CHAPTER 3

CORPORATE GOVERNANCE-AN OVERVIEW

3.0 INTRODUCTION

This chapter provides an overview of corporate governance system. The chapter begins with the definitions and delineating the history of corporate governance by giving an overview of various committees formed around the world to reform the corporate governance system. It further extended to describe the evolution and restructuring of corporate governance system in India.

3.1 DEFINITIONS OF CORPORATE GOVERNANCE

Corporate governance enables to govern a company by providing rules and norms which are required for the survival of firm and protection of the interests of its shareholders & stakeholders.

Sir Adrian Cadbury Committee, which was setup in May 1991 for corporate governance issues in U.K., defined corporate governance, “As the system by which companies are directed and controlled. The basic objective of corporate governance is to enhance and maximize shareholder value and protect the interest of other stakeholders.”

Keasey and Wright (1993) defined corporate governance as a framework for effective monitoring, regulation and control of companies which allows alternative internal and external mechanisms for achieving the laid down objectives. The internal mechanisms include the board composition, managerial ownership, and non-managerial shareholding including the institutional shareholding while external mechanisms includes; the statutory audit, the market for corporate control and stock market evaluation of corporate performance.
Simon Deakin (1995) explained corporate governance in context of how companies are directed and controlled. Good governance is an essential element for the success of corporates and sustainable economic growth. To conduct research in context of governance necessitates an interdisciplinary analysis, drawing above all on economics and law, along with that close understanding of modern business practices coming from detailed empirical studies in a range of national systems. It describes the connection among various stakeholders i.e. shareholders, Chief Executive Officer (CEO), management, employees etc., in influencing the direction and corporate performance.

According to Shleifer & Vishny (1997) “Corporate Governance deals with the ways in which the suppliers of finance to corporations assure themselves of getting a return on their investment.”

Corporate Governance Forum of Japan (1997) explained corporate governance as the responsibility of the board of directors, who are elected to act on behalf of the shareholders.

Mathiesen (2002) defined corporate governance as a field in economics that investigates how to motivate efficient management by using incentive mechanisms that help in enhancing the performance of the corporations. These incentives can be in the form of contracts, organizational designs and legislation.

Craig (2005) stated that corporate governance depends upon the relative power of owners, managers and provider of capital. It entails the procedures, customs, laws and policies of different economies around the world. An important objective of corporate governance is to ensure accountability and transparency of those who are involved in the policy implementation of organizations through mechanisms that will reduce principal agent conflict.

Paul J. Sobel (2005) defined corporate governance as the process approved out by the board of directors, and its related committees, on behalf of and for the benefit
of the company’s stakeholders, to provide direction, authority, and oversights to management.

Goergen and Renneboog (2006) defined corporate governance as a system which is a blend of mechanisms which ensures that the management as the agent(s) runs the firm for the benefits of one or several stakeholders (principals). Such stakeholders may cover shareholders, creditors, suppliers, clients, employees and other parties with whom the firm conducts its business.

Bruce Weber, who is professor and dean of Business Administration of Alfred Lerner College of Business & Economics, defined corporate governance during an inaugural meeting of the newly reconstituted advisory board for the John L. Weinberg Center for Corporate Governance in 2011, as accountability to the providers of capital.

Marc Goergen (2012) viewed that corporate governance deals with the conflicts of interests between: the suppliers of funds and the managers; the shareholders and the stakeholders; minority shareholders and large shareholders; along with the mitigation in these conflicts of interests.

Peter Crow (2015) stated that the act of directing and controlling, describes what boards should do when they have to make decisions. It does not explain and is not a substitute for the board itself, nor any other party or activity outside the boardroom.

According to American Management Association (AMA) corporate governance is about how suppliers of capital hires managers to get returns on their capital, ensure that managers do not exploit the capital by investing in non-feasible projects, and how the suppliers of funds monitor managers.

ASX (Australian Securities Exchange) Corporate Governance Council gave definition of corporate governance as the framework of rules, relationships,
systems and processes within and by which authority is exercised and controlled within corporations.

According to International Chamber of Commerce, the application of corporate governance can be seen as the association between corporate managers, directors and the providers of equity, people and institutions, who save and spend their capital to earn a return. It ensures that the board of directors is responsible for the quest of corporate objectives and that the corporation itself conforms to the rules and regulations.

