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Failing boards, ailing governance.

Content

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There's No Such Thing as a Part-Time Watchdog

By Menaka Doshi

"In India it's less about board management and more about 'managed' boards."
That comment by a veteran lawyer succinctly describes the corporate governance fiascos of the last several months.

From grave incidents of alleged fraud and mismanagement to underperformance, conflicts of interest and culture clashes – Indian companies have put every flaw on display.

Each time investors were left asking – **"what in heavens was the board doing?"**

Tata Sons

The board, aligned to the majority shareholder, gave Cyrus Mistry a glowing performance review only to sack him a few months later.

Axis Bank

The board seemed unquestioning of managing director and chief executive officer Shikha Sharma. But the regulator wanted her gone.

Infosys

The board first played supplicant to chief executive officer Vishal Sikka, then to former promoter NR Narayana Murthy. Investors paid the price for unstable leadership. And even today, investigations into certain acquisitions have not been shared with all shareholders.

ICICI Bank

The board appeared like a deer in the headlights, dazed by the celebrity of MD and CEO Chanda Kochhar, allowing her continued presence in the company, even as she was being investigated for alleged nepotism.

Fortis
Promoters held sway, the board turned a blind eye to many suspicious transactions, and finally shareholders booted them out.

Yes Bank
Yet another board seemed unaware of the regulator's unflattering assessment of the MD and CEO Rana Kapoor. And then was found wanting a succession plan.

IL&FS
The board was either kept in the dark by an entrenched management or struggled with the complexity of hundreds of subsidiaries. And slept through a liquidity crisis.

Smaller companies like Vakrangee and Manpasand may have less recognised board members but they too watched silently as financials turned murky, auditors resigned and investors fled.

How Did It Come To This?

To be sure, over the last decade and more India has put in place one of the most rigorous corporate governance frameworks in the world, one that has often been ahead of changes in other countries.

For instance – it is only this year the United Kingdom, in its Corporate Governance Code, provided for at least half the board to be independent, a measure India imposed on listed companies several years ago. Audit firm rotation became part of European Union law in 2014, after India legislated the same in its company law. India mandated rotation of independent directors four years ago, many developed countries still don't.

So before a government committee gets itchy to change the law or add one...that's not what needs changing.

But a few other things do...

1. Culture

> "Behaviour can never be legislated. Behaviour is strongly influenced by the culture and culture takes a very long time to change. - **Former General Counsel**"

Culture and behaviour are not easily altered by legislation. At least not in the medium-term. And India's corporate governance regime is just two decades old.

The challenge in India has been two-fold. To dial down the overwhelming influence of promoters and their anti-minority actions, and to turn up the independence quotient of directors.

The aggressive legal framework has had some success in restraining promoters, curtailing related party transactions and empowering shareholders. Curiously though, governance issues have now cropped up in non-promoter-led companies or those with dispersed shareholding, such as IL&FS.

"Promoter capture has been replaced by CEO capture," is how the former general counsel put it.

It's the second part, on independent directors, that's proving trickier.

2. Selection of Independent Directors

The most effective cure to a star-struck board is the induction of fiercely independent directors. But that spine is taking time to strengthen.

Again, not for the lack of a robust legal provision. To be clear, both company law and SEBI regulations have a detailed, stringent definition of what makes a director 'independent'.

But the law can only draw boundaries, the rest must be supplied by people of quality and independent spirit.

And, while on paper the appointment of independent directors is to be independent of management and determined by shareholder vote, in reality the candidates are often handpicked by the promoter or the CEO.

As a result many boards continue to run like old boys clubs where camaraderie ranks high and dissent causes discomfort.

Some of this may change when the rotation of independent directors truly kicks in and the club is forced to cast the net wider and admit new members. That may take another five to six years.

Because when the rotation rule became effective in 2014, previous terms of independent directors were not counted towards the new mandate of maximum two terms of five years each.

There's also been a debate on whether the process of selection and appointment of independent directors should change. That they should be selected by an independent nominating committee and approved by a majority of non-promoter (public) shareholders. The first has been somewhat achieved by mandating that the nomination and remuneration committee should be independent. The second is a contentious point as it undermines the majority shareholder and "control".

3. Shareholder Activism

In the last decade, shareholder activism has increased aided by an increase in institutional ownership of Indian equity, voting disclosures by institutional investors and the rise of domestic governance and proxy advisory firms.

In 2012, KV Kamath, who served as managing director and chief executive officer of ICICI Bank till 2009, was designated as an independent director on the same board. While this was in conformity with the law it didn't quite meet the spirit test. Yet no one demurred.

In 2014 mutual funds and governance advisory firms opposed Maruti Suzuki's plan to allow parent Suzuki to build a manufacturing facility in Gujarat which would contract manufacture cars for Maruti. This, even though independent directors had approved the plan. It took the carmaker a year and several changes to get institutional shareholder approval.

This year, former RBI Governor Bimal Jalan and well-known accountant Bansi Mehta stepped down as independent directors of HDFC after proxy advisory firms recommended voting against a proposal to extend their directorships. In the same shareholder meeting, veteran business leader and HDFC Chairman Deepak Parekh retained his seat on the company's board by the skin of his teeth.

In May when institutional shareholders of Fortis Healthcare moved a resolution to remove four independent directors from the board, it marked a first in India. Three quit. One was booted out.

