

# Corporate Governance & New Company Law

(Responsibilities of Management & Independent Directors,  
Related Party Transaction & Internal Controls etc.)

CA Rajan Kamat  
rdkamat@gmail.com

# Contents

- A snap-shot of the Change in Company Law
- Corporate Governance – Evolution and a reality check
- ‘Managed’ v/s ‘Governed’ Corporation – the dilemma
- Role of Independent Directors
- Related Party Transactions
  - Relevance of focus on Related Parties
  - OECD initiative and SEBI response
  - Some thoughts and practical issues
- Internal Controls
  - A critique – have Clause 49 stipulations been effective ?
  - COSO Framework
  - Understanding Internal Controls on Financial Reporting..

# New Company Law

## The direction: less Government, more Governance..

- Administration: Simplifies processes. Contemporary and possibly flexible.
- Accounting & Reporting: Categorizes, standardizes and entrusts a regulator for policy.
- Group Structuring: Caps multi-layers. Seeks consolidated view.
- Internal Controls: Fixes accountability and enhances reporting scope.
- Fraud: Establishes measures for handling and reporting frauds.
- Board: Enhances accountability, participation and use of technology.
- Independent Directors: Increases accountability & responsibility – towards governance.
- Auditors: Focuses on independence and regulation.
- CSR: Requires companies to take-on social responsibility.
- Overall:
  - Focuses on investor protection, particularly minority shareholders.
  - Aims at stricter enforcement - investigation, adjudication and penalty.
  - Adopts self-regulation, e-governance, etc.

Flexibility to respond to changing environment is in-built through 'delegated legislation'. Given the widespread changes, in the short-term there could be some pain, before things eventually settle.

## The Corporate governance story so far .... *the good news*

- Clause 49 of the Listing Agreement as effective from 2006 brought in to focus, the Board role in governance as distinguished from management. Aspects covered:
  - **Composition of Board** – non-executive/independent directors
  - **Audit Committee** – Constitution, powers and role
  - **Certification by CEO/CFO** – primarily ICFR
  - **Financial transparency and disclosures** – Related Party transactions
  - **Risk Management Framework/Process**
- More than 90% of the companies listed on the National Stock Exchange and between 60-65% of companies on the Bombay Stock Exchange reported compliance with the revised Clause 49. Indian Corporates have won awards for Corporate Governance/Excellence
- Around 2008, India ranked 3rd in Asia-Pacific on CG score. \*\* CLSA (Asia-Pacific Markets – CG Watch)

*“Morality cannot be legislated, but behavior can be regulated. Judicial decrees may not change the heart, but they can restrain the heartless” – Martin Luther King Jr.*

## ***.....and not so good***

- India ranked 7th in the latest CLSA's CG survey. Out of nearly 7000 listed companies may be 50-100 are well governed (and a handful could be outstanding) which remains a small percentage of the total.
- In around 30% of BSE companies promoters changed over to 'non-executive chairmen' thereby avoiding increase in independent directors. SEBI reacted in April 08 modifying this requirement.
- Certain episodes brought in to focus the role of 'independent directors'.
- ERM/ICFR not well entrenched in practice – compliance certification has not been effective
- “Informational asymmetry” that Cadbury Committee identified is still an issue .
- Professional challenge to management assumptions by Board requires competence apart from independence.

# Independent Directors

- Implications of Company law changes

## The essence of Board oversight...

“The age of the empowered Board of Directors is here. Major public corporations now acknowledge that they have no choice but to make management more accountable to shareholders and that strengthening the hands of outside directors is the logical means of doing so. But exactly how to proceed remains an open question. More specifically directors and managers wonder how the relationship between the Board and the CEO should be recast. Most directors and managers agree that the Board should be a more effective watchdog without undermining management’s ability to run the business. They also say Boards need to decide how to distance themselves more from their CEOs without turning a constructive relationship into an adversarial one” ##

## Source : Harvard Business Review

# Boardroom paradigm and practices..

## Characteristics of Managed Corporation

- Board's role is to hire, monitor and when necessary, replace management
- Power sufficient to control the CEO and the evaluation process
- Independence to ensure that CEO is honestly evaluated and directors are not compromised by conflicts or co-opted by management.
- Board procedures that allow outside directors to evaluate managers dispassionately and effectively

