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Corporate Governance: Challenges during and Post Covid 19

Asish K Bhattacharyya

Asish K Bhattacharyya is the founder of Nonlinear Insights. He was a Professor at the Indian Institute of Management Calcutta and Indian Institute of Corporate Affairs. Also, he was Director of the Institute of Management Technology Ghaziabad and the Head of the School of Corporate Governance, Indian Institute of Corporate Affairs. Dr. Bhattacharya started the Centre for Corporate Governance at IIM Calcutta. He is a regular columnist for Business Standard for the last 12 years.

INTRODUCTION

Issues related to corporate governance (CG) came into prominence in the USA with the separation of control from ownership, highlighted by Brealey and Means in 1932.[1] At that time equity (risk capital) in most companies was provided by dispersed shareholders. These shareholders had neither the capability nor the interest in controlling the use of the assets held by the company. Therefore, professional managers enjoyed 100 percent control over assets with trivial rights on the cash flows generated by the use of those assets. As a result, the agency problem arises in CG. Like an agent, the manager expropriates the shareholders' wealth to enrich himself using the residual decision making powers.[2] In a principal-agent relationship, a complete contract cannot be written as all contingencies cannot be foreseen; even if anticipated, they cannot be articulated unambiguously. In a business, contingencies arise daily. Therefore, the manager enjoys huge residual rights. CG issues come to focus again and again when corporate frauds and scandals are reported. CG practices evolve to protect the interest of shareholders. The basic premise, which is that the manager enriches himself by expropriating shareholder's wealth unless effectively monitored, continues.

Shareholders enjoy two important rights – the right to vote and the right to receive timely information. CG Code ensures that the management facilitates the use of the voting right by shareholders freely without any cost (for

[1] Berley, Adolf. and Means, Gardiner. The modern corporation and private property. Transaction Publishers, New York (1932).
[2] I have used he/his/himself to refer to all the genders without any gender bias.

example, e-voting). It also mandates the management to provide timely information to shareholders either directly or through the stock exchange or media. Shareholders elect/appoint two important actors in CG – directors (particularly independent directors) and the auditor. Therefore, discourses on CG focus on the independence of independent directors and auditors. Directors and the auditor are elected/appointed by a simple majority (more than 50 percent votes of shareholders present in the general meeting should go in favour of the proposal, called ordinary resolution), except the appointment of an independent director for the second term (each term is of five years) and appointment of a non-executive director who has attained 75 years of age (in case of a listed company). In those two cases, the proposals are approved only if two-third of the votes go in favour of the proposal (called, special resolution). The law specifies that some crucial decisions reserved for shareholders, in addition to those two, should be approved by special resolution. In practice, in companies with a dominant shareholder, nominees of the controlling shareholder get appointed as directors, and an auditor recommended by these directors is appointed.

Shareholders are prohibited from interfering in the management of the company. They have recourses under the law if the company is mismanaged. The law entrusts the responsibility for managing the company on the board of directors (Board) constituted of directors elected by shareholders. It gives the Board full freedom to take decisions, except those that are reserved for shareholders. The courts provide immunity to directors by restraining themselves from having a second look at a business decision unless it is blatantly inappropriate, or the decision-making process is tainted by the conflict of interest (business decision rule).

BOARD’S DUTIES – CHANGING PERSPECTIVE

Corporate law in most jurisdictions requires directors to act in the best interest of the company as a whole. It was viewed for long that the company is a collective of shareholders and the phrase ‘company as a whole’ implies shareholders’ interest, treating all shareholders equally. However, now it is universally accepted that directors should act in the interest of the company, which is a legal entity separate from shareholders, and not in the interest of shareholders only.

Directors derive their power from the Articles of Association, which is the internal governance document approved by shareholders, and from the law. Although, shareholders have the right to incorporate, modify or delete clauses in the model Articles of Association provided in the law, directors primarily derive their power from law.

Corporate law accepts the primacy of shareholders by not giving any right to other stakeholders of the company. However, in defining the director’s duties, corporate law in different jurisdictions have taken different

perspectives on a director's duties toward some important stakeholder groups. For example, the U.K. Companies Act 2006 has incorporated the 'enlightened stakeholder value' (ESV) principle in section 172 (1) of the Act. It reads,

> "A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to— (a) the likely consequences of any decision in the long term, (b) the interests of the company's employees, (c) the need to foster the company's business relationships with suppliers, customers and others, (d) the impact of the company's operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct, and (f) the need to act fairly between members of the company."