More such shareholder actions will create a demand pull for directors who are independent.

4. Expectations

Are independent directors supposed to play trusted strategic advisors to the management/promoter or serve as watchdogs for the company's public shareholders?

This confusion in roles was highlighted in a 2010 paper by Vikramaditya Khanna and Shaun Mathew. "These roles are not easy to balance and indeed may run at odds with each other at times," the authors noted.

"Further, the time needed to be a strategic advisor may differ considerably from that needed to be a "watchdog". The latter likely requires more ongoing and consistent oversight, whereas the former may require only more limited and discreet time commitments. Despite the general perception in the public that independent directors ought to serve as watchdogs, it would appear that the strategic advisory role may be more suited to the actual functioning of boards, given that few boards meet more than once every two months."

-The Role Of Independent Directors In Controlled Firms (Courtesy: Manupatra)

Those words ring truer today as business and financial complexity puts more demands on the time of independent directors.

5. Board Engagement

The IL&FS audit committee met five times in financial year 2017-18. Only two of the five committee members attended all five meetings, the other three attended one each.

The company's risk management meeting didn't meet even once in the year.

Even when meetings are held and attendance is full, time is short.

A random check on the duration of recent board meetings held to approve October-ended quarterly earnings suggests that members spend between 2-5 hours on deliberations.

TIME TAKEN TO REVIEW Q2FY19 RESULTS

Company	Duration of Board Meeting
Reliance Industries	2 hours
Tata Steel	4 hours 15 minutes
HDFC	2 hours 40 minutes
Maruti Suzuki	3 hours
ITC	2 hours 30 minutes
Larsen & Tubro	5 hours 30 minutes
Sun Pharmaceuticals	4 hours 40 minutes
Yes Bank	5 hours

Source: Stock Exchange Filings

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Most boards meet between five and eight times a year.

NUMBER OF BOARD MEETINGS IN FY18

Company	Number of Meetings
Reliance Industries	6
Tata Steel	7
HDFC	6
Maruti Suzuki	5
ITC	6
Larsen & Tubro	6
Sun Pharmaceuticals	5
Yes Bank	8

Source: FY18 Annual Reports

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But is it enough to grasp operational and financial complexity of large businesses and their numerous subsidiaries?

More importantly, given the time spent, is it realistic to expect independent directors to fulfil the role of watchdogs?

6. Weak Enforcement

Given their limited engagement independent directors face disproportionately high liabilities...on paper. It is nobody's case that independent directors should be punished for a company's misdeeds, unless they were actively complicit in them.

But what about instances of negligence or ineffective oversight?

In February this year the U.S. Federal Reserve board issued an unprecedented enforcement action against Wells Fargo & Company following revelations that the leading American bank opened dummy customer accounts and other "pervasive and serious compliance and conduct failures".

Besides imposing restrictions on growth and replacing four board members, the Fed board also made public letters of reprimand not only to Wells' former CEO and chairperson but also to the former Independent Lead Director.

The letters are unsparing and directly address the failures.

The Order is addressed to the current WFC board. However, the Board is issuing this letter to you because of your role as lead independent director during the time period many of these problems occurred. To fulfill that role, you needed to have sufficient information from firm management to understand and assess problems at the firm. This would require robust inquiry and demand for further information about the serious compliance problems that were occurring at the firm.

You were made aware of sales practices and other compliance issues while you were lead independent director. However, you did not appear to initiate any serious investigation or inquiry into the sales practices problems or put a proposal to do so to the WFC board. In addition, you did not appear to lead the independent directors in pressing firm management for more information and action, even after you were aware of the seriousness of the problems. This lack of inquiry and lack of demand for additional information are not consistent with the duties and responsibilities of the Lead Director as described in the firm's Corporate Governance Guidelines between 2013 and 2016. For example, those guidelines provide that the Lead Director will facilitate communication between the WFC board and senior management, including advising WFC's Chairman and CEO of the WFC board's informational needs and approving the types and forms of information sent to the WFC board.

The Federal Reserve Board has been troubled by the sales practice abuses at WFC, and the ongoing disclosures of misconduct in other areas. A lead independent director is appointed to serve the interests of the firm and, to that end, provide an alternative view of, and (when necessary) check on, executive directors of the board and the management of the firm. Your performance in that role is an example of ineffective oversight that is not consistent with the Federal Reserve's expectations for a firm of WFC's size and scope of operations.

"...the Federal Reserve's enforcement action and public letters of reprimand are a striking reminder of the persistently rising expectations on boards of directors," said a client memo published by law firm Paul Weiss.

Meanwhile, shareholders of Axis Bank and Yes Bank are still trying to figure out when and how their CEOs lost the confidence of RBI and outlived their utility.

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Five Questions To Ask On Why Boards Are Ineffective

By Cyril Shroff

With the heightened media focus on 'governance issues' and the re-enactment of several legislations in the recent past, we see that the discussion in boardrooms, and the common understanding of the roles and responsibilities of directors, is undergoing a major overhaul. While efforts towards legal compliance continue to be a top priority, we believe that embedding good governance practices into the fabric of corporate culture in India will entail addressing some tough questions.

1. Why Are Boards Still Ineffective In Dealing With A Governance Crisis?

It is universally accepted that the role of the board is to steer a company towards growth and away from crisis. There, however, appears to be a predictable and all-too-frequent collapse of boards in critical situations. It is arguable that the boards could have taken more mature decisions in a timely manner to mitigate or avert the damage altogether, had they been better prepared.

