable. There is no iota of doubt on that.

Whichever company has been strong corporate governance may have taken a little time but has come up with flying colors and those which have not followed and gone for short term gains, fly by Night companies. They are all gone swept away. By that process, what do we mean really following corporate governance? Simple thing is balancing interests, taking care of all stakeholders' interest, not allowing decisions by the majority shareholders to be thrust upon the minority shareholders.

Listen to the voice of the minority shareholders; allow the independent directors to raise their voice and induct strong independent directors in the board. The basic pillar of corporate governance is the strength of the independent director in the board of any corporate.

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Balancing that is the word in corporate governance and who will do the balance provided you have a voice to raise for balance? Who will raise that voice for balancing? The independent directors will raise the voice for balancing because the board consists of minority shareholders interest bearing directors and majority shareholders interest bearing directors. The majority shareholders interest bearing directors are the owner shareholders directors.

Majority shareholder will always have its directors in the board. Maybe the chairman will be the majority shareholder in most of the companies. Then you have the non-executive directors who are not independent, largely in favour of the majority shareholders, largely, then you have the managing director who is a paid employee. He cannot be an independent director. He will always be leaning towards the majority shareholder.

Professionally, he may be 100% professional. But when it comes to board, he would be leaning towards the majority shareholder because he is running the company. End of the day, he is a paid employee. So hard fact is a fact; truth is a truth. So, who is left behind? Who is there in that block of directors? Who is independent? Who can raise the voice? Who can look after the interests of all the stakeholders including the minority shareholders?

The left is only the independent directors and why they have been brought? In India, the concept of independent directors was not there before 15 years. Companies Act was there 1956. Companies were in existence even before that. Shareholders were existence from day 0, 56. Why the concept of independent directors had to be brought in 15 years back? Because of all that happened during this year showed clearly that there is a huge need for an independent voice in the board to be dazed.

If not, gradually company form of organisation will totally perish. And there will be more and more lifting of corporate veils. There will be more and more cases of fraud. There are more and more cases of corruption. There will be more or more cases of diversion of funds. And finally, the very structure will break down; the economy will break down. So, that is the importance of balancing. And therefore, the importance of independent directors.

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We will discuss with independent more. Yes, corporate governance is the mantra for inclusive growth, growth of all, all stakeholders, not one employee, vendors, shareholders, suppliers, environment, society and even beyond. Today, we are talking about diversity, inclusion, consider LGBTQ is coming in. To what extent, governance is going. All status of society should be taken care of benefited by the corporate.

Corporate should be the overarching entity or the force which will bring balance and inclusive growth finally.

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Transparency and accountability: these are the 2 strong words for corporate governance. Why transparency? Decisions that are taken by the board has for reaching consequences, our decision to merge with a company, our decision to invest funds in our company, our decision to acquire another company. Each of these decisions can be a decision which will destroy a company or make a company for the success; short term to matters investments killed a company short term.

Diversion of funds, raising money for one purpose and using it for a different purpose has been the age-old practice in corporates. Just because limited liability is there. Business risk is something which cannot be made into a personal failure. Corporate is not given any shield; no shield is given for that. But unfortunately, some corrupt companies have done this and therefore, the bad name has come.

Institutional investors shied away from India after short term for a long time. FDI was low. FDI was going down like anything. A lot of things got exposed after that and has been tightened to a large extent. But I am not saying for the moment that everything has stopped, no, long way to go, but the direction is there and we have to be more stringent on this. It is very important to have a strong independent board where voices are raised, recorded.

A lot of good actions have been taken by Securities and Exchange Board of India. If corporate governance is seeing light of the day in India, it is because of SEBI today and independent director resigns, he cannot just resign like that he has to give a reason why he is resigning. And if he wishes to, he can put everything in writing that why he has resigned and if he complaints because of fraud, he has resigned.

Then it will open investigation against that company and the promoters because he has been the custodian. He has been the person who has been looking after the interests of the stakeholders and independent director is supposed to bring out all these facts. If we go to the code of conduct of independent directors, his duties and responsibilities, it is clearly mentioned.