Delaware Supreme Court opined that the most primary principles of corporate governance are the functions of the distribution of power within the corporation, between its stockholders and its board of directors.

3.2 HISTORICAL OVERVIEW OF CORPORATE GOVERNANCE

3.2.1 Cadbury Committee on Corporate Governance, 1992

This committee was constituted in May 1991 jointly by London Stock Exchange, the Financial Reporting Council and the accountancy professionals in UK in the backdrop of series of financial scams and corporate failures in the 1980s in Great Britain. The Committee examined the accountability of the board of directors to shareholders and to the society and submitted its report and associated ‘Code of Best Practices’ in December 1992. The Cadbury Committee sets the objectives of corporate governance as a system that help to elevate the standards of corporate governance and the enhancing the level of confidence in financial reporting and auditing, by setting out clearly what are the respective responsibilities of those involved in and what is expected from them. Committee in its report spelt out the methods of governance needed to achieve a balance between the essential powers of the board of directors and their proper accountabilities.
3.2.2 The Paul Ruthman Committee

This committee chaired by Ron Hampel, was constituted to deal the controversy faced by Cadbury committee report on the grounds of its practicality. This committee restricted the reporting requirement to internal financial controls only, which was contrary to the code stipulated by Cadbury committee as ‘the effectiveness of the company’s system of internal control’. The final report of the committee had some central and progressive elements, notably the extension of directors’ responsibilities to ‘all relevant control objectives including business risk assessment and minimizing the risk of fraud’.

3.2.3 The Greenbury Committee, 1995

This committee chaired by Sir Richard Greenbury, was constituted in January 1995 to recognize the good practices of the Confederation of British Industry (CBI) in response to growing concern related to the level of salaries and incentives being paid to top management. It was constituted to shape directors’ remuneration and to arrange a code of such practices for use by public limited companies of the United Kingdom. This committee produced the ‘code of best practices’ for corporate governance which was divided into the following four sections:

1. Remuneration
2. Disclosure
3. Remuneration policy
4. Service contracts and compensation

3.2.4 The Hampel Committee, 1995

The Hampel Committee was constituted in November 1995 by the Financial Reporting Council, London Stock Exchange, Confederation of British Industry, and Institute of Directors. This committee was established under the
chairmanship of Sir Ron Hampel to endorse high standards of corporate governance and to review and extend the recommendations of Cadbury and Greenbury Committees. Some of the recommendations of Hampel committee were:

1. Auditors should report on internal control privately to the directors.

2. Directors maintain and review all controls, not limited to just financial.

3. Companies not having an internal audit function should analyse their need from time to time and introduce the Combined Code that consolidated the recommendations of earlier corporate governance reports of Cadbury and Greenbury committees.

3.2.5 The Combined Code, 1998

The Combined Code was derived from the reports of Ron Hampel Committee, Cadbury and the Greenbury in 1998. It was published by Financial Reporting Council (FRC). The Combined Code is applied to the companies listed on the London Stock Exchange. This included code related to companies, institutional shareholders, provisions on the design of performance related remuneration, guidance on liability of non-executive directors and disclosure of corporate governance arrangements.

3.2.6 The Turnbull Committee, 1999

The Turnbull Committee chaired by Nigel Turnbull constituted in 1999 by the Institute of Chartered Accountants in England and Wales (ICAEW). It provides direction to aid companies in implementing the requirements of the Combined Code relating to internal control. The main features of the report are:

- To provide guidance to assist companies in implementing the requirements of the Combined Code relating to internal control.

- To suggest companies which are not having internal audit function that
the board should consider the need for carrying out an internal audit annually.

- To recommend that boards of directors should authorize the procedures of estimating and managing key risks.

Corporate governance is constantly evolving to reflect the current corporate, economic and legal environment. For effective corporate governance practices there is a need to make rules and norms according to the particular needs, objectives and risk management of the organizations. Corporate governance is a dynamic concept and therefore needs to be improved with changing business environment of the economy accordingly.

3.2.7 World Bank on Corporate Governance

The World Bank was one of the first international organizations to study the subject of corporate governance and suggested certain guidelines. It was interested and concerned in equitable and sustainable economic development worldwide. The World Bank in its report on corporate governance identified the difficulties related with of the concept of corporate governance and emphasized on the values on which it is based.

