Simplified Framework For Corporate Governance

Arun Duggal
Chairman
Shriram Capital and other Shriram Group companies

At present a listed company in India has to comply with a number of requirements relating to corporate governance. These include the Companies Act provisions, SEBI's Clause 49 and the recently issued voluntary guidelines of the Ministry of Corporate Affairs. In addition, the companies issuing securities overseas have to comply with provisions of Combined Code in the UK and the NYSE requirements and Sarbanes Oxley Act in the US.

These results in a plethora of requirements of Corporate Governance, which are very detailed, prescriptive, ritualistic, overlapping and sometimes contradictory. Substantial managerial, administration and clerical effort is needed in a company to ensure compliance with all these requirements. Unfortunately, this extensive effort does not lead to actual improvements in Corporate Governance, as the corporate energy is wasted on bureaucratic compliance rather than focusing on few important steps to improve governance. We have reached a state of over regulations and prescriptions which is diminishing actual Corporate Governance.

For all of these reasons, there is an urgent need to develop a short, simplified, basic framework for corporate governance which best meets the needs of investors. For smaller companies the framework should be even more simple and abbreviated.

The heart of corporate governance is an effective Board which provides oversight such that interests of all stake holders i.e. customers, employees, suppliers, community and shareholders particularly minority shareholders are protected and properly balanced. The Board ensures that the company's published accounts give a true picture of company's financial position, the company complies with all laws and regulations and it has strong internal control processes. An effective Board has to have sufficient number of independent directors and directors from diverse backgrounds to enrich the Board discussion and improve its decision making

'Simplified Framework for Corporate Governance' outlined below captures the best features of Clause 49, MCA's Voluntary Guidelines, UK's Combined Code and NYSE's requirements in a simpler manner. Having served on many Boards in different capacities in India and overseas, I have used my real life Board room experience to emphasize those areas which really make the Board more effective. On the premise that 'Sunlight is the best disinfectant' various disclosure items are identified in this framework.

Direct beneficiaries of better Corporate Governance are the shareholders, particularly the minority shareholders of a company, and the Simplified framework is designed on that premise. Better Corporate Governance framework, more importantly if it is implemented diligently will improve the investor confidence and reduce the cost of capital of Indian companies.

The primary responsibility for assuring proper Corporate Governance of a company rests with the owners i.e. promoters and large shareholders, Board of Directors and Research Analysts who analyze the company. Investors, not regulators, can really be effective in improving corporate Governance. Investors can vote with their feet, rewarding those companies who practice better corporate governance and punishing those who do not. Research has demonstrated that when a Private Equity investors takes up a large position in a company and joins its Board, the market rerates the company up by 20+%. Market expects that the sophisticated Private Equity investor's involvement will result in better Corporate Governance.

This Simplified Framework outlined below can replace Clause 49 and MCA's Voluntary Guidelines.

Globally, also there is a need to develop a simple and reasonably uniform Corporate Governance framework similar to the global accounting standard, IFRS. The simplified framework described below could also serve as a basic template to develop a 'Global Corporate Governance' framework applied to various countries with some modifications to take into account local laws, regulations and practices. This would facilitate global movement of investment capital as international investors will have better understanding and greater confidence in the governance practices in various countries.

The key elements of the 'Simplified Framework for Corporate Governance' are as below.

1. BOARD OF DIRECTORS

A. Appointment

i) This should be a formal, rigorous and transparent procedure for appointment of new Directors on the Board handled by the Nomination & Governance Committee of the Board. All Directors should be issued a formal letter of Appointment which should outline terms of appointment including tenure, remuneration, duties and responsibilities, etc. (D)

ii) Companies should, preferably, have separate CEO and non executive Chairman. In case CEO and Chairman roles are combined the company will have a Lead Independent Director. The duties and authorities of these office bearers should be clearly defined.(D)

iii) The Board should have at least fifty percent Independent Directors. All Independent Directors should given an Annual Certification confirming their independence and arms length relationship with the company, its promoters and other major shareholders. This Certification should include their brief Biodata, all fees / compensations received from the company in the previous year, relationship (including any income received) from any Related Party, the numbers of days they spent on Board work in the last one year, contributions made by them on the Board during the year, and Information related to other Boards (and Committee Positions) they serve including time spend on each Board & Compensation received. This Certification should be considered and approved by the Board. (D)

iv) An individual may not remain an Independent Director in a company for more than 10 years and no individual should serve on the Boards of more than 10 public companies.

v) The Board should have a formal induction and development process for all directors. It should have a process to monitors its effectiveness as a Board, its Committees as well as contribution of individual Directors thru an annual review process.

vi) Independent Directors should meet amongst themselves and meet members of the management to get better insights into the operations of the Company and engage outside advisors, at company's expense, if needed to study issues at greater depth.

