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Corporate Governance and Sustainability- Mandate of the Board

Corporate Governance

Corporate governance as defined in dictionary terms broadly refers to the mechanisms, processes and relations by which corporations are controlled and directed with the intention to align the conflicting interests of its stakeholders. It includes the processes through which corporations' objectives are set and pursued in the context of the social, regulatory and market environment. However, in simpler terms, corporate governance is how an organization wires its DNA to run itself, so that even when there is no regulator or higher body governing the organization, it runs on the same norms that it has set itself to run. That is why we see certain Companies who are perceived as more ethical and upright in its business dealings, have a higher brand image and Market Capitalization, and others though might be having a strong documented set of guidelines for Public consumption, are not that well respected.

Good corporate governance is tantamount to an acceptance by the management that the shareholders are the owners of the corporation and the Management is mere trustees on behalf of the shareholders. Management therefore needs a high commitment to values, not just of themselves, but of the entire organization, commit themselves to an ethical business conduct and move towards creating a healthy and sustainable business organization for the long term benefit of not only shareholders but also stakeholders.

The importance of corporate governance practices have increased, following the high-profile collapses of a number of large corporations especially during the past 10-15 years, as Corporations and CEOs try to drive volumes and profits even at the cost of various stakeholders and general public. Ethical profit is not a dirty word. But accounting frauds, inflated profits, violation of regulatory norms, have all led to a situation of deficit of a trust in the way certain corporations are governed. And this means a requirement of stronger regulatory bodies. We have had recent disclosures on Automobile companies who have, for the sake of self-gain, endangered not only the environment, but actually perpetuated fraud on the buyers, Governments and public at large. This might not have happened had there been a stronger code of ethics and corporate governance. But mere regulations without an internal code of conduct are not ever going to meet the requirements of the corporate world, with all its competition and huge body of analysts and financial experts dissecting every action and move. It is not an easy survival.

Corporate Governance has been moving from voluntary to mandatory and from mandatory back to voluntary and then back to mandatory, as Regulators and Governments see Corporates slipping and denying stakeholders as well as sometimes shareholders their rights especially in relation to transparency and ethical behavior.

In context to India, the typical issue of contestation has been the distinctive line between disciplining and regulating the dominant shareholder who generally manages and controls the Company, to protecting the interests of the minority shareholders, who have invested into the Company.

With more and more joint ventures and foreign collaborations taking place, the issues become more complex and contentious, as there are generally 2 blocks of shareholders, one with a 51% or more stakes and the other with a 49% or lesser stake.

The issue and complexity in aligning a foreign corporate governance structure in the Indian corporate and business environment, is further compounded with the Indian legal framework and weak enforcement of corporate governance guidelines. Not surprisingly, a lot of such ventures are fighting legal battles over governance issues.

Moreover, though MNCs are generally perceived to have better Corporate Governance

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laws, the alignment of the Company is in tune with the norms of the parent Company, and hence the implementation of local laws are left to the local managers of the Company, which is not an ideal situation for the organization. A typical example of this is the recent high profile case of a MNC involving the high content of lead in its food items. When it came to light, it broke the confidence of the consumers in the Company globally.

Furthermore, Corporate Governance is basically a soft issue, whose essence cannot be captured by quantitative and structural factors alone. The whole issue is about accepting and internalizing the guidelines, or using them as a mere checklist to be ticked when required, is an issue which requires a lot of mentoring and training about.

Corporate Governance is basically about:

- **Rights and equitable treatment of shareholders**
- **Interests of other stakeholders**
- **Role and responsibilities of the board**.
- **Integrity and ethical behavior**
- **Disclosure and transparency**

In view of the above principles of Corporate Governance, certain obligations have been cast upon the Board of Directors of the Company:

- The board is responsible for the successful perpetuation of the corporation, which cannot be relegated to the management.
- The board has responsibility for: CEO selection and succession; providing feedback to management on the organization's strategy; compensating senior executives; monitoring financial health, performance and risk; and ensuring accountability of the organization to its investors and authorities.
- Board members should be informed and act ethically and in good faith, with due diligence and care, in the best interest of the company and the shareholders.

