# Corporate Governance - Legislation vis-à-vis Self Regulation Practices

**ASHISH MAKHIJA** *
**B.Com (Hons.), MICA, LL.B., AICWA, MICA, FCA**
**CORPORATE LAWYER**
**ashish@amclawfirm.com**

The present era of globalization calls for greater transparency in corporate disclosure practices as a result of which *corporate governance practices* have assumed greater significance than ever before. The extremely competitive business scenario coupled with changing pattern of corporate ownership has led to the development of concept of c*orporate governance* which was hitherto overlooked by majority of corporate houses.

The perpetual need for transparency in reporting and accountability has laid emphasis on adoption of measures, policies and practices commonly termed as *`corporate governance practices'*. These practices impart balance between *'exercise of power'* and *'acceptance of accountability'*. The concept of Corporate Governance is, however, not restricted to the notion of transparency and accountability alone but also concerns itself about *independence* of all those charged with governance. Corporate governance stipulates rules for composition of governance team and defines relationship primarily between those governing and those on whose behalf governance is being carried out, namely, the stakeholders.

## Concept of Governance

The word 'governance' has been derived from Latin word `gubernare' that means `to rule or to steer'. The concise Oxford dictionary 10th Ed gives the meaning of `govern' as `to constitute a rule, standard or principle' or `to conduct the policy and affairs'. In the era of kings and kingdoms, there used to be a normative framework for exercise of power and acceptance of accountability thereof. Over the years, the governance has turned out to be of utmost relevance for the corporate world on account of its sheer size, ever widening base of their shareholders, increased participation of financial institutions and evolution of concept of corporate social responsibility.

In recent years, corporate failures, chiefly on account of misgovernance, have been witnessed resulting in loss of faith in the *ability, capability and stability* of the corporates and their management. All these factors have contributed in bringing 'good governance' into even greater limelight. This concept has now caught the fancy of promoters, directors, regulators, government, management gurus and the like having stake in the corporates.

**Governance & Management**

By and large the terms 'governance' and 'management' are used interchangeably though conceptual difference exists between the two. The primary difference lies in *activity* orientation - the governance is `*strategy'* oriented whereas management is `*task'* oriented. The *management* concerns itself with `execution of tasks' in order to achieve pre-determined goals & objectives. The focus under governance is wider than management; it encompasses framing of policy and ensuring disclosure and transparency. The focus under 'management' is *internal* – to control, direct and monitor the activities of management personnel and executives and to make them accountable for proper implementation of pre-determined policies. On the other hand, the focus under `governance' is *external* – it involves accountability of promoters and directors to the outside world namely, the stakeholders. Though the concepts are distinctive, there is a common thread, which establishes irrefutable inter-relation between the two - `*better governance leads to better management'*.

**Who are stake holders?**

The focus under Corporate Governance has shifted from 'shareholders' to `*stakeholders'*. Nobel Prize winner in Economics, Milton Friedman linked Corporate Governance to *the conduct of business in accordance with the shareholder's desires*, which primarily meant to create wealth for shareholders/owners but at the same time conforming to the laws, rules, regulations & customs established by the society. The Corporate Governance is no longer restricted to creation of wealth for the shareholders; the concept now *encompasses*

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[*] The author is a Corpoarte Lawyer and can be reached at amclawfirm@rediffmail.com

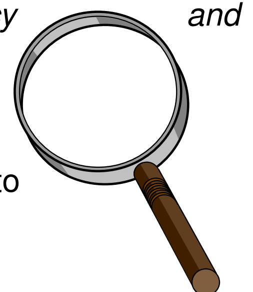
interests of stakeholders. But who really are the stakeholders? The stakeholders include, besides the shareholders, other participants in the corporation such as the board of directors, managers, employees, workers, customers, vendors, lenders, dealers, regulators, society and even government. Thus the social and community goals cannot be overlooked under Corporate Governance. Sir Adrian Cadbury, in his preface to the World Bank Publication, Corporate Governance: A framework for Implementation laid emphasis on this aspect and stated "Corporate Governance is holding the balance between *economic* and *social* goals and between *individual* and *community* goals. The aim is to *align* as nearly as possible the interests of individuals, corporations and society." A corporation no longer has sole objective of `maximizing profit or wealth'; its success and growth is no longer measured by the magnitude of its operations and income earned by it but by the degree of adoption of good governance practices.

