Board Committees : Emerging Roles and Responsibilities

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Corporate governance mechanisms aim to protect minority interest by ensuring that the executive management formulates strategy and takes decisions for the benefit of the company and not to enrich its members. For easy reading, in the rest of this essay, we shall refer the executive management as CEO. We use the term minority shareholders to refer to those shareholders who do not have direct control on the use of assets and day-to-day operations of the company.

CEOs show opportunistic behaviour and take decisions to enhance 'personal benefits of control'. This is a typical agency problem that arises in any principal – agent relationship. CEO, as the agent of shareholders, is expected to work for the benefit of the company. But he/she does not have any motivation to do so unless his/her interest is aligned with that of the shareholders, who are deemed owners of the company. It is common to incentivise the CEO to align his/her interest with that of shareholders. Most common incentive schemes are performance related bonus based on accounting numbers and Employee Stock Ownership Plan (ESOP). Research shows that incentive schemes are not effective in inducing CEOs to use assets for the benefit of the company. CEOs often earn higher incentives even in bad times. Moreover, incentives based on accounting numbers often lead to accounting fraud. ESOP often leads to short-termism and accounting fraud to boost market value of shares. Although, various mechanisms have been introduced to improve the effectiveness of incentives, problems persist.

The other corporate governance mechanism to control the opportunistic behaviour of the CEO is to monitor him/her. There are two types of monitoring. One is speculative or passive monitoring. In speculative monitoring the monitor has no controlling right. Speculative monitors are players in the capital market and credit rating agencies. Financial analysts follows performance and strategies of companies, forecast their future performance, value shares and issue buy or sell advise to their clients. The CEO of an under-performing company faces the thereat of losing control over the company when its share price dips on the sale recommendation of financial analysts. Similar situation arises when credit-rating agencies downgrade rating of securities of a company. The effectiveness of the speculative control depends on the quality of corporate financial reporting, quality of other disclosures and the quality of internal governance of monitoring institutions. Research finds that speculative monitoring is not very effective. Therefore, the corporate governance mechanism focuses on monitoring by those who have the controlling right.

Retail investors and institutional investors have no incentive to monitor the CEO. They prefer to exit the company rather than spending resources and efforts to monitor the manager. Some pension funds opt the strategy to buy shares of under-performing companies and use resources and efforts to improve the governance and performance of the company. The increase in the share price benefits the unit holders. They can adopt that strategy because they do not have the pressure to improve their ranking based on short-term performance of their investments and they do not face the free riders problem. Block holders, who do not have control over the company but hold non-trivial percentage of shares (say 5 per cent) do not face the free riders problem and therefore they should have the motivation to spend resources and efforts to improve the performance of the company. But, research shows that they prefer to collude with the CEO for personal gains. Large creditors intervene, but very late when the poor performance in the product market persists for long. Therefore, minority shareholders and regulators assign the responsibility to monitor the CEO to the board of directors.

Balanced Board

Only a balanced Board can monitor the CEO. A balanced Board is one that has the diversity in terms of relevant knowledge and experience and which has adequate number of outsiders, that is, independent directors. The extant law requires that fifty percent of the members of the board of directors should be independent directors if the chairman is an executive chairman. One-third of the total number of members should ne independent directors if the chairman is a non-executive chairman. The Companies Bill 2012 (Bill) requires that one-third of the members should be independent directors. For example, if the size of the board is ten members, only three will be independent directors. Therefore, in a full board meeting independent directors cannot vote down a proposed resolution. Usually, board of directors endeavours to build consensus on critical and important issues before arriving at a final decision. Independent directors are expected to bring independent views in that deliberation. Regulators expect independent directors to do something more than that to ensure good governance. Corporate governance mechanism requires the Board to form committees with independent directors as members. This serves twin objectives. First, the independent directors can deliberate on critical issues objectively and formulate recommendations that cannot be wished away by the CEO, the executive-chairman of the company and executive directors in the Board. Second, committees have the authority to interact with senior executives and others, who are not members of the Board and take expert opinion to enable them to form judgement. This helps them to develop in-depth understanding of problems and issues. All the committees have only the recommendatory power. The Board takes final decisions. This has a very important implication. First, the Board can reject the recommendations of committees. Independent directors being minority in the board, they cannot block its decisions. In other words CEO's decisions hold. The only option available to dissenting directors is to record their dissent in the minutes of the meeting. This protects them from charge of negligence but fails to protect minority shareholders.

The concept of working through committees of independent directors is widely accepted across the globe. Therefore, it is not a unique feature in Indian corporate governance practices. We shall discuss the responsibilities and accountability of committees with reference to provisions in the Bill. In our discussion we shall not ignore the crucial issue of how independent are independent directors, although that impacts the effectiveness of the committees.