If he fails in that, he will be responsible for not doing his duty. It falls under his due diligence. As I was coming, as I was going through a news appeared on 22nd of October and independent director of a company has made it public to the stock exchange. He was sitting director. Even now, he is sitting in that board. He has said some anomalies; he has taken specified the anomalies.

Fraud has happened and he wants it that SEBI should take action immediately and find out the reason. First time, I normally follow this kind of disclosures in the stock exchange, anybody who wants to understand more about corporate governance can find out from stock exchange, what kind of intimations are given and from there can make out what is the latest development on corporate governance.

Here is a case where an independent director writes to the stock exchange sitting in the board. He is actually doing the job whistle blow and independent director acts as a whistle blower of a listed entity. For the first time, I have come across very independent directors after resignation has blown the whistle. But here is the director who is sitting in the board and has blown the whistle. And he is still in the board. Let us we have to see how SEBI reacts to this.

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Mindset: very important of the independent directors and of the owners, promoter directors. Is promoter directors really wants the company to shine, success sustain? Then it is his duty to allow the independent directors to voice their advice or grievance or whatever they want to say. If that is not the case, then corporate governance will not see the light of the day. No independent director of worth will join a company.

Independent directors join companies not for fees or commission, they join companies for their own, you know, self-belief that they can turn out this company. They can contribute in this company. Fees and commissions are definitely important for everybody and should be remunerative. The fees for the directors today has gone up to one lakh rupees per meeting, which was 10 to 20000, 10 years back, which is a very construct.

If an independent director has to spend 4 or 5, 6 hours per meeting and he has to attend the meeting, with all his study and all, it is worth paying him a lakh rupee for a sitting fee, which is allowed and most of the companies are paying. They are getting also the commission on the net profits of the company, which is again a welcome thing. But this is not what the independent directors are looking for off worth.

Independent directors of worth wants the company to grow during their tenure. So that they take pride in seeing, the company is getting further improved and transformed of course, with the emphasis on corporate governance.

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Is the old saying, corporate governance is like taking the horse to the pond, but cannot be made to drink water if it does not do so. But the choice is whether you want the horse to drink water or not. Are you only showing that I am taking him to the pond, but I am not really making him drink the water? You are from a distance, I am saying that you are taking him dragging to the pond that much I am seeing, but after ditching the pond, are we allowing him to drink the water? That is the mindset question.

You have taken independent directors, but you are not listening to the voice of the independent directors. Then that is not corporate governance. That is not the mindset of the promoter directors or the majority shareholder directors, which will help the company to grow. Then there is a big problem in the mindset of that promoter directors or majority shareholder directors.

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The corporate governance has been implemented by Securities and Exchange Board of India by an agreement which is called the listing agreement. Now, what is the listing agreement? A listing agreement is an agreement between a company and the stock exchange. Now in India, there are 2 stock exchanges which have got nationwide terminals effectively today only 2 stock exchanges.

One is called the Bombay Stock Exchange. Other is the National Stock Exchange. So, all companies which are listed are in 99.9% cases, enters into an agreement with both the stock exchanges both BSE and NSE. And do not require to be listed in any other stock exchange because these 2 stock exchanges are enough, allowing all the shareholders for freely trading in the shares of the company.

But in that agreement, there are provisions which are almost similar to both the stock exchanges. As regards the corporate governance very clearly, it is mentioned as dictated by SEBI Security and Exchange Board of India. Security Exchange Board of India does not directly enter into any agreement with any stockiest or with any corporate. It is a regulatory body. It does not enter into any agreement.

It has got its 2 arms, which is a BSE and NSE through which it regulates. And today, these 2 arms are most important for a company to keep it market cap up. If for any reason, the stock exchange issues are notice to you at your corporate and that notice is not replied with time properly, then stock exchange puts that in his website and the institutional investors looks at it very, very, very thoroughly and effectively.

And if there is anything, which throws doubt to them, they will immediately write to the company, why this kind of issues are coming up, please clarify. And if you are not, the next morning, they may actually dispose of or liquidate either their entire shareholding or 50% of shareholding. The moment that happens, the market cap goes down. So, no corporate will ever allow it to happen. So, it is very important.