## Evolution of concept of Corporate Governance

The concept of Corporate Governance did not emerge overnight. It has evolved over a period of time but came in sharp focus recently due to varied reasons. The emergence of corporate culture brought in a new *idea* of **separation of ownership and control.** This concept of connoting divorce of "owners" and "managers" coupled with overwhelming public interest in the corporations led to the concepts of *accountability* & *transparency* in working of corporations and disclosure of information. The corporations have realized that *management without good governance practices is like a ship without a sail*. The significance of the accountability coupled with transparency cannot be undermined, as the managers responsible for managing the affairs of a corporation are merely the custodians of the assets owned by it.

## What is Corporate Governance?

Corporate Governance is a synonym for *sound management, transparency and disclosure*. To quote J. Wolfensohn, former President of the World Bank, "Corporate Governance is about **promoting corporate fairness, transparency and accountability"** Corporate Governance, thus, seeks to



establish control system and structure in an organisation, guides decision making process to ensure high degree of accountability to stakeholders and builds credibility by creating and maintaining an effective channel of information and disclosure. Corporate Governance focuses on building trust and confidence amongst stakeholders. The survey by Mckinsey & company in collaboration with the World Bank in June 2000 established strong link between corporate governance and investor confidence. The Organisation of Economic Co-operation & Development (OECD) has defined Corporate Governance as the *system by which business corporations are directed and controlled.* This definition encompasses *four* elements, namely,

a) distributing authority among constituents of corporate working;
b) defining rules and establishing procedures for attaining corporate objectives;
c) making, those charged with governance and management, accountable; and
d) creating and maintaining channels of information & disclosure.

The code of best practices submitted by Cadbury Committee, under the chairmanship of Sir Adrian Cadbury, in 1992 identified the ways of governance in order to achieve and maintain balance between *`exercise of power'* and *`accountability'* by the board of directors.

**<u>Why Corporate Governance now?</u>**

The big question, what led to such a forceful emergence of Corporate Governance now? , does not have any straight answers. In recent times, number of committees – Cadbury Committee (1991), Bank Committee for promotion and adoption of sound corporate practices in banking sector (September 1999), Blue Ribbon Committee in United States and Kumar Mangalam Birla Committee, Naresh Chandra Committee and Narayana Murthy Committee in India - have been set up on the issue of Corporate Governance. There have been other numerous codes and reports - OECD Code, IMF'S code of good practices on transparency in monetary and financial policies, Ney report in Canada and King report in South Africa - suggesting and recommending adoption of set of good corporate governance practices. Why sudden interest in corporate governance?

The corporate culture and public institutions have been existence for number of years; their emergence is not a recent phenomenon. The first and foremost reason for regeneration of

interest in corporate governance is the sudden falling of established corporations such as World Comm & Enron, which sent tremors and shock waves around the globe. The crumbling of these corporations coupled with financial irregularities noticed in various other corporations resulted in erosion of faith of stakeholders in perpetuality of these concerns, which in turn led to the emergence of the concept of good governance.

The other reason can be attributed to overwhelming public interest in these corporations. No corporation can work in isolation and naturally what happens to a particular company affects all. If any corporation fails due to lack of corporate governance practices, all the stakeholders feel its impact. For examples, a failure of a corporation affects not only its shareholders but also its employees (they tend to lose their jobs), customers (they are deprived of quality products and concerns are raised about after sales service), government (they lose revenue and have to deal with problem of unemployment), lenders (sticky loans now called as non-performing assets – NPA's), creditors (fear of non-recovery of amounts due) and suppliers (lose valuable customers which is turn affects their operations). Thus, the entire economy gets affected with one failure. The rest of the globe tends to suspiciously look towards such a country, which may lead to adverse flow of investment in that country. The effect of misgovernance in any corporation initiates chain of unfortunate events affecting the entire economy.

In the epoch of liberalized economies, the emphasis is on *`freedom, independence & autonomy'* with no or less government/state interference. But no freedom including those guaranteed by the Constitution is unrestricted. This *`freedom, independence & autonomy'* unless restricted by *`accountability'* might result in corporate failures recently witnessed by the planet. The highest Courts around the globe including our Supreme Court have upheld that no freedom is *unfettered* and all freedoms including constitutional freedoms have *`reasonable restrictions'* attached to it. Unregulated freedom leads to chaos, confusion and anarchy. In a similar way, corporate governance, by establishing systems and procedures, seeks to ensure *balance between `exercise of power' and `accountability'*. Much as one would desire to disregard corporate governance practices, this concept is here to stay though multi-dimensional evolution of this concept in times to come is likely.