3.2.8 OECD Principles

The Organization for Economic Co-operation and Development (OECD) is one of the earliest non-governmental organizations. The OECD Principles on the codes of best practices provide the similar trendsetting corporate governance guidelines as provided by Cadbury Report. The main beliefs laid out by the OECD for its member countries are rights of the shareholders, stakeholders’ role in corporate governance, equitable treatment of all shareholders, disclosure and transparency and the responsibilities of the board of directors.
3.2.9 Mckinsey (International Management Consultant Organization) Survey on Corporate Governance, 2002

McKinsey conducted a survey on 188 companies from 6 countries, to explore the correlation between good corporate governance and the market valuation of the company. The countries which selected for the survey were the emerging markets of India, Malaysia, Mexico, South Korea, Taiwan and Turkey. This survey found a positive correlation between the two.

3.2.10 Sarbanes-Oxley Act, 2002

Sarbanes-Oxley Act is a step towards good corporate governance. It provided certain standards of good governance as specific requirements. This act strengthened the independence and financial-literacy of boards. Some examples are: Creation of Public Company Accounting Oversight Board (PCAOB) to oversee the accounting industry; provision of job security to whistleblowers; and personal accountability of CEOs for inaccuracies in accounting audits.

3.2.11 Blue Ribbon Committee on Corporate Governance in the US, 1999

The Blue Ribbon Committee published its report in February 1999 to improve the effectiveness of corporate auditing committees. Its recommendations were mainly focused on the ways of enhancing audit committee oversight of corporate financial reporting like suggestion related to audit committee and external auditor relation, strengthening the independent auditors, quality of financial reporting etc.

3.3 CORPORATE GOVERNANCE: EVOLUTION AND RESTRUCTURING INDIA

In India, during 3rd century B.C. Chanakya expounded fourfold duties of a king viz. Raksha, Vriddhi, Palana and Yogakshema which could be seen as a concept of good governance. King was considered as steward who now substituted with
the CEO or board of directors of the company. Chanakya’s fourfold duties can be compared with principles of corporate governance:

<table>
<thead>
<tr>
<th>Chanakya’s Fourfold Duties</th>
<th>Principles of Corporate Governance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Raksha</td>
<td>Shareholders’ wealth protection.</td>
</tr>
<tr>
<td>Vriddhi</td>
<td>Wealth maximization by proper utilization of assets.</td>
</tr>
<tr>
<td>Palana</td>
<td>Wealth maintenance through profitable and feasible endeavors.</td>
</tr>
<tr>
<td>Yogakshema</td>
<td>Protecting the interests of the shareholders.</td>
</tr>
</tbody>
</table>

However, the concept of corporate governance was not in focus until early 1990s. India opened up its economy in 1991 which brought up the growth initiators viz. liberalization, privatization and globalization. With the advent of these events, Indian market became more reachable for domestic as well as foreign corporates which was vitally imperative for the growth and revival of the economy. Even at that time the book of law did give much reference to it. Governance system was weak and was in need of a reform in corporate governance. Some weaknesses of the system were:

- Undesirable stock market practices.
- Boards of directors without adequate fiduciary responsibilities.
- Poor disclosure practices, and
- Lack of transparency etc.

A number of measures have been adopted as a part of corporate governance reforms like strengthening of certain shareholder rights and increased empowerment of SEBI.

3.3.1 The CII Code

The Confederation of Indian Industry (CII) circulated its final draft on the ‘Code of Corporate Governance’ in 1997 and the final code of ‘Desirable
Corporate Governance Code’ was released in April 1998. These codes were applied on listed companies on voluntary basis to access domestic as well as international fund at an economical rates.

3.3.2 Kumar Mangalam Birla Committee Report, 1999

Overwhelmed with the positive response received for CII (Confederation of Indian Industry) code, SEBI constituted a committee chaired by Kumar Mangalam Birla in 1999. The objective of this committee was to raise the standard of good corporate governance and emphasis was to make it statutory rather than a voluntary code. In early 2000, the SEBI Board accepted and given consent on the key recommendations of the committee (mandatory and non-mandatory) which were incorporated into Clause 49 of the Listing Agreement of the Stock Exchange. The ultimate responsibility of putting the recommendations into practice rests directly with the Board of Directors and the management of the company.