The other important aspect of corporate governance is that the listing agreement I was talking off, also has a provision of another body of the board very important to discuss corporate governance, like independent directors are so important. The group of independent directors who sits in the committee of the board is called audit committee. This audit committee today is far stronger than even the motherboard.

The mother is a board of directors from which the committee is formed, but the child or the creation of that body is much stronger than the mother itself or the parent itself. Because the way it has been created. If I discussed the creation, you would understand that the board today has to have. If the chairman of the board is a non-executive director, then at least one third of the board should consist of non-executive directors or other independent directors.

But if the chairman of the board is an executive director, at least 50% of the board shall be independent directors or if the chairman of the board is even if not an executive director is a non-executive director, but still is a majority shareholder in most of the companies that is the case, the chairman is always the representative of the majority shareholder or he is the majority shareholder.

However, he is not an employee of the company, therefore, he is not an executive director, he is not Chairman cum MD. He is only chairman. But he is the majority shareholder. In that case, also 50% of the board should be independent directors 50% at least. This is a board structure. So, even if 50% is independent, still, you have a board where the other half is non-independent and the Chairman has the veto power if there is a balance.

And these decisions in the board are always taken by majority decisions. No special majority, only majority that is enough. Out of 9, if 5 are yes, then the decision gets passed, however, SEBI has made it mandatory those 4 which are not passing it, supporting it, they should record it in the minutes of the meeting that they have not participated or they have not in favour of this. And they are doing it religiously now. Because if later on it is happens that because of this decision, the company went down.

And this decision was not really a decision as per business. But for certain reasons, it held the majority shareholders, then this director who voted against will not get production because they have not recorded their dissent in the minutes. We call it recording of dissent, very important that directors should record the dissent in the minutes of the meeting. Earlier it was not there. Now the directors are doing it.

So, what is happening in a board when it finds that 4, 5 directors are not agreeing, majority shareholders are not taking those proposals. Why? Because it will be recorded in the minutes and later on, if it is becoming a backfire, then it will happen. This majority shareholders in spite of the fact for directors voted against went for this proposal. So, it will put them into more difficulty.

So, they are not going ahead with those things, a positive development which is happening. In the various boards, dissent, recording of dissent has happened. The other important thing is if you look at the audit committee, you will be surprised the constitution of the audit committee is totally different. The audit committee should consist of only non-executive directors, majority independent and Chairman independent.

So, if our committee has got majority independent, no question or at least majority independent and Chairman independent also. So, suppose if it is 4, 3 would be independent and Chairman also independent. If it is 5, 3; if it is 4, it is 3. So, what I am trying to say is that all decisions are taken by the independent directors, even if a non-independent director is voting against, nothing will happen because the independent director deficiency will prevail.

And this audit committee is so powerful. Each and every financial decision, each and every account, each and every expansion diversification, each and every strategic investment has to be pre-approved by the audit committee before it goes to the board. So, audit committee approves, then only goes to the board. Now, if the audit committee does not approve, even if it goes to the board, can the board override the decision of the audit committee?

Yes, it can override, but if it overrides, it has to give an explanation in the board meeting, why it has been taken a decision against the recommendation audit committee and if it is a financial result, then it has to be disclosed in the stock exchange. The entire investor community will come to know that the independent directors did not approve the financial results or the expansion plan or the diversification plan or the acquisition.

However, the board in its wisdom consisting of majority from the majority shareholders have taken a decision overriding the decision of the independent directors and has gone ahead. So, any institutional investors will think twice in investing or remaining invested in this company, but the independent directors are saying no, but the majority shareholders because of the number has gone for years. However, this was never disclosed before.

Now, SEBI has said you have to disclose that. Disclose to whom? To its regulator, there is a stock exchange and stock exchange so, you would put it in their website, public notice please be careful, this is a company where a decision has been taken which is in disregard to the decision of the independent directors. So, any company of repute having high market cap will never do that.

Effectively, this has stopped decisions being taken by corporates looking at the interests of the majority shareholders only because of this creation of audit committee, however, as I said, are the independent directors truly independent that question remains. The directors who are called independent directors, will they continue to remain independent or they will be only independent in name, but not in practice. That is a question mindset question.