This raises the question of whether our boards are adequately trained to handle a crisis.

Have they developed a response plan in 'peace-time' to ensure a timely rollout in crisis? Have they stress-tested their response plan in different kinds of crisis situations? It is like the proverbial adage of digging a well once the fire starts. Most importantly, is the conversation in board rooms steering the approach towards crisis management from a curative to a preventive one, or, are boards lost in the tyranny of the standard agenda of goal setting and approving financial numbers every quarter?

2. As Institutional Ownership Rises, Are Boards Actively Increasing Governance Sophistication?

Public companies are increasingly witnessing a higher portion of their equity being held by the category known as 'institutional investors'. This coincides with the relative decline of controlling promoters. In many ways, this trend is hailed as a welcome one, from a governance standpoint with the focus on professionalisation of management, absence of conflict, increased diversity in the boards, and better disclosure practices. The experience of the West, however, poses some predictable challenges that arise from dispersed shareholding patterns, including the 'agency problem' with the interests of stakeholders and managers being at divergence, the increased pressures of short term-ism in decision making, and the unpredictability of the changing nature of shareholder priorities on strategic issues.

With this rise of institutional investors, I ask – are companies building up their sophistication to respond to activist investors and tackle the pressure to take decisions in the interest of certain institutional investors that may not align with its own?

"In the absence of a powerful voice on the board, who will ask tough questions? Or instead, will we have a conspiracy and silence of players without skin in the game?"

3. Is It Time To Deal With Board Dysfunctionality Arising From Narrative That Demonises Promoters?

In many strains, we see the discourse on governance challenges in India, being attributed to the deeds and misdeeds of 'promoters'. There is a presumptive bias of dishonesty or conflict. Several amendments have been introduced to the Companies Act, 2013, and SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, with a view to restrict and check the powers, and the seen and unseen influence, of the promoter.

I now ask whether the overly negative discourse on promoter-led organisations, has made us overlook many positive facets of the dedicated leadership that promoters offer to the company that they founded.

Is the creation of 'sides' on the boards, and the subsequent 'us versus them' syndrome constructive?

Is there a need to recognise and value the deep commitment of promoters to a company, similar to the value that is attributed to the role of independent directors, in order to effect a re-balance that results in more functional and constructive boards?

There seems to be a risk reward imbalance and that cannot augur well for a stable governance framework. Especially in a corporate and social culture which is and will always have many promoters, as it lies at the heart of India's definition of entrepreneurship.

4. Is Over-Regulation Disincentivising Board Effectiveness?

Admittedly, India is a jurisdiction where regulators, and not the markets, are seen to be driving governance conversations and benchmarks.

Compliance then, has become the primary metric for the board, rather than actual effectiveness of the boards in driving forward a good governance agenda.

In this context, I ask whether, arguably, over regulation provides a safe blanket to the boards to work within a 'letter of the law' framework and does not incentivise assessment or enhancement of actual effectiveness.

Also, does such prescriptive regulation make the boards adopt a 'survival' attitude, lost in the eternal 'gatekeeper's anxiety'? Is the challenge enhanced by the reality that much of the law is ambiguous and 'grey' and in today's environment – grey could more often mean 'black'?

The erosion of the benefit of doubt is adding to an over-technical, risk-averse outlook.

Is this what we intended?

5. Are We Addressing Structural Gaps That Deter High-Quality Professionals From Directorships?

Unlike the settled position of limited liability of owner-shareholders, the liability of directors appears to be at an evolving state of jurisprudence, trending away from reasonableness or limits.

The cautious tone that has been set by the courts in the recent cases, where the corporate veil is readily lifted, personal assets of independent directors have been frozen, and corporate boundaries getting ignored, raises the obvious question on whether we have adequately weighed the cost of the unintended consequences of over-zealous and unpredictable regulation and enforcement.

The duality of remuneration that is capped and liability that has no limits, begs the question of whether there is adequate regulatory and judicial will to address the structural gaps that inhibit high quality professionals from accepting directorships.

Populism cannot drive judicial commentary.

Where corporations are increasingly forming the driving force of the economy and social structures, it is pertinent to question whether the system will survive the lack of quality professionals at its helm, having fallen at the altar of judicial and regulatory zeal.

Let us know which question is on the top of mind for you in the comments section.

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The Travails Of Corporate Governance Without Enforcement

By Umakanth Varottil

This year marks the twentieth anniversary of the earliest corporate governance initiative in India, namely the release in 1998 of a voluntary code for 'Desirable Corporate Governance' devised under the aegis of the Confederation of Indian Industry.

This code formed the bedrock of a flurry of activity on the governance scene in India. In the first decade since then, the Securities and Exchange Board of India devised mandatory corporate governance norms based on reports of various committees headed by industry leaders such as Kumar Mangalam Birla and NR Narayana Murthy. Thereafter, matters transitioned to the domain of the Ministry of Company Affairs that then incorporated corporate governance norms and, in particular, the role, responsibility and liability of the board of directors, into the Companies Act enacted in 2013. SEBI altered its framework to match that of the legislation. These measures, no doubt, ushered in a paradigm shift in Indian corporate governance, as the norms have become considerably more stringent over the years.

This, however, gives rise to a key puzzle.