Board has to:

- Review and guide corporate strategy, objective setting, major plans of action, risk policy, capital plans, and annual budgets; Oversee major acquisitions and divestitures.
- Ensure the integrity of the corporations accounting and financial reporting systems, including their independent audit.
- Ensure appropriate systems of internal control are established.
- Oversee the process of disclosure and communications.
- Where committees of the board are established, their mandate, composition and working procedures should be well-defined and disclosed.

Monitoring by the board of directors: The board of directors, with its legal authority to hire, fire and compensate top management, safeguards invested capital. Regular board meetings allow potential problems to be identified, discussed and avoided. Whilst non executive directors are thought to be more independent, they may not always result in more effective corporate governance and may not increase performance. Different board structures are optimal for different firms. Moreover, the ability of the board to monitor the firm's executives is a function of its access to information. Executive directors possess superior knowledge of the decision-making process and therefore evaluate top management on the basis of the quality of its decisions that lead to financial performance outcomes. It could be argued, therefore, that executive directors look beyond the financial criteria. However, Executive Directors also have their remunerations linked to the performance of the organization, and hence may not be the best whistle blowers when it comes to reporting malpractices.

- **Internal control procedures and internal auditors**: Internal control procedures are policies implemented by an entity's board of directors, audit committee, management, and other personnel to provide reasonable assurance of the entity achieving its objectives related to reliable financial reporting, operating efficiency, and compliance with laws and regulations. Internal auditors are personnel within an organization who test the design and implementation of the entity's internal control procedures and the reliability of its financial reporting.

Balance of power: The simplest balance of power is very common; require that the CEO be a different person from the CFO. This application of separation of power is further developed in companies where separate divisions check and balance each other's actions. One group may propose company-wide administrative changes, another group review and can veto the changes, and a third group check that the interests of people (customers, shareholders, employees) outside the three groups are being met.

What has changed in the Indian Context?

The Companies Act, 2013 have cast upon certain obligations on the Directors of the Company, so as to ensure transparency and good governance.

Section 166- Duties of Directors:

- 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, and the community and for the protection of environment.
- A director of a company shall exercise his duties with due and reasonable care, skill and diligence and shall exercise independent judgment.
- A director of a company shall not involve in a situation in which he may have a direct or indirect interest that conflicts, or possibly may conflict, with the interest of the company.
- A director of a company shall not achieve or attempt to achieve any undue gain or advantage either to himself or to his relatives, partners, or associates and if such director is found guilty of making any undue gain, he shall be liable to pay an amount equal to that gain to the company.

Section 134(5) - Directors Responsibility Statement:

The Report of the Board of Directors is required to contain the following Responsibility Statement:

a) that in the preparation of the annual financial statements for the year, the applicable accounting standards have been followed along with proper explanation relating to material departures, if any;

b) that such accounting policies as mentioned in Note 2 of the Notes to the Financial Statements have been selected and applied consistently and judgments and estimates have been made that are reasonable and prudent so as to give a true and fair view of the state of affairs of the Company for the year ended on that date;

c) that proper and sufficient care has been taken for the maintenance of adequate accounting records in accordance with the provisions of the Companies Act, 2013 for safeguarding the assets of the Company and for preventing and detecting fraud and other irregularities;

d) that the annual financial statements have been prepared on a going concern basis;

e) That system to ensure compliance with the provisions of all applicable laws was in place and was adequate and operating effectively.

Formation of the Committees of the Board of Directors

The Board of Directors will have to form various committees to deal with specific issues:

1) Audit Committee:

The scope of work of Audit Committee is defined in Section 177(4) of the Companies Act, 2013:

i) the recommendation for appointment, remuneration and terms of appointment of auditors of the company;

ii) review and monitor the auditor's independence and performance, and effectiveness of audit process;

iii) examination of the financial statement and the auditors' report thereon;

iv) approval or any subsequent modification of transactions of the company with related parties;

v) scrutiny of inter-corporate loans and investments;

vi) valuation of undertakings or assets of the company, wherever it is necessary;

vii) evaluation of internal financial controls and risk management systems;

viii) Monitoring the end use of funds raised through public offers and related matters.

2) Nomination and Remuneration Committee and Stakeholders Relationship Committee u/s 178:

This Committee is responsible for following functions:

- Identify persons who are qualified to become directors and who may be appointed in senior management in accordance with the criteria laid down,
- Recommend to the Board their appointment and removal,
- Carry out evaluation of every director's performance.
- Formulate the criteria for determining qualifications, positive attributes and independence of a director and Recommend to the Board a policy, relating to the remuneration for the directors, key managerial personnel and other employees.