## Characteristics of Governed Corporation

- Board's role is to foster effective decisions and reverse failed policies
- Expertise sufficient to allow the Board to add value to the decision making process
- Incentives to ensure the Board is committed to creating corporate value
- Procedures that foster open debate and keep board members informed and attuned to the shareholders' concerns



# Boardroom paradigm and practices..

## Policies in a Managed Corporation

- Separate the CEO & Chair (or lead outside Director)
- Board meetings without CEO present
- Committee of independent directors to evaluate the CEO
- Explicit yardsticks for judging the CEO's performance
- Independent financial and legal advisors to outside directors

## Policies in a Governed Corporation

- Required areas of expertise that must be represented on the Board such as core industry and finance
- Minimum time commitment of 25 days
- Large option packages for directors
- Designated critic to question new policy proposals
- Regular meetings with large shareholders
- Board members free to request information from any employee.

# Independent Director

## Particulars

### Companies Act 1956

Independent Director

No specific provision

### Companies Act 2013

- Listed companies to have at least 1/3<sup>rd</sup> of its total number of directors as IDs
- CG may prescribe minimum number of IDs in case of any class of public companies
- ID is not liable to retire by rotation
- ID not to be included in the “total number of directors” liable to retire by rotation
- Code for IDs containing detailed guidelines for professional conduct, roles and responsibilities provided

- 
- **Schedule IV prescribes roles, duties of independent directors. Qualifications prescribed by Rules and responsibility of BOD.**
  - [Rule 4 of Companies (Appointment and qualification of Directors) Rules 2014 requires following class of companies to appoint ID:
    - Unlisted public companies having
      - paid-up capital of minimum INR 10 (Draft Rules 100 ) crores; or
      - Turnover of minimum INR 100(Draft Rules 300 ) crores or more ; or
      - Aggregate outstanding loans or borrowings or debentures or deposits exceeding INR 50 (Draft Rules 200 )crores

# Additional criteria for independent directors

Elements of independent director under 2013 Act differ from those under Clause 49 of the Listing Agreement:

- Not to have any pecuniary relationships and not just material pecuniary relationships
- Such pecuniary relationship should not have existed either in the current financial year or immediately preceding two years
- Embargo for pecuniary relationship / transaction with relative of independent director with limits
- Excludes nominee directors as independent directors
- Prohibits independent directors from holding stock options. [currently some of the independent directors hold stock options
- Not to be related to the Promoters or directors of the company where he is appointed but also not be related to the Promoters or directors of holding, subsidiary or associate company
- Not to be employee / partner of firm of Auditors / Company Secretary / Cost Accountant / legal or a consulting firm which has served not only the holding but also holding/ subsidiary / associate co.
- Not to hold more than 2% of voting power in the company either himself or through his relatives
- He / his relatives should not be a Chief Executive or director of any NGO that receives 25% or more of its receipts from Company / promoters / directors / holding / subsidiary / associate co. or that holds 2% or more of voting capital

## Consequential implications

- Reassess independence of independent directors
- Companies not mandated to have independent director would be required to have through the CSR route.

# Independent Director – Compliances

Compliances Requirement	
Particular	
Remuneration	<ul style="list-style-type: none"><li>Independent directors shall not be entitled to any stock option and may receive remuneration by way of sitting fee ([draft] Rules - upto INR 1,00,000 per Board / Committee meeting), reimbursement of expenses for participation in the BOD and other meetings and profit related commission as may be approved by the members</li></ul>
Separate meetings	<ul style="list-style-type: none"><li>Independent directors of the company are required to hold at least one meeting in a year without the attendance of non-independent directors and members of management</li></ul>
Alternate Director	<ul style="list-style-type: none"><li>Only an independent director can be appointed as an alternate director to an independent director</li></ul>
Retirement by rotation	<ul style="list-style-type: none"><li>Independent Director excluded from the Directors liable to retire by rotation</li></ul>
Transitional Provision	<ul style="list-style-type: none"><li>1 year</li></ul>

\* Key Difference - Nominee a director as per the 2013 Act is a director nominated by any financial institution in pursuance of the provisions of any law for the time being in force, or of any agreement, or appointed by any Government, or any other person to represent its interests. As per Clause 49, Nominee directors appointed by an institution, which has invested in or lent to the company considered as independent directors BUT this is an aspect that is debated in SEBI consultation paper on Clause 49 amendment expected to be finalized shortly.