3.3.3 Central Coordination and Monitoring Committee, 1999

Central Coordination and Monitoring Committee (CCMC) was set up in 1999 by the Department of Corporate Affairs (DCA) to monitor the action taken against the disappearing companies and dishonest promoters who misused the funds raised from the public. This committee was co-chaired by Secretary, DCA and Chairman, SEBI. On the recommendations of this committee, seven task forces were decided to be set up to recognize the companies, which have disappeared, or which have misutilised the funds raised from public and suggested appropriate action in terms of Companies Act or SEBI Act. The region selected for these task force were Mumbai, Delhi, Chennai, Kolkata, Ahmedabad, Bangalore and Hyderabad.
3.3.4 Report of Task Force, 2000

In 2000, the Task Force on Corporate Excellence set up by the group under the chairmanship of Dr. P.L. Sanjeev Reddy, Secretary of Department of Corporate Affairs. He presented a number of recommendations and the aims of these recommendations were to set up a Centre for Corporate Excellence and raising the standards of governance of all the Indian companies.

3.3.5 Naresh Chandra Committee Report, 2002

Naresh Chandra committee was appointed by Ministry of Finance and Company Affairs in 2002, to observe and recommend some amendments to the law involving the relationships between auditor and client, and the role of independent directors. The recommendations were based on two significant facets of corporate governance i.e. (1) Financial and non-financial disclosure, (2) Independent auditing and board oversight of management.

3.3.6 Narayana Murthy Committee Report, 2003

SEBI constituted a committee under the chairmanship of Narayana Murthy for reviewing implementation of the corporate governance code by listed companies and issue of revised clause 49. Some of the major recommendations of the committee predominantly related to audit committees and reports; directorships and director compensation; independent directors; codes of conduct and financial disclosure; related party transactions and risk management.

3.3.7 National Foundation of Corporate Governance, 2003

Ministry of Company Affairs (MCA) was set up by National Foundation for Corporate Governance (NFCG) in association with Confederation of Indian Industry (CII), Institute of Company Secretaries of India (ICSI) and Institute of Chartered Accountants of India (ICAI) in 2003. The NFCG focused on the following areas: sustainable wealth creation; awareness relating to good
corporate governance practices; platform for quality discussions and debates amongst academicians, policy makers, professionals and corporate leaders; improvement in the implementation and enforcement of various laws related to corporate governance; to set up 'National Centers for Corporate Governance' across the country.

3.3.8 J.J. Irani Committee Report, 2004

The Government took an initiative and set up a committee in December 2004, under the chairmanship of Dr. J.J. Irani with the objective of advising the government on the proposed revisions to the Companies Act 1956. The Committee submitted its recommendations in May 2005. The recommendations were mainly related to:

- Management and board governance
- Related party transactions
- Minority interest
- Investors education and protection
- Access to capital, accounts and audit,
- Mergers and amalgamations,
- Offences and penalties,
- Restructuring and liquidation, etc.

3.4 CURRENT STATUS OF THE CORPORATE GOVERNANCE IN INDIA

The corporate governance framework in India primarily consists of the following legislations and regulations:
The Companies Act, 1956: This act governs both listed and unlisted companies which itself administered by the Department of Companies Act (DCA). This Act deals with following:

- Rules and procedures regarding company incorporation.
- Prospectus and allotment of ordinary, preference shares and debentures.
- Management and administration of a company.
- Annual returns.
- Frequency and conduct of shareholders’ meetings and proceedings.
- Maintenance of accounts.
- Board of directors, prevention of mismanagement and oppression of minority shareholder rights.
- Power of investigation by the government plus powers of the Company Law Board (CLB).

The Securities Contracts (Regulation) Act, 1956: This act outlines the parameters of conduct of the stock exchanges as well as its powers.

The Securities and Exchange Board of India (SEBI) Act, 1992: This act established SEBI as an independent capital market regulatory body. The main objectives of its establishment are to protect the interests of investors, and promotion and regulation of the securities market.

The Depositories Act, 1996: This act established the depositories of share and securities. Depositories are also involved in transformation of securities in electronic form i.e. dematerialization and vice versa i.e. rematerialization.

Listing Agreement with stock exchanges: This act delineate the rules, processes, and disclosures that companies must follow to remain as listed on
the stock exchange. Clause 49 or Revised Clause 49 Equity Listing Agreement is one of the main elements of corporate governance practices that listed companies must comply with. This clause consists of mandatory as well as non-mandatory provisions:

**Mandatory Provisions:** Totally essential for corporate governance and it can be enforced without any legislative amendments.