Audit Committee

The concept of Audit Committee is not new in India. It is in existence from the year 2000 when Corporate Governance Code was first incorporated as clause 49 in the Listing Agreement. The Bill has expanded the scope of the Audit Committee, although there is no substantive change in the constitution of the same. The Audit Committee shall have a minimum of three members and majority of them shall be independent directors. Majority of the members, including its chairperson, should be persons with ability to read and understand the financial statement.

The primary task of the Audit Committee is to protect the independence of auditors, including the internal auditor; and to ensure the quality of corporate financial reporting, the adequacy and effectiveness of the internal control and risk management systems, that inter-corporate loans and investments are not detrimental to the interest of the company, and that the related party transactions are not abusive. The Audit Committee has the power to investigate into the issues related to all the above issues and any other issue referred by the Board. It can obtain professional advice from external sources for this purpose. The Audit Committee is also responsible to ensure that the vigil mechanism is adequate and operating effectively. Although, like other committees, the Audit Committee has recommendatory power only, it is little more powerful than other committees of the Board. The power flows from the requirement that if the Board does not accept a recommendation of the Audit Committee, it shall disclose the same and explain reasons for the same.

We cannot rank the tasks of the audit committee in terms of importance or criticality. All the tasks assigned to it are equally important and critical. We shall elaborate on a few emerging responsibilities.

Dominant shareholder, who manages the company, directly or indirectly, may use related party transactions to tunnel company's wealth. Abuse of related party transactions worries regulators, particularly in economies like India, where companies with a dominant shareholder occupy the centre stage in the economy. The Bill requires that a company shall enter into any contract or arrangement with a related party with respect to the following specified transactions only with the prior approval of the Board: sale, purchase or supply of any goods or material; selling and buying of property; leasing of property, availing or rendering of any services; appointment of any agent for purchase or sale of goods, materials, services or property; appointment of such related party to any office or place of profit in the company, its subsidiary company or associate company; and underwriting the subscription of any securities or derivatives thereof, of the company. Board's approval shall not be required if the transaction is entered into in the ordinary course of business and it is an arm's length transaction. The Bill also requires that related party transaction exceeding certain amount or in case companies of certain size, to be specified in the Rules to be framed by the government, shall require the approval of the company by a special resolution. A shareholder, who is a related party, shall not vote on such special resolution. In a way, the 'majority of minority' rule shall apply to those special resolutions.

The Bill requires the Audit Committee to approve, and if required modify related party transactions. This is a very important and onerous responsibility. If the Audit Committee fails to apply due diligence, the members will be held accountable for negligence. The Audit Committee should formulate a policy on related party transactions, which will provide guidance on criteria that will be applied to determine whether a transaction is in the ordinary course of business and how to determine the arm's length price. Arm's length price (ALP) is the comparable price as available to any unrelated party in open market conditions. Tax laws provide mechanisms to estimate the ALP. Estimation of ALP is judgemental particularly, if there is no market for the product or service. It is advisable that the Audit Committee consults external experts in formulating the policy and in approving complex transactions. This will benefit minority shareholders and will also protect independent directors if any of its decision is challenged in the court of law.

Another formidable responsibility on the Audit Committee relates to the vigil mechanism. All over the globe the vigil mechanism, which is commonly called the 'whistle blower mechanism', is considered to be the only effective mechanism to build ethical culture in the company and for managing the fraud risk. The extant clause 49 of the Listing Agreement (corporate governance code) recommends companies to establish the vigil mechanism. It is not mandatory. The Bill mandates listed and specified classes of companies to establish a vigil mechanism. The Bill stipulates that the mechanism should enable a whistle blower to directly approach the chairperson of the Audit Committee in appropriate and exceptional cases. The extant Clause 49 requires the Audit Committee to review the whistle blower mechanism, if that exists. The Bill does not require the same. One may argue that the Audit Committee does not have any responsibility for the adequacy and effectiveness of the vigil mechanism. This argument is flawed. The Audit Committee is responsible for the evaluation of the risk management system and therefore should necessarily evaluate the vigil mechanism. This responsibility of protecting the whistle blower is onerous. In absence of a robust law to protect the whistle blower, it is difficult to induce directors and employees to blow the whistle. The vigil mechanism is bound to fail.

Nomination and Remuneration Committee

Nomination and Remuneration Committee plays a crucial role, particularly in a company that is managed by the dominating shareholder. The role of the Committee assumes importance because the law cannot and does not prescribe qualification, experience and remuneration of directors. In a company managed by a dominant shareholder, individuals at key positions are appointed based on extraneous considerations at a remuneration that is much higher than that professional managers earn. This is a kind of expropriation of shareholders' wealth. This also weakens the management. Similarly, an individual is appointed as an independent or a non-executive director primarily based on the comfort level of the CEO in working with that individual. Directors so appointed find it difficult to protect their independence against subtle pressures from the CEO. Moreover, the requirement regarding the diversity in terms of knowledge, experience and gender is compromised. Unfortunately, under the extant Clause 49, Board is not obligated to establish a Nomination and Remuneration Committee.