The concept of ESV was introduced by Michael C. Jensen in 2000. ESV requires directors to pursue the goal of 'maximising the long-term market value of the firm', and in doing so, they should meet the demand of important stakeholders.

Indian Companies Act goes beyond ESV and imposes on directors the duty to balance the interest of the company, employees, shareholders and the community. They are also duty-bound to protect the environment. Section 166 (2) of the Indian Companies Act 2013 stipulates,

> "A director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of environment."

A plain reading of the Indian law gives the impression that directors have fiduciary responsibilities towards employees and the local community. One has to wait for the court's interpretation of the law.

INDIAN CORPORATE SECTOR

Family firms dominate the Indian corporate sector. As per the ET Intelligence Group's analysis, the market capitalisation of family businesses was around INR 65 lakhs crores, which is an average of the market cap for January 2020.[3] This represented 42 percent of India Inc's total market cap of INR 156 lakh crores. In January 2020, the NIFTY 50 had 31 family-run companies and the S&P BSE Sensex 30 had 16 family-run companies.

[3] Available at: https://economictimes.indiatimes.com/markets/stocks/news/family-businesses-are-doing-better-than-rest-of-india-inc/articleshow/74109424.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst; extracted on July 20, 2020

In accordance to a report published in Business Standards on July 29, 2019, based on research by NSEInfobase.com, the value of the holdings of Domestic Institutional Investors (DIIs)—comprising mutual funds, insurers, banks and other financial institutions—rose to 13.78 percent at the end of June 30, 2019.[4] Ownership of foreign portfolio investors (FPIs), stood at a two-year high of 19.8 percent on June 30, 2019. The percentage holding of promoters in companies listed on NSE stood at 54.46 percent as of June 30, 2019. Thus, on June 30, 2019, investment by retail investors was 11.96 percent. It is pertinent to note that retail investors lack motivation for exercising their voting rights. As per a report published in The Hindu Business Line on December 29, 2019, based on the research by the National Institute of Securities Market, only 0.6 percent of retail investors in India cast their votes. [5]

In accordance to analyses published by Economic Times on October 17, 2019, during the period from June 2018 to June 2019, top 50 companies by market cap attracted 77 percent of the total domestic institutional investments (DII) and 63 percent of the total foreign institutional investments (FII). [6] Companies ranked 51-100 received 7 percent of DII, ranked 101-200 received 12 percent, ranked 201-300 received 3 percent, 301-400 received 1 percent and ranked 401-500 saw a net outflow of 1 percent. If this trend continues, institutional investments in companies that are not among the top 100 companies will come down, and they will not feel the pressure from institutional investors for improving CG. The CG standards on those companies will depend primarily on the management and the quality of financial reporting and audit quality.

CORPORATE GOVERNANCE IN INDIA

CG Code in India is based on the Anglo-Saxon model, which is based on the agency theory. Indian CG Code is contemporary and comparable with CG codes and practices in advanced countries like the U.K. and U.S.A., which have adapted the 'Unitary Board' concept. Indian Boards have both supervisory and executive responsibilities. In India, the same SEBI CG Code applies to all the listed companies - family-group companies, stand-alone family-controlled companies, public sector enterprises (PSEs) and others. The government and regulators have taken a 'one size fits all' approach, although they provide certain exemptions to PSEs.

The efficacy of the Anglo-Saxon model and the 'one size fits all' approach is questionable. Under Indian culture and tradition, individuals are not purely economic person. They are a combination of economic person and social