3) Corporate Social Responsibility Committee (CSR Committee): The CSR Committee shall formulate and recommend to the Board CSR Policy, recommend the amount of expenditure to be incurred on CSR activities and monitor CSR policy of the Company from time to time.

Section 188- Disclosure of Related Party Transactions

This section requires the Company to make disclosure of all the transactions entered into with the parties in which the Directors are interested. This section indirectly requires that the transactions should be entered into with the Related Parties at Arm's Length Price.

Composition of Board of Directors

The Companies Act, 2013 requires that there should be at least one Women Director in case of listed Companies and Public Companies having share capital of Rs.100 Crores and turnover of more than Rs.300 Crores.

There should be minimum one Resident Director.

The Listed Companies may have one Director elected by small shareholders, holding the shares of nominal value of not more than twenty thousand rupees.

There should be at least one third of the total number of Directors as independent Directors for listed public Companies and at least two Directors for unlisted public Companies having turnover of more than 100 Crores or outstanding loans exceeding Rs. 50 Crores or share capital of Rs. 10 Crores.

Rotation of Auditors:

The Companies Act, 2013 provides that the Firm of Auditors can function as Auditors of the Company for maximum period of 10 years, subject to the condition that one Partner can sign the Financials for maximum period of 5 years. After the period of 10 years, the Company has to change its Audit Firm.

Pursuant to Section 144 of the Companies Act, 2013, Auditors are prohibited to give Management Consultancy and other non-Audit related services to maintain their independence of mind and to avoid conflict of interest.

Section 177(9) - Vigil/Whistleblower mechanism:

As per Sec.177 of the Companies Act, 2013, certain companies have to establish Vigil/Whistle-blowing mechanism to report any unethical behavior or other concerns to the management and Section 177(10) provides for adequate safeguard against victimization of such person who uses such mechanism and makes access to the Chairperson of Audit Committee.

Corporate Sustainability

In the new definition, corporate sustainability is an alternative to the traditional growth and profit-maximization model. While corporate sustainability recognizes that corporate growth and profitability are important, it also requires the corporation to pursue societal goals, specifically those relating to sustainable development — environmental protection, social justice and equity, and economic development.

Corporate Social Responsibility (CSR)

In the most general terms, CSR deals with the role of business in society. Its basic premise is that corporate managers have an ethical obligation to consider and address the needs of society, not just to act solely in the interests of the shareholders or their own self-interest. In many ways CSR can be considered a debate, and what is usually in question is not whether corporate managers have an obligation to consider the needs of society, but *the extent to which* they should consider these needs.

Who are the stakeholders?

Stakeholders are defined as "any group or individual who can affect or is affected by the achievement of the organization's objectives." The basic premise of stakeholder theory is that the stronger your relationships are with other external parties, the easier it will be to meet your corporate business objectives; the worse your relationships, the harder it will be. Strong relationships with stakeholders are those based on trust, respect, and cooperation. Unlike CSR, which is largely a philosophical concept, stakeholder theory was originally, and is still primarily, a strategic management concept. The goal of stakeholder theory is to help corporations strengthen relationships with external groups in order to develop a competitive advantage.

One of the first challenges for companies is to identify their stakeholders.

There appears to be general agreement among companies that certain groups are stakeholders — shareholders and investors, employees, customers, and suppliers. Beyond these, however, it becomes more challenging because there are no clear criteria for defining stakeholders. Most authors agree that if the term 'stakeholder' is to be meaningful, there must be some way of separating stakeholders from non-stakeholders.

The contribution of corporate accountability theory to corporate sustainability is that it helps define the nature of the relationship between corporate managers and the rest of society

Assuming that the main stakeholders have been identified, the next challenge for corporate managers is to develop strategies for dealing with them. This is a challenge because different stakeholder groups can, and often do, have different goals, priorities, and demands. Shareholders and investors want optimum return on their investments; employees want safe workplaces, competitive salaries and job security; customers want quality goods and services at fair prices; local communities want community investment; regulators want full compliance with applicable regulations. However, there is a general acknowledgement that the goals of economic stability, environmental protection, and social justice are common across many stakeholder groups. Few groups would argue against these goals, although they may debate the level of priority or urgency.