Despite the constant evolution of corporate governance norms that have become rather robust, why does corporate India witness governance crises rather periodically?

Over the last two years, several high-profile crises erupted in well-known companies such as Tata Sons, Infosys, ICICI Bank and IL&FS, just to name a few, wherein the role of the board of directors has been called into question. One may be forgiven for harbouring the notion that the governance norms in India are an abject failure. But matters are more nuanced than that.

"While the substantive law on corporate governance has evolved at a rapid pace, the legal enforcement of these norms has fallen short of the intended goals."

Soft And Hard Law

One method, employed in several countries, is to implement corporate governance norms through voluntary codes, which are essentially 'soft' law. Using the 'comply-or-explain' approach, companies must either comply with the codes or, alternatively, disclose and explain why they fail to comply. A reliance on market enforcement would suggest that investors would incorporate these disclosures into their decision-making process and punish companies for non-compliance by assigning a discount for poor corporate governance that would reflect in the market price of the stock.

While displaying some sporadic affinity towards such voluntary codes, the Indian regulators have mostly viewed them with suspicion. Conversely, India has relied heavily on 'hard' law, namely mandatory rules of corporate governance that seek to impose legal sanctions for non-compliance. This began through corporate governance norms contained in the listing agreement, which then transitioned to the Companies Act and SEBI's listing regulations.

Arguably, such a mandatory approach to governance matters is apt for India, which has traditionally followed a top-down regulatory approach, and is thought to have a deterrent effect on delinquent managements and promoters.

Mandatory rules are optimal only when they are accompanied by robust enforcement mechanisms, both in the law as well as in action.

The lack of strong enforcement has possibly led to weaknesses in the governance framework.

Public Enforcement

On the one hand, public enforcement is considered the means by which civil or criminal penalties are imposed by the government, regulators or courts. In India, actions taken by the Ministry of Corporate Affairs and SEBI have been the mainstay of public enforcement. This can be a useful tool to ensure compliance with corporate governance norms and disclosure laws. Prescribing the conduct of management and boards of directors through such a mechanism would ensure that companies function in a manner that leads to investor protection. The focus is largely on the wrongdoers rather than the victims.

Even though public enforcement is the principal mechanism for implementing corporate governance in India, the track record of its utilisation paints a bleak picture.

"There have hardly been any successful criminal convictions in any of the high-profile cases of corporate governance lapses even when they have involved blatant fraud."

Due to such impunity, the use of criminal law is bound to have limited deterrent effect against wrongdoing of managements and directors of companies. While the use of civil penalties has witnessed relatively stronger results, it has remained woefully inadequate in instilling improved governance standards.

Moreover, SEBI has used blunt force instruments such as debarring individuals from accessing the capital markets for a period of time, often on an ex parte basis, rather than more targeted actions. The most acute concern with public enforcement lies in the delays in regulatory action. For instance, while SEBI has passed orders in the decade-long Satyam scandal, the enforcement is far from reaching a logical conclusion given the possibilities of appeals that leads to uncertainty. That can hardly be any deterrence at all.

Private Enforcement

In the case of private enforcement, victims—who are generally minority investors in companies—have access to a menu of options to seek remedies for expropriation or abusive conduct suffered at the hands of managements or controlling shareholders. An action for oppression and mismanagement would enable a minority shareholder to seek remedy if the affairs of a company are carried out oppressively or in a manner prejudicial to the interests of the company or to public interest.

"It is hard for minority shareholders to obtain a successful outcome in such actions, as they need to discharge a high burden of proving the requisite standard of wrongful conduct."

The Mistry group has relied upon the action for oppression and mismanagement as the primary prong of attack against the Tata group in the case involving Tata Sons but has failed to taste success so far.

Another action is a derivative suit brought about by the minority shareholders against wrongdoing directors on behalf the company. However, such shareholder derivative actions have been few and far between in the Indian context as they have to be brought before the regular civil courts that suffer from the usual delays and inefficiencies.

The last, and perhaps most potent—at least on paper—is the class action mechanism introduced under the Companies Act, 2013. Although it is wide in nature and confers considerable discretion to the National Company Law Tribunal to grant different types of remedies, the novelty of the provision leaves it with considerable uncertainty. There does not appear to be evidence of its successful use in any corporate governance lapses or other corporate wrongdoing, thereby making it premature to judge its effectiveness.

In all, while there are a number of private enforcement options available, they have seldom been used, and even rarely have they succeeded.

This leaves the victims of governance lapses without any recompense.

Consider a high-profile like Satyam. The holders of American depository receipts in the U.S. initiated a class action that compelled the company to settle by paying $125 million to the holders, and the auditors PwC to pay $25.5 million. In stark contrast, the Indian shareholders were unable to successfully bring an action for private enforcement before the Indian courts, and hence received no compensation at all despite suffering similar losses. The glaring inadequacies of private enforcement are on display through this episode.

Corporate governance in India is at crossroads. After having gone down the path of using 'hard law' in the form of mandatory rules, it suffers from a lack of effective enforcement. The logical path would be to create more avenues for the proper use of both public and private enforcement methods more effectively. The Ministry as well as SEBI ought to have a clear public enforcement strategy and execute it by deploying appropriate resources and capacity to that end. On the private enforcement front, existing bottlenecks can be removed by creative interpretation by the courts and tribunals. The other alternative would be to re-experiment with 'soft law' in the form of corporate governance codes, but it requires greater political will and momentum to effectuate such a drastic policy reversal.