B. BOARD COMMITTEES:

The Board should delegate some of its responsibilities to the following specialized committees:

i) Audit Committee
ii) Remuneration Committee
iii) Nomination and Governance Committee

The Board may set up additional Committees on permanent or ad hoc basis. The Charter of all Committees should be clearly defined (D).

C. BOARD COMPENSATION:

i) The Compensation should be market based so as to attract high caliber professionals, retain and motivate them to spend sufficient time on the governance of the company as Directors. The compensation should be structured to align Directors motivation to the long term interest of the company and the shareholders. It could include (i) Annual Retainer, (ii) Sitting Fees, (iii) Bonus linked to Company Performance, (iv) Long term incentives such as Stock Options, Stock Appreciation Rights, etc.

ii) Additional Compensation for Committee Members, Committee Chairman, Board Chairman, and Lead Independent Directors should be determined on market basis.

iii) Company's Board compensation policy and details of the Compensation paid to all Directors every year should be disclosed (D).

2. AUDITORS

i) The Audit Committee of the Board shall appoint Statutory Auditors of required qualifications and experience and monitor their performance.

ii) The Statutory Auditors will provide an Annual Certification confirming their independence and arms length relationship with the company, its promoters and other major shareholders. They should also outline the Audit and Non Audit fees received in the previous year form the company and all Related Parties.

iii) Audit Partners should be rotated every five years and Audit firms every ten years.

3. INTERNAL AUDIT AND RISK MANAGEMENT

i) The Audit Committee of the Board should ensure that the company has appropriate and effective Internal Audit and Risk Management Framework in place, either by internal resources or an external firm or a combination of the two.

ii) The CFO and CEO should certify on a quarterly basis that the internal control and risk management processes are effective, identify weaknesses, if any, and confirm compliance with laws and regulation and report violations, if any.

4. MANAGEMENT CONTROL SYSTEM

The Board should ensure that the Company has an effective Management Control System, to achieve its growth objectives in a systematic manner while minimizing the risks. It should be designed to best meet the needs of the Company (D) and may have the following elements:

i) PLANS:

The Board should review and approve (a) Medium Term Strategic Plans, (b) Annual Operating, Financial & Expenses Plans, and (c) Annual Capital Expenditure Plans.

ii) POLICIES

The Board should ensure that there are appropriate Policies and Practices relevant for the company's business are in place such as (i) Accounting & Financial Policies, including Expense Policy, Foreign Exchange Policy, Risk Management Policy, Investment Policy, Provisioning Policy, Dividend Policy, and other policies relevant to the business of the company. (ii) Other important Policies such as Ethics, Insider Trading, Equal Opportunity, Sexual Harassment, Whistle Blower, etc.

iii) MANAGEMENT INFORMATION SYSTEM

The Board should ensure that there is a robust Management Information system which helps the Board track actual quarterly performance against the plan (and last year) as well as exceptions to the Policies, if any. The Board should also monitor Company's performance against competition.

iv) SIGNIFICANT DEVELOPMENTS

The Board should review and approve all significant transactions including M&A transactions, major Capital raising transactions, large new projects, large asset sales and major new corporate initiatives. The Board should be informed of all senior level recruitments and departures, important Labor or HR issues, major litigation, significant technological and competitive developments, major customer or business acquisitions or loss, Quality Control issues, and any significant Operating developments.

5. Disclosure:

i) Companies would disclose all governance related information (marked D in this note) promptly by putting it on their website as well as reporting it to Stock Exchange, who should put it on their website.

ii) After 2012, these electronic disclosures will substitute the Corporate Governance section in the published Annual report but will be made available to any shareholders in paper form if requested.

Arun Duggal is former CEO India of Bank of America and now Chairman of Shriram Capital and other Shriram Group companies. He is also an Independent Director on the Boards of Companies in India and overseas and teaches at Indian Institute of Management Ahmedabad.