**Non-mandatory:** Either desirable or may require change of laws. It may be implemented at the discretion of the company.

**Gist of Cause 49 is as follows:**

A. Mandatory provisions comprises of the following:

- Composition of Board and its procedure: Frequency of meeting, number of independent directors, code of conduct for board of directors and senior management.
- Audit Committee, its composition, and role.
- Provision relating to subsidiary companies.
- Disclosure to Audit committee, Board and the Shareholders.
- CEO/CFO certification.
- Quarterly report on corporate governance.
- Annual compliance certificate.

B. Non-mandatory provisions consist of the following:

- Constitution of Remuneration Committee.
- Dispatch of half-yearly results.
- Training of Board members.
- Peer evaluation of Board members.
- Whistle Blower policy.

Corporate governance in India is restricted to Clause 49 of the listing agreement. The Corporate governance norms are very strict and disclosures are mandatory. These norms are only applicable to public limited companies in India which are listed on stock exchange(s). Listed companies in India have to strictly follow the guidelines provided by SEBI (Securities and Exchange board of India) regarding corporate governance. It was found that India follows more stringent corporate governance practices based on US model.

**Norms related to Board Size**

1. Board Size (Mandatory)

<table>
<thead>
<tr>
<th>The Companies Act, 2013</th>
<th>Minimum (No.)</th>
<th>Maximum (No.)</th>
<th>Note: A company is allowed to have more than 15 directors only after passing a special resolution.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board Size</td>
<td>03</td>
<td>15</td>
<td></td>
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2. Board Independence (Mandatory)

<table>
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<tbody>
<tr>
<td>No explicit provisions for independent directors</td>
<td>It has mandatory provision for independent directors.</td>
<td>Ministry of Corporate Affairs (MCA) made changes in the provisions of 1956 Act and included the requirement of having an independent director on the board to oversee corporate governance.</td>
</tr>
</tbody>
</table>
Independent Director- Definition (given in Clause 49): Independent Director is a Non-Executive Director (NED):

- who is NOT a Nominee Director Is/Was NOT a promoter / relative of the promoter of the Company or its holding, subsidiary or associate company.
- who has/had NO pecuniary relationship (apart from directorial remuneration) with the Company, its holding, subsidiary, associate company or the promoters or directors during two immediately preceding financial years.
- whose relatives DO NOT have/had any pecuniary relationship with the Company its holding, subsidiary, associate company or the promoters or directors, amounting to 2% or more of its total income or Rs. 50 lakh during the two immediately preceding financial years.
- who is/was NOT an employee of the Company its holding, subsidiary, associate company in the any of the three immediately preceding financial years.
- who is/has NOT been an employee/proprietor/partner of an audit /legal /consulting/any other firm which has transaction with the Company its holding, subsidiary, associate company, amounting to 10% or more of gross turnover of that firm, in any of three preceding financial years.
- who is NOT a CEO/Director of a non-profit firm that receives 25% or more of its receipts from the Company its holding, subsidiary, associate company, promoters or its directors, or holds 2% or more voting power of the Company.
- who is NOT a material supplier, service provider or customer or a lessor or lessee of the company. Is NOT less than 21 years of age.

Independent Directors on Boards

The Clause 49 of the Listing Agreement mandates for listed companies that the board should have an optimum combination of Executive Directors (EDs) and Non-Executive Directors (NED), satisfying the following criteria:

- If Chairman is an ED, at least 50% of the board should be Independent Directors (ID).
• If Chairman is a Promoter or related to a Promoter, at least 50% of the board should be Independent Directors (IDs).

• If Chairman is related to anyone occupying management position at the board level or one level below the board, at least 50% of the board should be Independent Directors (IDs).

• If the Chairman is an Independent Directors (ID), at least one-third (1/3) of the board should be Independent Directors (IDs).

• If the board doesn’t have a regular non-executive Chairman, at least 50% of the board should be Independent Directors (IDs).

3. Separation of the post of Chairman and CEO or CEO duality (Non-mandatory)

Primary Market advisory Committee (PMAC) recommended SEBI that separate post for the Chairman and the MD/CEO may not be mandated. It stated that existing provisions given in Clause 49 already mandates higher number of Independent Directors in case of executive Chairman. Although, the requirement of CEO duality is common in developed countries, the question of mandatory separation of the post of chairman and CEO/MD is not settled globally yet. However, it is proposed that the separation of the post of Chairman and MD/CEO may be implemented by companies as a good governance practice. Corporate governance has a wide variety of arrangements. Researchers categorize these arrangements into two mechanisms that contribute a significant role in improving corporate governance:

- Internal Mechanism: The ownership structure of the firm, the board of directors, the auditor and the audit committee, other committees.