# Board Report\*

## Additional responsibility on the Board in its report to members

- Board responsibility on financial statements now includes statement on implementation and operating effectiveness of
  - Internal Financial Reporting Controls (only in case of listed companies)
  - Controls over compliance with laws and regulations
- As per Chapter IX, Rule 8 the Board Report is to be prepared for the stand alone financial statements of the company with a separate section for performance and financial position, for each of the subsidiaries, associates and joint venture companies.
- Board report to also include particulars of
  - Loans, guarantees and investments made by the Company
  - Contracts or arrangements with related parties
  - Formal annual evaluation of its own performance, committees and individual directors
  - Chapter XIII Rule 5 require detailed disclosures related to director remuneration in the case of listed companies
  - Contents of CSR Policy, composition of CSR Committee, spend on CSR activities and any shortfall / non-spend and reasons thereof

**\* Effective from financial year commencing from April 1, 2014**

## Consequential implications

- Significant increase in involvement of Audit Committee/Board in financial reporting process of both the parent and the Group
- Need to establish comprehensive process for compliance with laws and regulations, including overseas operations
- Establish mechanism for evaluation of transactions with related parties and loans, guarantees and other investment transactions
- Board Report under the Rules will be cumbersome and internal consistencies will need to be observed.

# Related Party Transactions

- preventing abuse

# Relevance of focus on Related Parties

- Transfer of resources, services or obligation between related parties regardless of whether a price is charged, could be detrimental to other stakeholders (non-controlling shareholders, Revenue, Lenders). The focus here is on non-controlling shareholders.
- Independent Directors have a primary role in providing oversight on identification of Related Parties & controls on conduct of business without conflict of interest. Mere existence of relationship may be sufficient to affect the reported performance of the entity. Abstaining from value creation opportunities (forward/backward integration) OR staying with sub-optimal business models (not entering a particular segment) to indirectly favour another entity.
- The “Arm’s Length Pricing” (ALP) methods as accepted under Income Tax law may be relevant. These methods, in the order of objectivity involved, are:
  - Comparable Uncontrolled Price
  - Resale Price Method
  - Cost Plus Method
  - Transactional Net Margin Method
  - Profit split Method

- Governance requirements should not impede realization of synergies in business. The OECD paper also recognizes this and calls for a balance in tackling potential abuses v/s unfair regulatory burden on entities conducting their business in an equitable and transparent manner.

Knowledge of the entity’s transactions, outstanding balances /commitments and relationships with related parties are crucial in assessment by the users of Financial Statements of (i) Management Stewardship and (ii) Risks & Opportunities before the entity  
Transactions with wholly owned subsidiary do not normally pose potential for abuse. However, Indian investor’s mindset is still ‘stand-alone’ FS oriented rather than Consolidated FS oriented; potential for playing with reported financials exists.



## SEBI Consultative Paper on review of Clause 49

The paper considered the OECD approach and recognizes that RPTs can be abused by controlling shareholders, especially in Asian jurisdictions, which have concentrated shareholding. Two modes for regulating RPTs - **approval based controls** which require approval by Board of Directors/ Shareholders and **disclosure based controls**. Focus is not on making approval norms stringent but on making disclosure norms effective [para 11.25]. Changes considered:

Actions Proposed	Remarks
Immediate and continuous disclosure of material RPTs to exchanges	Will help create heightened investor awareness and put management on guard. Prevalent in certain jurisdictions. Eg. London
Approval of RPTs by ‘majority of minority’	clause 188 of Companies Bill 2012 introduces this concept
Pre-approval of RPTs by Audit Committees	Currently RPTs reported to AC periodically: (i) in summary form for transactions in the ordinary course, at ALP (ii) with details where not at ALP OR not in ‘ordinary course of business’.
Adoption of Ind-AS 24 for the purpose of requirements of the listing agreement	Slightly expands the scope of related parties as against AS 18 but adoption of the term as defined in the Companies Bill 2012 may make it wider.