[4] Available at: https://www.business-standard.com/article/markets/domestic-institutional-investors-bump-up-holding-in-indian-stocks-in-june-119072901038_1.html; extracted on July 20, 2020.
[5] Available at: https://www.thehindubusinessline.com/opinion/are-shareholders-exercising-their-vote/article30426866.ece, extracted on July 20, 2020.
[6] Available at: https://economictimes.indiatimes.com/markets/stocks/news/domestic-institutional-investors-zero-in-on-just-top-50-companies/articleshow/71624110.cms?from=mdr; extracted on July 20, 2020

person – a person who does not consider the accumulation of wealth a sin, but also holds values, cares for self and family reputation, enjoys peer recognition, and derives motivation from the job itself. CG code designed based on the agency theory might not be appropriate in the Indian context. CG system should be developed drawing from both the agency theory and stewardship theory. Stewardship theory is more appropriate than the agency theory in case of a family business where the decision-maker is the controlling shareholder, for whom protecting the family silver and creating family wealth are the priorities. Families do not want to give up control to non-family members even when they professionalise the management. The CEO is either a family member or a nominee of the family who functions under a shadow director, who is a family member, usually the '*Karta*' (patriarch) of the family. The family wants the balance of power between the CEO and the Board to be tilted towards the CEO. For example, families are not comfortable with the SEBI regulation that mandates the separation of the position of chairperson and the CEO in the top 500 listed companies and the appointment of a non-executive chairperson who is not related to the CEO. The application of the regulation has been deferred to April 1, 2022. Although research shows that family-controlled companies perform better than professionally-managed ones, research has also established that siphoning of funds is common in family-controlled businesses. Therefore, monitoring is required to check the siphoning off of company's wealth, which is detrimental to the interest of non-controlling shareholders. Therefore, the CG Code has made the audit committee to approve 'related party transactions' (RPT).

Families do not want outsiders in the Board. Therefore, family-managed companies comply with the provision of having independent directors in the Board by inducting those known to family members or to the senior management. The Nomination and Remuneration Committee (NRC) does not nominate anyone without the tacit approval of the controlling shareholder. Therefore, independent directors do not demonstrate the level of independence that is expected of them. If the independent directors are made accountable for every omission and commission of the company, it will be like 'throwing the baby out with the bathwater'. Competent individuals will not join Boards, and companies will be deprived of a good sounding board to test the controlling shareholder's ideas and strategies. Government, regulators and courts restrain themselves from imposing a penalty on independent directors for the company's omissions and commission, although the law holds all directors equally responsible for decisions taken by the Board.

The standard of CG in India hinges on the auditor's independence. Therefore, currently, the focus is on auditor independence. In July 2020, National Financial Reporting Authority (NFRA) has handed over severe punishment to the Ex-CEO of Deloitte in the case of beleaguered IL&FS Financial Services Limited (IFIN) related to the audit for the financial year 2017-018.[7] Indian Standards of Auditing are a clone of the International Standards of

[7] NFRA bars Ex-Deloitte CEO for 7 years, slaps Rs 25 lakhs penalty; available at: https://www.thehindubusinessline.com/money-and-banking/nfra-bars-ex-deloitte-ceo-for-7-years-slaps-25-lakh-penalty/article32165128.ece; extracted on August 2, 2020

Auditing. Similarly, Indian Accounting Standards (Ind AS) applicable to listed companies, are a clone of the International Financial Reporting Standards (IFRS). Therefore, in the coming years, the quality of financial reporting and audit are expected to improve and incidences of management fraud to come down. Consequently, on average, CG standard is likely to improve in coming years. In a nutshell, Indian Boards are not rubber-stamp boards but are mostly ornamental-cum-advisory boards. Director's performance is evaluated based on three important criteria: (a) reputation and capabilities in the eyes of institutional investors, (b) skills necessary for guiding the CEO and boundary spanning (lobbying), and (c) ability to present shareholder-friendly image while being management-friendly.[8] It has worked well so far but has also resulted in several large corporate sandals like Satyam and IL&FS. It may be incorrect to expect a significant change in current CG practices, which is to comply with the law by adopting the 'tick-the-box' approach, and adopt good practices appropriate for the company by improvising the CG Code. For example, reputed family-managed companies avoid having an independent Board, but engage meaningfully with large shareholders, disclose timely information and facilitate voting by shareholders, comply with laws and regulations and adopt high ethical standard. The CG standard in Indian companies hinges on audit independence and that is likely to improve.

CHALLENGES DURING AND POST COVID 19

The pandemic COVID-19 has posed a serious threat to established CG practices, particularly in companies that are not in the top league. Since many companies may not have adequate cash reserves, their future is uncertain and survival might be under threat. The most significant challenge for them is to ensure their survival through the COVID-19 crisis and building resilience to come back on the growth path post-COVID-19.