## **Core of Corporate Governance**

What lies at the bedrock of Corporate Governance? Is it ethics or disclosures or transparency or system of monitoring, oversight and taking corrective action? All these issues are indisputably part and parcel of corporate governance but at the heart of Corporate Governance lies the *risk assessment* and *risk containment*. The effort under corporate governance is risk determination and its evaluation and taking corrective action to minimize its impact. This calls for prompt modifications in corporate strategy and procedures. The entire model of corporate governance is based on judgment, prudence and wisdom. The risk assessment and containment involves the following steps: -

1. Designing independent sound management and control systems.
2. Allocating authority and responsibility – vertically, horizontally and laterally- within the organisation.
3. Monitoring risk exposure and establishing system of corrective action to contain the risk.
4. Establishing disclosure and transparency of information procedures.

*Sound Management & Control System*

Sound management & control systems effectively means establishment of system of monitoring within the organization hierarchy. The composition of board of directors, formation of committees for effective governance such as audit committee, good governance committee, remuneration committee, grievances committee and establishment of accounting system independent of decision-making & operations, form part of sound management & control system. Ignoring the existence of these factors could be crucial for survival of corporates. Early warnings help the management in taking corrective action.

*Authority vis-à-vis Responsibility*

To achieve its objectives, an organization has to determine and divide authority and responsibility among the participants of governance. A distinction between decision takers and decision makers is necessary for *organic objectives* of an organization. A clear assignment of responsibility and authority avoids disorder, chaos and duplicity of effort ultimately leading to smooth governance of corporations.

*Monitoring risk exposure and prompt corrective action*

Knowledge of limitations minimises risk exposures and assists in taking prompt corrective action.. Risk management essentially involves taking remedial measures swiftly. Sound auditing systems, better enforcement of policies and timely action against frauds and malpractices will ensure greater faith and confidence of stakeholders in a corporate.

*Transparency & Disclosure*

The ever-changing business environment no longer focuses only on profit motive but also encompasses social responsibility as part of its objectives The most significant element of corporate governance emanating from this focus is transparency & disclosure of information. Corporate governance loses its meaning without a fair and transparent disclosure. *Transparency* refers to creation of an environment whereby the decisions, conditions & actions are made visible, accessible and understandable. As opposed to opaque, transparency essentially means easy availability of the information pertaining to working of a corporation. *Disclosure* refers to the process and method of providing information. Disclosure has no meaning unless there is timely dissemination which essentially involves providing answers to the following questions: -

a) What to disclose?
b) How to disclose? and
c) When to disclose?

The answer to the above questions is provided after considering following factors: -

| Factor | Implication |
|---|---|
| Qualitative characteristic of | Disclosure of useful information. |

| Information | |
|---|---|
| Relevancy | Disclosure of material information to prevent overload of information. Materiality is to be judged from the point of view of stakeholders. |
| Reliability | Information to be devoid of bias and errors. Factors to be considered in judging reliability are prudence, substance over form, completeness, neutrality and faithful presentation. |
| Consistency | To ensure comparability. |
| Understandability | Disclosure, which is not at all understandable, has no meaning. The visibility of disclosure should also be appropriate. |
| Timeliness | Information loses its utility / value unless disclosed timely. This calls for cost benefit analysis. |
| Adequacy | The disclosure under corporate governance must be full and adequate. |
| Secrecy / confidentiality | As opposed to 'what to disclose?' this factor looks at 'what not to disclose?' This calls for judgement depending on facts and circumstances. |

**Self regulation vis-à-vis Legislation**

Now for the big question – whether corporate governance practices should be in the form of self-regulation only or should they be legislated? Legislation means 'declaration of legal rules by a competent authority.' Once Corporate Governance practices are legislated, they lose the voluntary character; they become mandatory. In other words, these practices would have to be compulsorily and necessarily followed by each and every corporation. On the other hand, self-regulation demands that corporates should follow the corporate governance practices voluntarily without any shadow of compulsion. According to this view, the corporate governance practices should be adhered to by the corporates as their obligation, more akin to eminent jurist Prof. H.L.A. Hart's concept of law, who emphasized that *law is concerned with obligation rather than compulsion*. As opposed to this conception of law, John Austin, another eminent British jurist, propounded that unless law is made mandatory, no one obeys it and hence his positive theory of law recognizes *law as a command* to be obeyed (duty) and attracts sanction on its violation. The advocates of this

logic support `*building-up of deterrent factor'* to ensure compliance. Merely treating them as moral/social obligations will not ensure compliance and there must be some external pressure in the form of rules/regulations/legislation, which will be monitored closely by regulators, government authorities and State.