- External Mechanism: The market for corporate control and product market competition.
The market for corporate control and product market competition play a significant role in improving corporate governance. Overall legal and institutional structures of the country are designed by the internal and external mechanisms.

### 3.5 THREE MAJOR PLAYERS OF CORPORATE GOVERNANCE

1. Shareholders (Ownership)
2. Board of Directors (Monitoring)
3. Management (Performance)

All the three important players of corporate governance must be able to act and must be motivated and informed enough to act correctly. There is no perfect financial arrangement. The definitive aim of a corporate governance structure must be that it recurrently re-evaluated so that the authority structure itself can adapt to altering times and needs.

![Corporate Governance Triangle](image)

American corporate governance doctrine chiefly describes the power, rights and connected responsibilities of three principal groups:

- **Shareholders**: They provide capital and must support major firm transactions.

- **Board of Directors (BODs)**: They are elected by shareholders to supervise the running of the corporation.

- **Senior executives/Management**: They are accountable for the day to day operations of the corporation.
3.6 FOUR PILLARS OF CORPORATE GOVERNANCE

1. Accountability

2. Fairness

3. Transparency

4. Independence

Accountability

- Ensure that management is answerable to the Board.

- Ensure that the Board is liable to shareholders.

Fairness

- It defends Shareholders rights.

- It takes care of all shareholders including minorities, equitably.

- It provides effective remedy for violations.

Transparency

- It ensures timely, correct admission on all material matters, including the financial circumstances, performance, ownership and corporate governance.

Independence

- It ensures that events and structures are in place so as to minimize or completely avoid the conflicts of interest.

- It ensures that Independent Directors and Advisers are free from the impact of others.
3.7 ELEMENTS OF GOOD GOVERNANCE

Good governance is concept which is difficult to achieve in its totality. Good governance has eight major features. It is participatory, agreement oriented, responsible, obvious, receptive, effective and efficient, just and inclusive, and follows the rule of law. Good governance is receptive to the present and future needs of the organization, exercises care in policy-setting and decision-making, and that the best welfare of all stakeholders are taken into account.

- **Rule of Law**

  The unbiased legal frameworks enforced by regulatory bodies, are the requirement of good governance which ultimately protect the interests of the stakeholders.

- **Transparency**

  Transparency means that information should be given in easily understandable forms and medium; that it should be available without any constraint and directly available to those who would be affected by governance policies and practices, as well as the impact resulting therefrom; and that any action taken and their implementation are in agreement with established rules and regulations.

- **Responsiveness**

  Good governance requires that organizations and their activities are designed to serve the best interests of stakeholders within a logical timeframe.

- **Consensus Oriented**

  Good governance requires discussion to understand the special interests of stakeholders in order to reach a large accord of what is in the best interest of
the entire stakeholder group and how this can be attained in a sustainable and prudent manner.

- **Equity and Inclusiveness**

  The organization should provide the opportunity for its stakeholders to maintain, enhance, or generally improve their well-being for which it was formed and value to society.

- **Effectiveness and Efficiency**

  The processes implemented by the organization to produce favorable results meet the needs of its stakeholders with utmost effective utilization of resources i.e. Human; Technological; Financial; Natural; and Environmental.

- **Accountability**

  Accountability is a key principle of good governance. Who is accountable for what should be recognized in policy statements. In general, an organization is answerable to those who will be affected by its decisions or actions as well as the relevant rules of law.

- **Participation**

  Gender diversity is a key cornerstone of good governance. Participation needs to be informed and organized, including freedom of expression and diligent concern for the best interests of the organization in particular and society in general.

### 3.8 BOARD OF DIRECTORS

Both under the Companies Act, 2013(2013 Act) and RC49, directors fall into two classes, viz., Executive Directors (EDs) and Non-Executive Directors (NEDs). Non-executive Directors can be Independent Directors (IDs) and others (NEDs). Whilst the 2013 Act defines the concept of Executive Directors,
Independent Directors and Non-Executive Directors, it also mentioned minimum requirement in respect of Independent Directors. For the balanced composition, a company is autonomous to select between Executive Directors and Non-Executive Directors. In contrast, RC49 requires that the board of directors of a listed company shall contain an optimum combination of executive and non-executive directors. It also lies down that minimum 50% of the board should constitute Non-Executive Directors, which include both Independent Directors and Non-Executive Directors.