The Companies Act 2013 requires that while fulfilling their duties, directors should balance the interest of shareholders, employees and neighbouring communities and should conserve and protect the environment. Boards are duty-bound to balance the interests of all employees and the local community while crafting and implementing strategies for survival and growth in the post-pandemic era.

The general prescription for survival and resilience is to take the 'people first' approach and deal with employees, customers, vendors and members of the neighbouring communities with empathy and compassion. Under the pressure to cut cost, a CEO might be tempted to compromise with this fundamental principle, ignoring the long-term impact on the company. In today's dynamic and competitive business environment success of a firm depends

[8] Management friendly does not imply conniving with the management in perpetrating management fraud. It implies softer attitude toward the management and be sympathetic to the management.

on its capability to effectively manage institutional knowledge and relationships, as technology and emerging management techniques are freely available and imitable. During this period of pandemic-induced disruption, the focus should be on protecting and augmenting relationship capital and retaining talent while taking tough decisions required for the survival of the company. Any bad decision will impair the relationship capital and make retention of talent extremely difficult. Therefore, people related strategies should be formulated jointly by the CEO and the Board.

During adversity, the company's ability to hold its core values is severely tested. This is an area for which the Board should think deeply. It is the Board's responsibility to ensure that ethical standards and risk culture are not diluted during the pandemic when the company is under tremendous stress for achieving economic performance.

The Board, jointly with the CEO, should design training programmes and identify internal trainers (managers) to reinforce the values and risk culture across the organisation.

It is the responsibility of the CEO to share new information about COVI 19 with employees. Board's responsibility is to guide and support him. The Board may create a committee of board members with CEO and outside experts for evaluating the reliability of the new information flowing in. The CEO should share only that information that is approved by the Committee.

The Committee constituted to evaluate new information should support the Board in scenario analysis, which is necessary to redesign the business models for different businesses. Existing business models might not succeed in the new normal. Every company should review existing business model and evaluate alternative new business models taking into account opportunities within the adversity and learnings during the pandemic period. It is likely that these times will see severe disruptions. The national protectionism will increase, so will the use of AI and IoT. Employment and disposable income, especially of the lower middle class and marginal communities, will fall. Customer tastes and buying preferences in different geographical locations be affected. Activism in support of higher social responsibilities of Business will emerge. These factors need to be considered in designing the new business model.

In general, a Board's (read independent director) engagement with the CEO has to be much more intensive than what it was before the outbreak of the coronavirus pandemic. The Board, jointly with the CEO, should develop a written CG Charter with a clearly defined relationship between the CEO and the Board. The Charter should clearly explain the roles of the CEO and the Board and establish the relationship between the CEO and the Board. This will avoid the possible tension between the CEO and the Board, as the CEO might view the increased engagement as an interference in his domain. The Board and the CEO should jointly design a new metric for evaluating the performance of the CEO and the company, as in the coming few years, financial and operating

performances will not be the only key criteria for measuring the performance. [9] Boards should strive to link the CEO's performance with integrated reporting and integrated thinking. If a company is using the Balance Score Card, the same should be redesigned and objectives and measures should be redefined.

CONCLUSION

Compliance with CG code is not difficult if a company adopts the 'tick-the-box' approach. Therefore, framing new rules does not necessarily improve CG. The standard and quality of CG depend on the quality of the Board, the Board's culture and contribution of independent directors, quality of financial reporting and audit quality. Indian corporate sector is dominated by family business. Families do not want to give up control of the company, which they have promoted and nurtured, to an independent Board. Therefore, independent directors will not be able to act as independently as is expected by regulators. However, in the post-pandemic era the engagement of independent directors with the CEO will intensify. The distinction between management and governance has been blurred. A sound CG system should take this fact into consideration. Both the CEO and the Board should recognise that providing guidance to the CEO in managing the company is not undue interference into the CEO's domain of responsibilities and does not undermine the CEO's position. In future deliberations on CG by academics and practitioners, softer CG issues should receive proper attention. Government and regulators should restrain themselves in revising the CG Code. The present CG Code should continue for at least the next five years.

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[9] It will be important to generate surplus. But performance cannot be measured by ROI (or EVA) or total shareholder's return, as stock market often fails to understand the strategy fully and its long-term impact. During next few years, companies may not able to earn ROI higher than the cost of capital.