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OPINION: RAISING STANDARDS OF CORPORATE GOVERNANCE

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Capital Market & SEBI

Embedding robust governance practices is imperative for companies to create positive sentiment in the minds of investors and the public at large. Over the last several years, due to the determined efforts by the government, Securities and Exchange Board of India and the stock exchanges, the corporate governance norms in India have been tightened significantly, with a focus on corporate boards, which are primarily responsible for sound governance and prudential management of a company. However, some critical challenges remain, as India Inc. continues to face several impediments that hinder effectiveness of their boards.

For instance, the ownership of corporates in India, including the listed ones, is still held in a few hands. The median ownership of all National Stock Exchange (NSE) listed companies, by promoters, is above 50%. Further, in many cases, a single shareholder or family controls a large group of companies. This leads to several governance-related challenges as the concentration of power in the hands of a few creates opportunities for controlling shareholders to enrich themselves at the cost of minority shareholders. Vested with large voting powers, promoters can and do abuse related party transactions (RPTs) as a means for expropriating corporate value. Historically, regulations have had limited impact in this area, as they relied only on disclosure to check abusive RPTs; but the Companies Act 2013 created a new paradigm that required approval by disinterested shareholders for many RPTs and thereby strengthened the RPT regulation regime. More measures are, however, needed. For example, should promoters, whether they are part of the board or not, be given fiduciary responsibilities towards minority shareholders, at least in respect of RPTs?

Another issue that springs from concentrated ownership is the undermining of the institution of independent directorship, which is aimed at acting as a check on the management that is controlled by promoters. While independent directors are expected to protect minority shareholders from misdeeds of the promoters, it is ironical that the promoters appoint independent directors in many cases. Further, if independent directors ask inconvenient questions, their positions on the board often become untenable. This aspect does not seem to have been addressed effectively yet, despite the strengthening of the regulations regarding independent directors. In the area of corporate governance, the effectiveness of the audit committee and statutory auditors is critical. They ensure that a company produces relevant, adequate and credible information, which investors and independent observers can use to assess the company’s performance. If these committees fail, investors will be misled and the integrity of the market will be compromised. While regulations have been tightened in India, we still fall short of world standards. For example, unlike most progressive jurisdictions, India allows executive directors to be members of the audit committee.

With corporate governance related regulatory regime getting stricter over the years, the boards of Indian companies have been entrusted with increasing and varied critical responsibilities and, therefore, continually raising or even maintaining the effectiveness of the board is not an easy task. The challenges boards face can be best handled with a board comprising individuals with diverse skill sets and shared values. This needs to be accompanied with sound board processes that include regular and adequate sharing of information by the companies with their respective boards. While appropriate board composition and sound board processes contribute to an effective board, it is healthy dynamics between the members that make the board a well functioning unit. Research shows that the quality of board-level dynamics is highly correlated with firm's profitability, and a board that can function effectively as a team has a significantly greater impact on the firm's profitability than any one well-qualified board director—in other words, the whole is greater than the sum of its parts. Board effectiveness is an evolving process, one that requires the board to regularly evaluate its own performance. The Companies Act, 2013 not only mandates board and director evaluation but also requires the evaluation to be formal, regular and transparent. An important provision in the regulation is that the continuance of the independent directors has been made contingent upon their respective evaluations.

It is expected that regular and formal board evaluations would over the years lead boards to adopt improved practices, raise board effectiveness and ultimately lead to a better alignment of interests and investor protection. With an objective to take stock of the prevalent practices of Indian boards that have an impact on board effectiveness, NSE recently facilitated a board study conducted by Korn Ferry, which will be released in December.

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Mint *is a media partner for a study titled* Boards That Lead*, jointly done by Korn Ferry and NSE. The report will be released on 17 December at an event in Mumbai and its key findings will be carried in* Mint.

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