There is no rationale to find folly with this logic as looking at Indian corporate scenario would also justify the legislation of these practices. Confederation of Indian Industries (CII) codified the corporate governance practices many years back but its compliance was non-existent. It was only after Securities & Exchange Board of India (SEBI) made it mandatory on the recommendation of Kumar Manglam Birla Committee set up by it that the listed companies began embracing them. On the other side, the regulators and government bodies have gone overboard and in their zeal to coerce the corporations to adopt corporate governance practices have over reacted resulting in overlapping of mandatory regulations. In India, besides SEBI, Ministry of Company Affairs (previously Department of Company Affairs) has also appointed committees on the subject of corporate governance and has amended even otherwise voluminous piece of company legislation, namely the Companies Act, 1956 in 2000. These amendments have, however, resulted in codification of corporate governance practices, which are at variance with corporate governance practices as codified by SEBI. The disparity in the codified practices has set off murmurs by corporations emphasizing the need to have only one regulator/government body to codify governance practices. A comparison of differential requirements as per SEBI guidelines and Companies Act, 1956 clearly brings out the variations in corporate governance practices.

| **Sub-clause of Clause 49** | **Requirement** | **Section Of the Companies Act, 1956** | **Requirement** |
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| 1(A) | **Composition of Board of Directors**<br><br>a) 50% of the total number of directors should be **non-executive directors.** | - | No such requirement under the Companies Act, 1956.<br><br>In fact, the Companies Act, 1956 does not use the expressions 'independent directors' or 'non- |

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| | b) If chairman is an executive chairman – at least half of the total number of directors should be **independent directors.**<br><br>c) If the chairman is a **non-executive chairman,** at least 1/3rd of the total number of directors should comprise of independent directors. | | executive directors' or 'executive directors' or 'executive or non-executive chairman' |
| I(B) | All **fees/compensation,** if any, paid to non-executive directors, including independent directors, shall be fixed by the Board of Directors and shall require previous approval of the shareholders in general meeting. | 299 | This section requires disclosure by directors of their interests in contracts and arrangements with the company. It is only a disclosure of information (Form 24AA) and there is no requirement of stating the same in Annual Report as it is under Clause 49 except the disclosures to be made pursuant to AS-18 – Related Party Disclosures. |
| II(A) | **Composition of Audit Committee**<br><br>a) The audit committee to consist of–<br><br>➢ **Minimum of 3 members, 2/3rd of which must be independent directors.**<br><br>➢ **All directors shall be financially literate having accounting and financial management expertise.**<br><br>b) Chairman to be an independent director<br><br>c) Chairman to attend Annual General Meeting<br><br>d) Committee to invite Finance Director, head of Internal Audit, representative of statutory auditor to attend the meetings.<br><br>e) Company Secretary to act as | 292A | Applicability of Section 292A<br><br>Section 292A applies to all public companies having a paid-up capital of Rs. 5 crores or more.<br><br>Composition of Audit Committee<br><br>a) The audit committee to consist of –<br><br>➢ **Not less than 3 directors**<br><br>➢ **2/3rd of which shall be directors other than managing or whole-time directors**<br><br>b) Chairman to be elected by the members<br><br>c) Chairman to attend Annual General Meeting<br><br>d) Director in charge of finance, Internal Auditor, statutory |