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Saving Promoters From Themselves

By Amit Tandon

Being an independent director on a board is a challenge. Doubly so in India.

From names on the masthead aimed at attracting capital, to counselors to families and managements, the role of independent directors has changed, as the law has steadily burdened them with more responsibilities. Just as independent directors narrowed down their role to being arbitrators between the controlling shareholder and public shareholders, legislation has now tasked them with providing oversight and exercising control. For example, the audit committee needs to approve related party transactions.

I expect the role to continue to evolve, as the duty of the director itself has changed. For the longest time, this was to promote the interest of the company, and by extension, its shareholders. Directors are now expected to promote the interest of all stakeholders – employees, suppliers, the community and the environment.

"From maximising value while balancing between two sets of shareholders, their role is now to balance multiple agendas."

Even as the law has changed, market expectations have soared. For the longest, it was the controlling shareholder who took the blow for governance failures. Now each misstep by a company is seen as a failure of its board and independent directors. Investors are quick to judge directors for their inability to rein-in strong CEOs, for their failure to push back on high salaries, for their inability to hold-off on related party transactions. Independent directors face these and similar dilemmas in each board meeting. Described as the hand that feeds syndrome, it is not always easy to go against the person who invited them to join the board. But they must.

Compounding this is how the law is now being interpreted by the courts.

Last November, the Supreme Court restrained not only the promoters of Jaiprakash Associates, but also the independent directors and their family members from transferring any personal assets or property without the court's permission. Earlier this year, three independent directors on Nirav Modi's firm—Sanjay Rishi, president of American Express for South Asia, Gautham Mukkavilli, a former PepsiCo India president, and Suresh Senapaty, a former chief financial officer of Wipro—were restrained from freely accessing their bank accounts as part of an ongoing investigation by the ministry of corporate affairs.

The real danger is that the lower and district courts now cite these as precedents to penalise independent directors.

Only a thorough check of the promoters and the business before joining the board, can mitigate this risk – but not wholly.

Resignations, And Explanations

How have independent directors dealt with being on boards and these changes? Drawing on Alberto Hirschman's framework, they have always had three choices - exit, voice or loyalty. Till recently, most chose to stay loyal. With the passage of the new Companies Act, we have seen a spate of exits from boards.

Resignations, from a public shareholders' perspective – especially from boards of beleaguered companies, is a sub-optimal outcome.

We have lately seen R Chandrashekar resign from Yes Bank, and Vikram Mehta from the board of Jet Airways. Investors would rather they stay back and help companies navigate through troubled times. Board members need to factor this into their decisions, but for them to do so, regulations need to draw a line between culpability of owner-managers and others on the board.

Regulations may now have pushed voices to the forefront: directors are articulating why they have left the board. We have seen two such instances in quick succession – Yes Bank and JM Financial ARC. Whether these are an aberration, or the beginning of a new trend, we will know soon.

Be More Prudent Than The Owner Is?

It is said that the best way to contribute on a board is to imagine you are the owner; but how does a director argue with someone who has skin in the game, when they themselves have no stake in the business? But clearly, directors giving their unqualified support to owner-managers has not been working. Look around and you will see that the corporate landscape is littered with failed companies and many more with anaemic performance.

- Expansions funded by debt, since promoters want to maintain their control.
- Acquisitions stapled through double leverage because promoters don't have equity funds to bring in.
- A high salary for the family members, because they believe this is where the value is, and not in the market capitalisation.
- Moving funds between group entities till the money is tunnelled-out.
- Auditors singing to the promoters' tune till the absence of liquidity bares all.

How can independent directors keep track of all these? Lawyers can no doubt draw-out a checklist to help directors steer through all this and more.

But there is one thread that runs through all this, and it is of promoters over-reaching themselves.

This gives directors a pointer. Directors should task themselves with protecting the promoters from themselves, and in professionally managed companies, managements from themselves. This alone will help directors earn the trust of the company, its stakeholders, the regulators and investors, and to play the part that they are elected to play.

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What Makes Boards Effective - An Independent Director's Views

By Nawshir Mirza

Whilst a great deal of effort has been devoted to making boards of directors more effective, the continuing cases of board failure put their efficacy in doubt. That is because all the reforms are aimed at ritualising governance and not at addressing the core issue – board behaviour. There are several factors that powerfully affect behaviour, some of which are unique to hoary societies such as India's.

Capitalism

This influence is powerful throughout the world. It makes the provider of equity pre-eminent amongst all stakeholders and, in a democratic system of governance, this results in the controlling shareholder being lord and master of his company. This pre-eminence was snatched 400 years ago because it was the only factor of production in the old industrial economy that was scarce. The pre-eminence of the controlling shareholder means that every decision must sub-serve his interest, often to the disadvantage of the other participants in wealth creation. As long as the controlling shareholder rules the roost, the hens in that nest will do his bidding, regardless of the rituals that regulators prescribe for the flock.

"A basic failing of capitalism is to measure success by growth rather than by survival. The eight-ton Tyrannosaurus Rex is history. The unicellular Cyano-bacteria is still around after nearly three billion years."

Groupthink

This is a common behavioural problem and the regulators have attempted to get around it by increasing diversity on boards. Whilst individuals can be classified into genders, castes, religions practiced or colour, what is needed is diversity in thought. As boards generally select directors who have a corporate background, that diversity of thought is absent. The corporate system ensures that a business manager reaches seniority only after he thinks like his peers, regardless of gender.