# Related Party Transactions & the new Company Law

- Definition of Related parties widened to include Director, KMP or his relative, subsidiaries, holding company, fellow subsidiaries and associates.
  - Includes a director or KMP of the holding company or his relative (Chapter I rule 3)
  - Relative includes spouse, members of HUF, father, mother, son, son's wife, daughter, daughter's husband, brother and sister only (Chapter I rule 4). Substantially reduced from draft rules.
- Audit Committee responsible for approval of RPT. To formalise the approval process, considerations that Audit Committees may look to include:
  - Framing guidelines for evaluation of nature, timing, need and pricing of RPTs
  - Establishing thresholds and levels for approvals
  - Timing of reporting RPTs to facilitate review
  - No method prescribed to assess if the price is arms-length. Substantiate arms-length through external valuations, where appropriate
- RPT that are other than “arms-length” need approval of shareholders who are other than the related party.
- Where an RPT needs approval of members, a special resolution of the holding company shall be sufficient in case of transaction with a wholly owned subsidiary
- Stringent penalties, including imprisonment, for directors and any other employee of the company who has entered into or authorised the RPT in violation of the provisions of the Act
- Sec 188 (1)/Rule 15 Special Resolution of General Body in place of CG approval.

# Related Party definition

Particulars	Companies Act 1956	Companies Act 2013
Specified persons with whom contracts are covered	<ul style="list-style-type: none"> <li>• Director of the Company</li> <li>• Relative of such director</li> <li>• A firm in which such director or relative is a partner</li> <li>• Any other partner of such firm in which director or relative is a partner</li> <li>• Private Company in which such director is a director or member</li> </ul>	<p>“Related Party” :</p> <ul style="list-style-type: none"> <li>• director or his relative</li> <li>• <u>KMP or his relative</u></li> <li>• firm, in which a director, manager or his relative is a partner</li> <li>• private company in which a director or manager is a member or director</li> <li>• public company in which a director or manager is a director or holds along with his relatives, more than 2% of its paid-up share capital</li> <li>• any body corporate whose BoD, managing director, or manager is accustomed to act in accordance with the advice, directions or instructions of a director or manager</li> <li>• <u>any person under whose advice, directions or instructions a director or manager is accustomed to act</u></li> <li>• any company which is –             <ul style="list-style-type: none"> <li>– a holding, subsidiary or an associate company of such company; or</li> <li>– a subsidiary of a holding company to which it is also a subsidiary</li> </ul> </li> <li>• such other persons as may be prescribed</li> </ul>

As per AS 18, related parties are parties considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/ or operating decisions. The scope of related party is substantially expanded to ensure interest of shareholders

# Related Party Transactions – Covered persons

Particulars	Companies Act 1956	Companies Act 2013
Specified persons with whom contracts are covered	<ul style="list-style-type: none"> <li>• Director of the Company</li> <li>• Relative of such director</li> <li>• A firm in which such director or relative is a partner</li> <li>• Any other partner of such firm in which director or relative is a partner</li> <li>• Private Company in which such director is a director or member</li> </ul>	<p>“Related Party” :</p> <ul style="list-style-type: none"> <li>• director or his relative</li> <li>• KMP or his relative</li> <li>• firm, in which a director, manager or his relative is a partner</li> <li>• private company in which a director or manager is a member or director</li> <li>• public company in which a director or manager is a director and holds along with his relatives, more than 2% of its paid-up share capital</li> <li>• any body corporate whose BoD, managing director, or manager is accustomed to act in accordance with the advice, directions or instructions of a director or manager</li> <li>• any person under whose advice, directions or instructions a director or manager is accustomed to act</li> <li>• any company which is –               <ul style="list-style-type: none"> <li>– a holding, subsidiary or an associate company of such company; or</li> <li>– a subsidiary of a holding company to which it is also a subsidiary</li> </ul> </li> <li>• <b>Rules</b> - a director or KMP of the company’s holding company or his relative</li> </ul>

## Consequential implications

- The scope of related party is substantially expanded to ensure interest of shareholders.

As per AS 18, related parties are parties considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/ or operating decisions.