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| | Secretary to the committee | | auditor shall attend the meetings without any right to vote. |
| II(B) | **Meetings of Audit Committee**<br><br>➢ To meet at least four times in a year<br><br>➢ Gap between one meeting and another should not be more than 4 months.<br><br>**Quorum**<br><br>Two members or one-third of the members of the audit committee, whichever is higher and minimum of two independent directors. | | **Meetings of Audit Committee**<br><br>The **frequency of meetings is not specified u/s 292A.** However, it states that Audit Committee should have periodical discussions with the auditors regarding the scope of audit and audit observations and review of half-yearly and annual financial statements before submission to the Board and also ensuring compliance of internal control systems.<br><br>**Quorum**<br><br>No quorum has been specified in Section 292A. The quorum should, thus, be as per Articles of Association of the company. |
| II(C) | **Powers of Audit Committee**<br><br>➢ To investigate any activity within its terms of reference<br>➢ To seek information from any employee<br>➢ To obtain outside legal or other professional advice<br>➢ To secure attendance of outsiders with relevant expertise, if it considers necessary. | 292A(7) | **Powers of Audit Committee**<br><br>➢ To investigate into any matter in relation to items specified in section 292A or referred to it by the Board.<br>➢ To have full access to information contained in the records of the company.<br>➢ To seek external professional advice, if necessary. |
| III(A) | **Remuneration of Directors**<br><br>The remuneration of non-executive directors to be decided by the board of directors with previous approval of shareholders. | | **Remuneration of Directors**<br><br>Section 309(1) of the Companies Act requires the remuneration of directors (whether executive or non-executive directors) to be determined by the resolution of the Board and the shareholders. |
| IV(A) | **Frequency of Board Meetings**<br><br>The board meetings shall be held at least four times a year, with a maximum time gap of three months | 285 | **Frequency of Board Meetings**<br><br>The board meeting to be held once in every three months and at least four such meetings to be |

| | between any two meetings. | | held in every year. The gap between two meetings could be more than 4 months. |
|---|---|---|---|
| V(B) | **Disclosures in respect of personal interest of the members of the management of the company**<br><br>Disclosures to be made by the management to the board relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large (for e.g. dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives etc.) | 299 | **Disclosure of interest**<br><br>Disclosure of interest u/s 299 relates to disclosure by the directors in respect of direct or indirect interest in any contract or arrangement with the company. The phrase 'members of the management' used in Clause 49 seem to be much wider. However, who all will be covered in the expression 'members of the management' has not been specified. |
| VII | **Report on Corporate Governance**<br><br>The company shall have a separate section on Corporate Governance in the annual reports of company, with a detailed compliance report on Corporate Governance.<br><br>Non compliance of any mandatory requirement i.e. which is part of the listing agreement with reasons there of and the extent to which the non-mandatory requirements have been adopted to be specifically highlighted. | - | **Report on Corporate Governance**<br><br>No separate report on corporate governance is required under the Companies Act, 1956. |
| VIII | **Compliance Certificate from Auditors**<br><br>The company has to<br>a) obtain a certificate from the auditors of the company regarding compliance of conditions of corporate governance as stipulated in this clause.<br>**b)** Annexe the certificate with the directors' report, which sent annually to all the shareholders of the company.<br>**c)** Send the same certificate to the | - | **Compliance Certificate from Auditors**<br><br>No such requirement under the Companies Act, 1956. |

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|  | Stock Exchanges along with the annual returns filed by the company. |  |  |

**Conclusion**

The *importance of codification of good corporate governance practices* having mandatory force cannot be mitigated. But in order to ensure implementation and compliance in true spirit, corporate governance practices need to be legislated by one regulator or body only to avert duplicity, confusion and uncertainty. The necessity of mandatory corporate governance practices, however, leads to another significant question – *Is mere compliance of legislated Corporate Governance practices an ideal situation?* The compliance with legislated corporate governance practices must be considered as corporate governance practices at minimum level. It, therefore, cannot be an ideal situation. What is desired, at the moment, is change in perception of persons charged with governance. It is for the corporate world to set up precedents of implementing unique and distinctive corporate governance practices as a leader to be followed by one and all. **The regulatory pressure is indispensable but voluntary compliance to more than minimum is desirable**. A case in example is the requirement of having *minimum number of independent directors* by a public limited company having paid-up capital in excess of Rs. 5 crores in India. But is the independent director *really independent*? Can any independent director get himself independently elected on the board of any company without the crutches provided by promoters? An independent director can be led to the board room but can any legislation/regulation make him think? Such academic regulations serving no purpose are a matter of great concern. These issues need to be addressed without delay or else these regulations would end up in making mockery of the purpose for which corporate governance practices are desired. The need of hour is thus *effective & continuous control system backed by independent and effective monitoring system*.

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