Managers are trained to be optimists and carry this ingrained trait into the boardroom; even after they become non-executive directors; they cheer-lead rather than critically evaluate. More companies have come to grief because boards did not challenge the hubris of their chief executive officers and controlling shareholders than because of abuse of minority shareholders; the current pile of cases going through the Insolvency and Bankruptcy Code is testimony to that.

The fundamental difference between managements and boards is that the former should bring optimism to their recommendations which must be balanced by the constructive pessimism of the board.

That is the yin and yang of company survival.

Disagreement

All old cultures shy away from open disagreement and they tend to put age on a pedestal. That is how those cultures are perpetuated. The New World has no old culture to preserve and it accepts disagreement far more easily. Indian directors are loath to openly disagree, instead use hints or outside-the-boardroom discussions to express their differences. Because such conduct results in a one-on-one conversation, many critical weaknesses of an idea are not disseminated to the rest of the board and are snuffed out by an opinionated CEO or controlling shareholder. The situation is worse when the CEO or chairman is a legendary, old man; disagreeing with him is unthinkable.

Further, the attitude of many non-executive directors is that ultimately it is the controlling shareholder's money at stake and if he is keen on doing something, why stand in his way? Even where directors believe that a plan could seriously harm the company, having raised their objections, they will then be content if the CEO glibly assures them that he will take the concerns into account in the plan's execution. Few will record dissent even if a plan could hurt a company badly because that error will only surface in the future.

Wisdom

If one plots the old hierarchy of data-information-knowledge-wisdom, against a corporate organogram, the corresponding levels are junior employees-junior managers-senior managers-the board. Why? Because the board's principal function is to appraise strategy that management has proposed. Management develops strategy by extrapolating their business knowledge into the future. It is for the board to bring its experience and breadth of knowledge-beyond-the-business to appraise the proposed strategy. That is wisdom. Wisdom is the ability to peer into the gloom of the future to decipher the vague shapes one sees to compare with the perfect solids that management predicts.

Management is medium-term tactical, the board long-term strategic.

If boards are to function effectively, there are only two purposes that the non-executive directors need to serve:

1. Be the voice of those not in the boardroom.

The equity shareholder is adequately represented in the room through the controlling shareholder and management generally speaks for the employees. Customers are usually respected, though their exploitation is not uncommon.

But when have boards discussed the fair treatment of vendors or the effect of the company's business on society, the community or future generations?

Being their champion is now the principal role of a non-executive director; the protection of minority rights is relevant only if the controlling shareholder is oppressing them.

2. Challenge management and the controlling shareholder.

Cultural conditioning means that lions outside the boardroom morph into sheep once they sit at the board table. Persons who come from the professions are generally better at constructive criticism in a group setting than are those who have been indoctrinated to applaud the boss.

In order to do this successfully, directors must possess three attributes:

- **They must have wisdom.** To paraphrase Churchill's words, to look back far into the past to be able to look far into the future.
- **They should possess integrity.** To say what they think and to do what they say. CEOs and controlling shareholders can exploit a hypocrite.
- **They should have courage.** Courage to speak up, to challenge the controlling shareholder. If necessary, to make public a serious wrong. They must be ready to face a very cold and uncomfortable situation without fear.

Some believe in expressing extreme dissent by quietly resigning. On boards, silent resignation is the coward's way out.

For those directors who are classified as independent, the key is independence from emotional dependence on a directorship. If a directorship brings prestige to a director and he is afraid of losing that status, he will not be independent. This cannot be legislated but it is the biggest shackle to very competent independent directors continuing to sit when they must stand-up.

Good boards foster a culture that enables good behaviour from their members. As much depends on the individual directors as on the chairman or controlling shareholder to bring about such an atmosphere. A single courageous and wise director can bring change in a boardroom. The key is to foster such individuals and get them into a board.

Nawshir Mirza is a professional independent director, and serves on the boards of a number of large Indian companies.

Why Audit Committees Aren't For The Faint-Hearted

By R Narayanaswamy

The audit committee is unquestionably the most powerful of all board committees. The board is responsible for eliminating the conflict of interest and reducing information asymmetry between shareholders and management. The audit committee is its principal arm for fulfilling these responsibilities.

The audit committee's mandate is to oversee financial reporting and related controls. It encompasses a review of financial earnings releases and filings, risk oversight, oversight of the external auditor, monitoring ethics and compliance policies, and oversight of internal audit. In practice, the audit committee becomes the referee in all matters involving questionable management conduct.

The audit committee's role became prominent in several companies including Infosys, IL&FS, Jet Airways, Ricoh International, ICICI Bank, the National Stock Exchange, and the Tata Group. The matters included acquisitions, real estate investment, financial reporting, top management decisions, related party transactions, and promoters' conduct.

At least four critical functions of the audit committee are either ignored or deserve more importance. From boards and committee members.

1. Accounting and Financial Expertise

Audit committee directors should be proficient in accounting. They should understand the accounting standards and practices related to the company's business. Accounting is getting more tortuous with every passing day. Revenue recognition and leases are just two current examples of Byzantine accounting regulations.

"I once asked an audit committee chair of a defence equipment company about the key accounting issues in the business. A celebrated scientist, he replied that he did not have to worry because the company's chief financial officer would know them."