Non-Executive Directors are not regular directors or employees of the company and are not in-charge of the day to day affairs of the business. The accountability of management of the company is not with them like Wholetime Directors (WD) and Managing Director (MD). However, they can claim sitting fees for attending Board Meetings (BMs) and General Board Meetings (GMs).

The Companies Act’2013 states that every listed company will have at least one-third of total number of directors as independent directors, with any fraction to be rounded off as one. In addition, the 2013 Act empowers the Central Government to prescribe minimum number of independent directors for other class of public companies.

RC49 states that where the Chairman of the board is a non-executive director, at least one-third of the board shall constitute of independent directors. In case the Chairman is an executive director, at least half of the board should consist of independent directors. Since the requirement under Revise Clause 49 (RC49) is rigid, listed companies need to comply with RC49 requirements.

### 3.8.1 Difference between Chairman and CEO

The CEO is a company's top decision-maker, and all other executives report to him or her. The CEO delegates many of the planned tasks to other managers, focusing instead on strategic issues, such as, to decide which markets to enter; how to take on the competition; and which companies to form partnerships with.
This is in distinction to the Chief Operating Officer (COO) or president, who supervises day-to-day operations and logistics. The CEO is ultimately answerable to the board of directors for the company's act.

The chairman of a company is the head of its board of directors. The board is chosen by shareholders and is responsible for shielding investors' interests, such as the company's productivity and stability. It usually meets several times a year to set long-term goals, review financial results, assess the performance of high-level managers, and vote on significant strategic moves proposed by the CEO. Directors employ and can let off higher level managers such as the CEO and president. The chairman typically wields considerable power in setting the board's program and shaping the outcome of votes. However, he or she does not necessarily play an active role in everyday management.

3.8.2 Unitary and Two-Tier Boards

- Under a unitary board structure there is a distinct board of directors, comprising executive and non-executive directors (NEDs).

- By contrast, there are two separate boards under the two-tier structure:
  - The management (operating) board which is accountable for the day-today running of the business, consisting of executives only and led by the chief executive.
  - The supervisory (corporate) board with a wider membership, answerable for the planned oversight of the organization and led by the chairman.

Under a two-tier board structure, the two boards meet separately, so executive conversation around running the business will not be heard by the higher board members, and vice versa. This is unlike the single board meeting that will be held for a unitary board.
India has adopted a unitary board model where the corporation has a single board comprising of executive and non-executive directors at the top.

**TYPICAL BOARD COMPOSITION**

![Diagram of Typical Board Composition]

*Unless specified otherwise

**Source:** Corporate Governance (A.C. Fernando, 2011)

### 3.9 CORPORATE GOVERNANCE MODELS

1. The Anglo-Saxon or Anglo-American model
2. The Japanese model, and
3. The German model
4. The Indian Model of Governance

#### 3.9.1. The Anglo-American or Anglo-Saxon Model

The Anglo-American model is based on unitary board following shareholder-oriented approach. In this model, both executive and non-executive directors...
are on a single board. This model is adopted for corporate governance by the countries like America, Britain, Canada, and Australia including India.

3.9.2. The Japanese Model

The Japanese model is based on business network and hence supports larger board in which executive and often ritualistic directors predominate. This model shows the cultural relationships as seen in the Japanese keiretsu network. Both the shareholders and the main bank, appoint the top management i.e. board of directors and the president, but following the keiretsu network, the real power in the company rests with board of directors.

3.9.3. The German Model

The German Model is based on the two-tier board following societal-oriented or/Continental European approach. In this model, there are two separate boards. Supervisory board supervises the management board on behalf of stakeholders while management board supervises employees and relation officer and deal with day to day operational issues. This model is adopted for corporate governance by the countries like Germany, Holland, and to an extent, France.

3.9.4. The Indian Model of Governance

The Indian corporates are governed by the Company’s Act of 1956 that follows more or less the UK model. The pattern of private companies is mostly that of closely held or dominated by a founder, his family and associates.

Available literature on corporate governance and the way companies are structured and run indicate that India shares many features of the German/Japanese model, but of late, recommendations of various committees and consequent legislative measures are driving the country to adopt
increasingly the Anglo-American model. In terms of the legislative mechanisms, Indian government and industry constituted committees to study.