The contribution of stakeholder theory to the corporate sustainability is the addition of business arguments as to why companies should work toward sustainable development. Stakeholder theory suggests that it is in the company's own best economic interest to work in this direction because doing so will strengthen its relationship with stakeholders, which in turn will help the company meet its business objectives.

Corporate Accountability

Accountability is the legal or ethical responsibility to provide an account or reckoning of the actions for which one is held responsible. Accountability differs from responsibility in that the latter refers to one's duty to act in a certain way, whereas accountability refers to one's duty to explain, justify, or report on his or her actions.

This is the relationship between corporate management and shareholders. This relationship is based on the fiduciary model, which in turn is based on agency theory and agency law, wherein corporate management is the 'agent' and the shareholders the 'principal'. This relationship can be viewed as a contract in which the principal entrusts the agent with capital and the agent is responsible for using that capital in the principal's best interest. The agent is also held accountable by the principal for how that capital is used and the return on the investment.

Corporate accountability need not be restricted to the traditional fiduciary model, nor only to the relationship between corporate management and shareholders. Companies enter into contracts (both explicit and implicit) with other stakeholder groups as a matter of everyday business and these contractual arrangements can serve as the basis for accountability relationships. For example, companies that receive environmental permits and approvals from regulators to operate facilities are often held accountable by the regulators for whether the terms of the approval are being met. Proponents of social contract theory often argue that corporations are given a 'licence to operate' by society in exchange for good behaviour, and as such the corporations should be accountable to society for their performance.

The contribution of corporate accountability theory to corporate sustainability is that it helps define the nature of the relationship between corporate managers and the rest of society. It also sets out the arguments as to why companies should report on their environmental, social, and economic performance, not just financial performance.

As stated earlier, corporate sustainability is a new and evolving corporate management paradigm. Although the concept acknowledges the need for profitability, it differs from the traditional growth and profit-maximization model in that it places a much greater emphasis on environmental, social, and economic performance, and the public reporting on this performance.

Corporate sustainability borrows elements from four other concepts. Sustainable development sets out the performance areas that companies should focus on, and also contributes the vision and societal goals that the corporation should work toward, namely environmental protection, social justice and equity, and economic development. Corporate social responsibility contributes ethical arguments and stakeholder theory provides business arguments as to why corporations should work towards these goals. Corporate accountability provides the rationale as to why companies should report to society on their performance in these areas.

Not all companies currently subscribe to the principles of corporate sustainability, and it is unlikely that all will, at least not voluntarily. However, a significant number of companies have made public commitments to environmental protection, social justice and equity, and economic development. Their number continues to grow. This trend will be reinforced if shareholders and other stakeholders support and reward companies that conduct their operations in the spirit of sustainability.

Transparency is the Route to Corporate Sustainability

Transparency deals with the idea that by having an engaging and open environment in the company as well as the community will improve performance and increase profits. It is an open culture that promotes employee involvement in the innovation and creative processes. Reaching out to the community creates a much bigger team is extremely cheap and provides evaluation from all angles. Companies are looking inward and realizing changes must be made to fulfill environment needs such as energy efficiency, limiting product waste and toxicity, and designing innovative products. One way for companies to accomplish this is through open communications with stakeholders characterized by high levels of information disclosure, clarity, and accuracy. This places greater emphasis on the Board.

Board's Mandate for Sustainability

Sustainability mandate requires the Board of Directors of the company to look internally and externally to understand their environmental and social impacts. This requires the engagement of stakeholders to understand impacts and concerns. A business can address sustainability internally by educating employees and seeking to reduce impacts through waste reduction, energy efficiency, etc. Employee engagement can be a powerful motivator by having a philanthropy committee or a green team. As a company looks externally, stakeholders include customers, suppliers, community, and non-government organizations.

Board of Directors of many large Companies have adapted themselves by implementing new creative ideas related to sustainability, such as preparing upgraded technology that can transform the product rather than throwing away old materials. New solutions that involve use of renewable energy, conserve energy and natural resources, improve recycling and waste redirecting can ultimately reduce costs and increase profits in the long term. Short term is a little bit more painful especially for new organizations setting off on the path t growth in a competitive environment.