Fortuitously, he had a smooth tenure. However, later he was ensnared in an accounting scandal in another company that cost him his hard-earned lifetime reputation and a lot of money in legal costs.

2. The Audit Game

The audit committee recommends auditors and reviews their work. Appointing a good auditor is a necessary, but not a sufficient, condition for prevention and detection of wrongdoing. For a start, auditors define their responsibilities so narrowly that they cannot be held responsible for many failures. When something goes awry, they come up with defences such as that the terms of engagement do not cover such matters, management is responsible for controls, they have to rely on information provided by management, auditing is not intended to detect fraud, and suchlike.

When all is said and done, an unlikely coalition of management, board and auditors could blame the audit committee.

Populism cannot drive judicial commentary.

The audit committee mediates between management and auditor. Its job is to ensure that management addresses auditor concerns.

In promoter-controlled companies the audit committee even chastises the auditor for daring to question the promoters. In my experience, auditors are mostly putty in management's hands, notwithstanding occasional brave words in audit committee meetings. In joint audits, they sometimes compete to please the management. Since the buck stops with the audit committee, it should not hesitate to take independent advice for better assurance.

3. Arbitrating On Conflict Of Interest

Securities and Exchange Board of India regulations require audit committee approval for all related party transactions. There should be a policy for consideration and approval of such transactions. Key considerations for approval would include the business reasons for a transaction, the terms including price, how insiders may benefit from it, and how outsiders may view it.

The board has a fiduciary duty to the shareholders. Any suggestion that insiders seek to benefit from a transaction will adversely affect a company's reputation and stock price.

In September 2018, the market value of Infibeam Avenues was destroyed by 71 percent based on a WhatsApp message that said that the company had given interest-free and unsecured loans to related parties. PC Jeweller and Raymond were also hit by related party questions.

4. Risk Management

The audit committee is responsible for reviewing the company's risk management and mitigation policies. It should question the relationship between strategy and risk. Cybersecurity risk and foreign exchange risk require constant attention. The audit committee should ask for information about security drills and hedging. Mergers and acquisitions run the risk of overpayment and lack of a strategic and cultural fit. In financial services firms, an asset-liability mismatch is a major risk.

The real danger is that the lower and district courts now cite these as precedents to penalise independent directors.

Unfortunately, even a major fraud has not been able to reduce the prevalence of incompetent or ill-equipped or spineless audit committees.

Satyam Slack Versus Enron Effect

The role of the board and the audit committee came under scrutiny in the wake of the irregularities in Satyam Computers Ltd. A corporate collapse that shook India's markets and regulators, and was widely characterised as "India's Enron," should have led to major improvements in the functioning of audit committees of Indian companies.

Research shows that the Satyam failure had a limited effect on Indian audit committees. Here are some numbers for Satyam and Enron:

Did Things Change After Enron And Satyam?

Measure of effectiveness	Satyam Pre	Satyam Post	Enron** Pre	Enron** Post
Number of audit committee directors	3.69	3.94	4.16	4.23
Proportion of independent directors	0.888	0.889	0.894	0.925
Number of audit committee meetings	4.83	5.12	4.76	7.59
Attendance at audit committee meetings	86.8%	83.8%	Not Available	
Number of firms in the sample***	323	323	432	432

Source: R Narayanswamy, K Raghunandan, and Dasartha V Rama

Bloomberg | Quint

*Satyam fiscal year: Pre 2007-2008; Post 2009-2010. ** Enron fiscal year: Pre 2000; Post 2002. *** Sample for India has BSE 500 companies excluding government companies and non-March 31 fiscal year companies. Sample for U.S. has S&P 500 companies. Companies with insufficient data have been excluded in both samples.

The reactions in the two countries to a major corporate scandal could not have been more different.

- Though the number of audit committee directors increased after Satyam, it is still below the pre-Enron U.S. average.
- The proportion of independent directors hardly changed after Satyam, as compared to a significant increase after Enron.
- The number of audit committee meetings increased significantly after Enron, but was much less after Satyam.
- Counter-intuitively, attendance at audit committee meetings declined after Satyam.

The Satyam fraud should have jolted corporate governance practices but all we got was a mild jerk, at best.

The Companies Act, 2013 lays down a code of conduct for independent directors. SEBI has widened the responsibilities of the audit committee in the Listing Obligations and Disclosure Requirements Regulations, 2015. These include reviewing the functioning of the whistle-blowing mechanism.

There are high expectations from audit committee directors. Deep accounting and financial expertise, the ability to manage tricky relationships with management and auditors, and constant alertness to risks and conflicts are necessary for a successful and trouble-free audit committee. These positions are not for the faint-hearted, for sure. Unfortunately, the audit committee is often regarded as a frill by both management and board. That is a costly a mistake.

R Narayanaswamy is Professor of Finance and Accounting, Indian Institute of Management, Bangalore. Views are personal.

If Winter Comes

By M Damodaran

If 2008 was the year of the global financial meltdown, 2018 will be remembered, at least in India, as the year when corporate governance came of age. With major irregularities coming to surface in large entities, some of which had prided themselves as the flag bearers of the corporate governance movement, the myth of a direct relationship between size and governance standards exploded.

Whistle blowers began to find their voice, and the commentariat found adequate opportunities to express informed and uninformed opinions on issues, real and imaginary. Those that lived in denial came up short, and the transgressors found that no longer could excuses masquerade as explanations. In the midst of the episodic excitement and entertainment that such events produced, the lessons were obvious and compelling.