Therefore, that question still remains you can create everything by law, you can create the you know, this whole ambience for good governance, but finally, it is the mindset of those people, the independent directors to do it and wherever it has been done, wherever the voice has happened, the voice is heard and the voice has raised. All those companies have really come out with flying colors. So, that is something which is still to unfold.

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Of course, careful governance has a positive impact on shares. It improves the trust. The foreign institutional investors are very, very alert on this. They know it very well that a good corporate governance, a bunch of strong independent directors and today, there is a body called IIAS.

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They are doing a lot of study on this. We will discuss in next slides on how IIAS does study corporate governance. A lot of control measures. risk control measures, internal audit measures. Risk management is another thing which corporate governance looks into. A separate committee is formed, again a board committee to look into the various risks associated with the business.

Some risks are not even perceived like nobody anticipated pandemic risk. There was not a single risk register of any company containing a pandemic. Today, all risks raised as contained pandemic.

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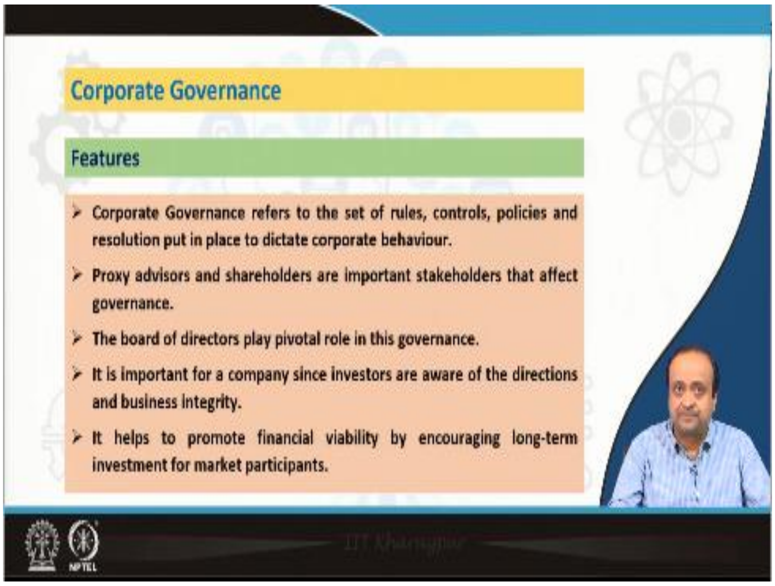

Business community looks at corporate governance always as a long-term sustainable option.

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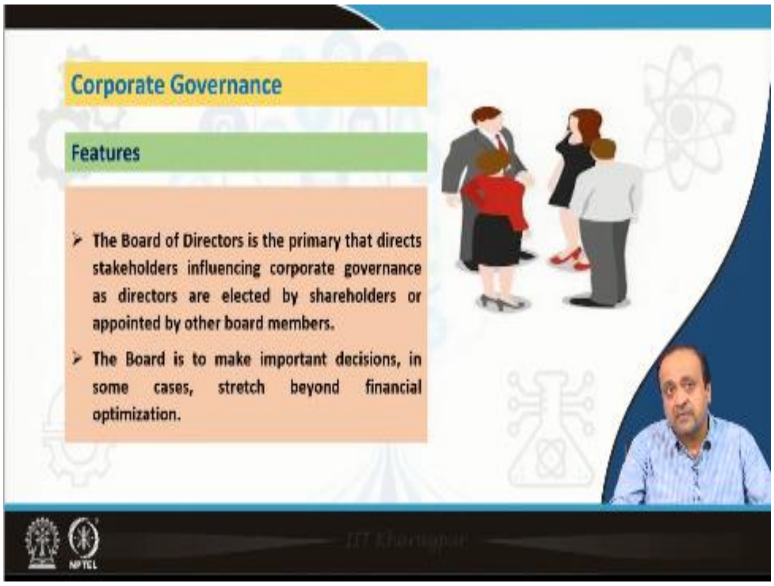

The board of directors are the main custodian of corporate governance. The decisions have to be balanced, balanced from all angles, normal stakeholders, financial and non-financial. Again, one thing very clear, it does not mean only charity, business decisions are taken. Even after all these decisions can go wrong. Best of minds, best of mindset, best of independent directors can take decisions which may go wrong, that business is all about.