In Sweden, the nomination committee is subordinated to the annual general meeting (AGM) and shareholders elect its members. However, the Swedish-Norwegian approach differs from the other Nordic countries e.g. Finland and Denmark, as well as from the UK and the US. In these countries the nomination committee is subordinated to the board and consists of independent directors. The Bill mandates that every listed company and specified classes of companies shall constitute the Nomination and Remuneration Committee. The Committee shall consist of three or more non-executive directors out of which not less than one-half shall be independent directors. The Chairperson may be a member of the Committee, but shall not chair the Committee.

The Committee shall be responsible for wide responsibilities regarding the appointment, evaluation and removal of directors and senior management personnel. It shall formulate and recommend to the Board the appointment policy setting out the criteria for appointments at the Board level and at levels that are one level below the position of executive directors. It shall also set criteria for appointment of members of the core management team. The policy shall include the criteria for determining qualifications, positive attributes and independence of a director. The Committee shall identify individuals who are suitable for the appointment at those positions and shall recommend to the Board their appointment. It shall recommend to the Board removal of individuals holding those positions, if required. It shall be responsible for evaluating the performance of every director.

The Committee shall formulate the remuneration policy and shall recommend the same to the Board for approval. The policy should ensure that the remuneration is reasonable and linked to the performance.

The accountability of the Committee shall be enforced through disclosure. The Bill mandates that companies shall disclose the policy, relating to the remuneration for directors, key managerial personnel and other employees in the board of director's report. The Chairperson or his/her nominee shall attend the general meetings to answer queries from shareholders.

Stakeholder Relationship Committee

The extant Clause 49 requires listed companies to constitute a Shareholder/Investors Grievance Committee under the chairmanship of a non-executive director to address complaints from shareholders and investors. The Bill requires that a company with more than one thousand shareholders, debenture-holders, deposit-holders and any other security-holders at any time during a year shall constitute a Stakeholder Relationship Committee under the chairmanship of a non-executive director. The Committee shall address grievances of security holders of the company. Except the change in the name of the Committee, there is no substantive change in tasks assigned to the Committee. The change in name suggests that the lawmakers had in mind that the Committee should provide a channel of communication to stakeholders. In the context of 'responsible business' there is an urgent need to establish an effective mechanism to enable all stakeholders to communicate to the company their expectations and concerns and to receive communications from the company on how the company has dealt with the same. However, for some reasons or the other the lawmakers could not take the bold initiative of mandating establishment of such a mechanism. The Chairperson or his/her nominee shall attend general meetings to answer queries of shareholders.

CSR Committee

Corporate Social Responsibility (CSR) Committee is unique in the Indian governance structure. The Bill requires companies that meet the net worth or the turnover criteria to spend two percent of the average of the previous three years profit in CSR activities. Those companies shall constitute a CSR committee with three or more members out of which at least one director shall be an independent director. The CSR Committee shall formulate the CSR policy and shall recommend the same to the Board for approval. Although not specifically mentioned, the Committee shall monitor CSR projects and shall assess the impact of CSR activities periodically.

Conclusion

Tasks assigned to the Audit Committee and the Nomination and Remuneration Committee are very important and critical for good governance. If the committees are serious about their responsibilities, members of those committees shall be required to spend significant time for the committee work and for meeting senior executives of the company. Therefore, anyone who agrees to be a member of those committees should be ready to commit adequate time for the committee. Although, in theory, the Board will set the 'tone at the top', in practice the CEO sets the 'tone at the top'. The Board intervenes only when some untoward incident is reported. I feel that the Audit and the Nomination and Remuneration Committees, by virtue of their unique position, can get a feel of the culture of the company during interactions of their members with senior executives and they can initiate corrective actions, if required, before the damage is done. Although, this is not a legal responsibility, the Committees should take up this responsibility voluntarily.

Companies should use the Stakeholder Relationship Committee to build social and relationship capital. In future, that will be an important capital for running the business. Companies that will fail to build that capital will face immense difficulties due to their failure to address reasonable expectations and concerns of stakeholders. Stakeholder Relationship Committee and the CSR Committee should work in tandem to ensure that CSR activities reinforce the efforts of the company to build social and relationship capital.

In general Committees are at the centre of the corporate governance structure. The quality of corporate governance depends significantly on the efficiency and effectiveness of committees. An important question is how to motivate members of those committees to commit required time and efforts for committees' work. We should debate this issue. In absence of the same the committees will be paper tigers only. Let us try to avoid that situation.

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