3.10 STANDING COMMITTEES

‘Standing Committee’ is a committees made up of members of the board with particular sets of duties. The main committees that are most often constituted by listed companies are the audit committee, the remuneration committee and nominations committee and the risk management committee.

3.10.1 Audit Committee

Audit Committee is constituted to supervise the company’s financial reporting procedure and the disclosure of its financial information. Audit committee makes sure the correctness, adequacy and credibility of the financial statement. The committee may conduct investigations into matters reported by whistleblowers. The Committee can advise on the matter related to board, the appointment; re-appointment; replacement or removal of the statutory auditor (if required); and the fixation of audit fees.

Under Section 292A of the Companies Act, 1956 and Clause 49 of the listing agreement, the constitution of audit committee is mandatory. The committee can be of facilitator of Board to put into practice, observe and continue good corporate governance practices for the welfare of the company and its stakeholders.

3.10.2 The Nominations Committee

Both 2013 Act and Revised Clause49 require all listed companies to constitute Nomination committee. Nomination Committee makes recommendations to the Board about the future arrangements of Non-Executive Directors, chairman, Chief Executive Officer and future appointments of Executive Directors on recommendations of the Chief Executive Officer to the board. Also, both 2013 Act and Revised Clause49 require three or more Non-
Executive Directors in Nomination committee, out of total number of Non-Executive Directors, at least one and half should be Independent Directors. Along with that both allow the chairperson of the company (executive or non-executive) to be appointed as a member of this Committee but not as the chairperson of the committee.

Revised Clause49 specifically requires that the Chairman of Nomination committee should be an independent director but there is no such requirement under the 2013 Act.

3.10.3The Remuneration Committee

Both 2013 Act and Revised Clause49 require all listed companies to constitute Remuneration committee. Remuneration committee takes decisions related to the compensation of Executive Directors, and sometimes other senior executives. Also, they both require three or more Non-Executive Directors in Remuneration committee, out of total number of Non-Executive Directors, at least one and half should be Independent Directors. Along with that both allow the chairperson of the company (executive or non-executive) to be appointed as a member of this Committee but not as the chairperson of the committee.

Revised Clause49 specifically requires that the Chairman of Remuneration committee should be an Independent Director but there is no such requirement under the 2013 Act.

3.10.4 The Risk Management Committee

- Revised clause 49 requires constitution of a Risk Management Committee. The roles and responsibilities of the Risk Management Committee rest in the hand of board of directors. They may delegate monitoring and reviewing of the risk management to the committee and other related functions as it may deem fit.
• The Companies Act, 2013 requires its boards to develop and implement a risk management policy for identifying and preventing risks which may be detrimental for the survival of the Company. Unlike revised clause 49, the 2013 Act does not require constitution of a separate risk management committee.

Vigil Mechanism under Companies Act, 2013 for Listed Companies

• Sec 177 (9): Establishment of a vigil mechanism for directors and employees by listed companies.

• Sec 177(10): Safeguard against victimization
  Policy against ill-treatment of persons using the mechanism:
  o Provides for admission to Chairperson of Audit Committee in appropriate or exceptional cases.
  o Exhibits policy on the company website, if any.
  o “Vigil mechanism” to be included in Board’s report.

• Schedule IV
  o Code for independent directors
  o Ascertain and ensure that the company has an adequate and functional mechanism.
  o Ensure that interests of a person who uses the mechanism.
  o Buffer for the management.

Institute of Chartered Accountants of India (ICAI) issued a direction note on fraud reporting under section 143 (12). This direction note is in context of a fraud reported through vigil mechanism of the company and if it has been remediated by the management and informed to the auditor then auditor will not be required to report the same under section 143(12). This is because the auditor has not by itself identified the fraud.
3.11 SUMMARY OF CHAPTER

This chapter details the overview of corporate governance system which involves a set of relations between a company’s management, its board, its shareholders and other stakeholders. The board of directors is the key element of the corporate governance along with other significant participants like employees, customers, suppliers, and creditors. The corporate governance structure also depends upon the legal, regulatory, institutional and ethical settings of the economy. This chapter describes the various models of corporate governance. Also, the committees formed at international and national level to improve the corporate governance system so that the objective of attaining good corporate governance could be achieved.