But risk is there in the business, nobody can guarantee the decisions will not backfire. But when you have a bunch of independent directors who have taken everything, there is nothing for a business or an owner or a majority shareholder to shy away from. And no one can even think of attaching the property of anyone because everything is transparent. It is a business risk. We all have to leave it. Therefore, so important is to ensure that corporate governance is in practice and is in letter as well as in spirit.

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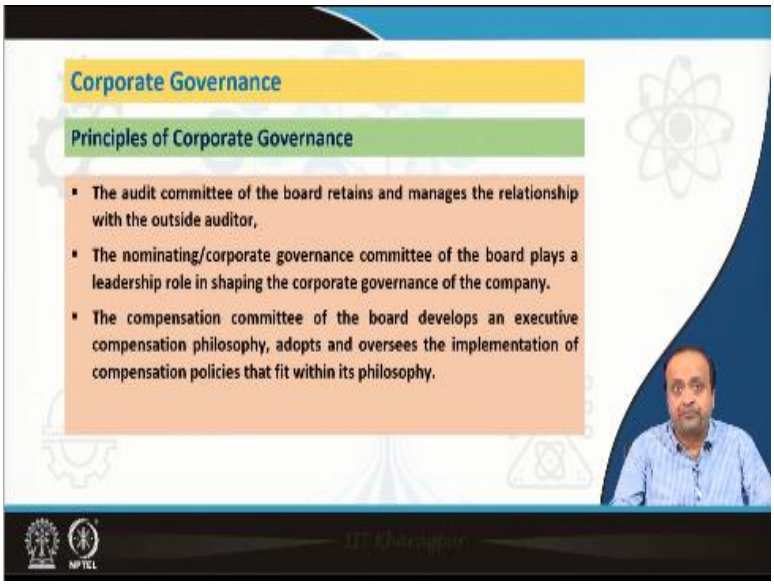

Audit committees remains to be the most important committee having enormous power including appointment of statutory auditors, including appointment of the chief financial officer of the company, including looking at the remuneration of the key managerial personnel, like the managing director, the company secretary, the chief financial officers, the internal auditors, their performance review, everything happens only through the audit committee.

In today's scenario, the duration of a board meeting can be 1 hour or 2 hours, but the duration of audit committee goes up to 4 hours or 5 hours. So, one can understand the importance of audit committee. It really is the committee which drives corporate governance.

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Various references are there in this presentation of mind; I have taken from different sources.

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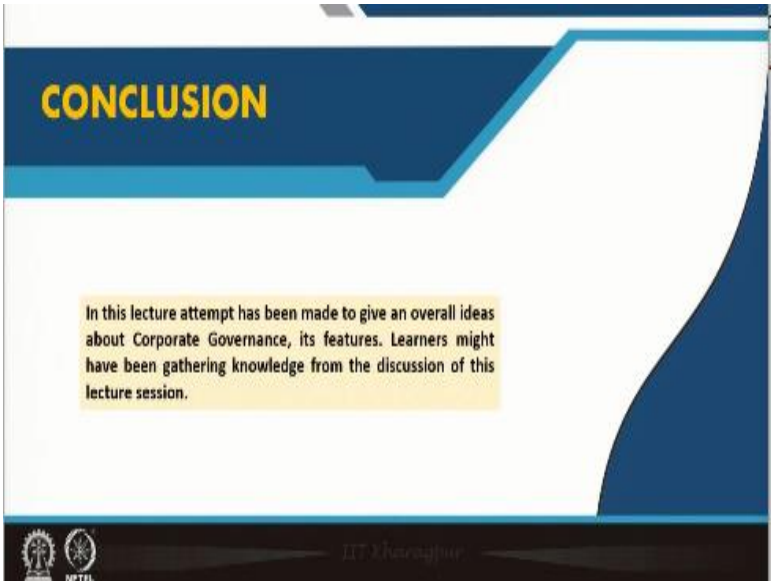

Of course, I would say still much of it is from my experience. I have been talking about corporate governance in various forums. So, when I speak of this, I speak more from my experience and my insights into many things that I want to share. Thank you so much.