Some of the cornerstones of corporate governance became no more than rebuttable presumptions in marquee companies.

Independent directors and indeed whole boards moved up to the top spot in the merit list of non-performers, with auditors coming a close second. Those deemed the defenders of the faith got shown up as disbelievers.

Top Of The Demerit List

The board of directors deserves the highest place in the pecking order of those that let the side down. This collection of individuals—presumably chosen for experience, maturity, wisdom, a sense of balance, and fair play—proved through action, and inaction, that they were no more than clapper boys or cheerleaders for chief executive officers who were considered infallible, invincible, indispensable and immortal.

"The highly questionable performance of boards was best illustrated by the manner in which a chairman bolted out of a boardroom, at a pace which Usain Bolt would have envied, to mount a public defence of a CEO whose conduct was in question."

When The Music Stopped

Independent directors have for some time been the punching bag of those who seek to find villains on occasions of corporate misfeasance. Protestations of being part-time non-executive functionaries, and at the disadvantageous end of information asymmetry, have not convinced anyone that they did not rest their conscience, their thought processes and their voice when they were in boardrooms.

Statutory stipulations regarding the role and responsibilities of independent directors were at best seen as read, but not absorbed and acted on. Part of the blame clearly lies at the doorstep of those who over prescribe in the mistaken belief that more laws and regulations necessarily lead to better conduct. The icing on the cake continues to be the attempt to define director independence in quantitative or monetary terms. We seem to be only one step away from seeking to define integrity in monetary terms.

The simplistic perception that compensation and independence have an inverse relationship is striking at the root of the institution of independent directors.

Legislative and regulatory excess is worse than the perceived excess in compensation of independent directors.

The auditor community has also legitimately received a fair share of the blame attached to financial crimes and misdemeanours. With stakeholders placing complete faith in the observations of the auditors, and hoping to make investment decisions based thereon, auditors have sought refuge in increasing disclaimers and complexity of language to escape the responsibility of stating what subsequently has become obvious at least in a few cases. With an independent statutory disciplinary body, NFRA, now in place, there is reason to hope that auditing conduct will improve and that auditors who wrongly perceive management as their employers, will not pull their punches if irregularities, or worse, are noticed.

Many Challenges In The New Year

2019 is on everyone's mind as the year in which India goes to the polls. At the same time corporate India is expected to witness a significant churn in the composition of the boards, with the first five year term of many directors, after the implementation of the Companies Act, 2013, coming to an end. Sensing the opportunity that a potential influx of new directors will give rise to, there are attempts to create a revenue model for an institute that will be tasked with assessing the suitability of new appointees to board positions. There is no clarity yet on how attributes such as collegial behaviour (as distinct from collusive behaviour), independence and integrity will be determined by an institute through an assessment process. The outsourcing of the statutory responsibility of the Nomination and Remuneration Committee to a bunch of academics is a highly questionable move.

2019 will also see the position of chairman of the board being occupied by a number of new entrants to the board, especially with the position becoming non-executive in the near future.

The presumption that every chairman will hit the ground running and will need no orientation to provide leadership to the board deserves to be set aside.

Programmes are required to be designed to handhold new chairmen to clearly understand their role as leaders of the board, and to help create an enabling environment for board members to contribute effectively in exercising superintendence, direction and control.

Breaking Up Unwieldy Boards

The size of the board is also a cause for concern. Unwieldy boards with a large number of executive members, many of whom do not express views other than on their functional areas, is a problem that needs to be addressed.

Simultaneously, the fear factor that drives independent directors out of boardrooms has to be taken cognizance of, so that the corporate sector is not denied the benefit of their wisdom.

"The answer presumably lies in a two-tier board structure that has the independent directors on the supervisory board, and the executive directors on the fiduciary board."

This approach will provide relative safety for independent directors while factoring in the legitimate aspirations of functional business leaders to become board members. An abundance of executive directors on a unitary board also negates the board-management distinction.

An Evaluation Mechanism

If boards and their constituent directors are to add value on a continuing basis, it is necessary to have a robust no-holds-barred evaluation system put in place. The mutual admiration societies that come into being, as a result of what passes for peer evaluation within the boardroom, should be a thing of the past.

The salutary example of the United Kingdom which provides for evaluation by an external agency at least once in three years would be a good starting point. Due disclosure here: Excellence Enablers, with which I am associated with, functions as an external board evaluation consultant.

The Ideal Package

Boards that are right in size and content, and have role clarity, board committees that are correctly constituted and contribute meaningfully, constructive tension between boards and managements, auditors that seek and state the truth, retail shareholders that ask questions, institutional investors that practice activism—and do not stray into adventurism—and proxy advisory firms that distinguish the grain from the chaff, is the package that Santa should hopefully bring this month.

The lessons have hopefully been learnt. The solutions are in sight. What is needed is clarity, courage and conviction to put in place a meaningful pragmatic value-adding structure, supported by appropriate procedures, to ensure that 2019 will be the turning point in India's corporate governance history.

> **No longer must it be said that when the going got tough, the tough got going from the boardrooms, and the stakeholders got burnt at the stake.**

M Damodaran is the Chairperson of Excellence Enablers, and former Chairman of SEBI, UTI, and IDBI.