# Related Party Transactions – Scope

Particulars	Companies Act 1956	Companies Act 2013
Scope of Section	<ul style="list-style-type: none"> <li>• sale, purchase or supply of any goods or materials;</li> <li>• sale, purchase or supply of any services;</li> <li>• underwriting the subscription of any shares, debentures of a company</li> </ul>	<ul style="list-style-type: none"> <li>• sale, purchase or supply of any goods or material</li> <li>• buying, selling or disposing of property of any kind</li> <li>• leasing of property of any kind</li> <li>• availing or rendering of any services</li> <li>• appointment of any agents for purchase or sale of goods, materials, services or property</li> <li>• related party's appointment to any office or place of profit in the company, its subsidiary company, associate company; or</li> <li>• underwriting the subscription of any shares in or derivatives thereof</li> </ul>
Approval required	<ul style="list-style-type: none"> <li>• Prior consent of the BoD by resolution passed at Board meeting</li> <li>• Prior approval of Regional Director, in case the paid-up capital of company is exceeding INR 1 crore</li> </ul>	<p>Where a transaction with a related party is (i) not in the ordinary course of business or (ii) is in the ordinary course of business but not on an arm's length basis:</p> <ul style="list-style-type: none"> <li>• Prior consent of the BOD by a resolution at a board meeting and compliance with the conditions to be prescribed is necessary</li> <li>• Prior approval of the shareholders where paid-up capital of company or transaction amount exceeds prescribed limit (Refer slide 29)</li> </ul> <p>Related party who is a member of such a company cannot vote on such a special resolution</p> <p>Requirement of obtaining CG approval for related party transactions done away with</p>

# Related Party Transactions – Exemptions

Particulars	Companies Act 1956	Companies Act 2013
Exemptions	<ul style="list-style-type: none"> <li>• Purchase/Sale of goods and materials for cash at prevailing market price.</li> <li>• Purchase/Sale of goods and materials or services the cost of which does not exceed INR 5,000/- in any year during the period of contract</li> <li>• Any transaction of banking / insurance company in the ordinary course of such company</li> </ul>	<p>Any transaction can be entered into by a company in the ordinary course of its business with a related party on an arm's length basis</p> <p>Arm's length transaction means a transaction between two related parties that is conducted as if they were unrelated, so that there is no conflict of interest</p>

- Related party transactions at arms' length price may result in aligning the benchmarking under transfer pricing norms as per Income tax Act
- Operating / license fees for immovable property also covered

## Non cash transactions

Particulars	Companies Act 1956	Companies Act 2013
Non-cash transaction with directors	No such restriction	Non-cash transaction with a director of the company or its holding, subsidiary or associate company or a person connected for acquisition or sale of assets allowed only with prior approval of the members in a general meeting and supported by values determined by Registered valuers

# Related Party Transactions – Share holders approval

## Approval of Related Party Transactions (RPTs)

Related party transactions by a company having paid-up capital of INR 10 crores or exceeding value of transaction as mentioned below will require prior approval of members by special resolution if such transaction (i) is not in the ordinary course of business or (ii) is in the ordinary course of business but not on an arm's length basis.

Nature of transaction	Transaction value *
Sale, purchase or supply of any goods or materials directly or through appointment of agents	Exceeding 25% of annual turnover
Buying, selling or disposing of property of any kind directly or through appointment of agents	Exceeding 10% of net worth
Leasing of any kind of property	Exceeding 10% of net worth or 10% of turnover
Availing or rendering of any services directly or through appointment of agents	Exceeding 10% of net worth
Appointment to any office or place of profit in the company, its subsidiary company or associate company	Monthly remuneration exceeding ` 250,000
Remuneration for underwriting the subscription of any securities in or derivatives thereof	Exceeding 10% of net worth

\* Turnover or net worth criteria is required to be based of the audited financial statements of the preceding financial year.

# Related Party Transactions – Matrix of approval

Nature of RPT	Audit committee	Board of Directors	Shareholders
In the ordinary course of business and on an arm's length basis	✓	X	X
Not in the ordinary course of business and not on an arm's length basis	✓	✓	✓ *
In the ordinary course of business but not on an arm's length basis	✓	✓	✓ *
Not in the ordinary course of business but on an arm's length basis	✓	✓	✓ *

\* Where required (See Slide 29)



## Some relevant considerations

The following elements may be relevant in determining if, de facto, transactions or behavior is influenced by relationship:

- **Blood relation:** Relevance of blood relation varies across cultures. IFRS uses the term ‘close members of the family’ – as those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity.
- **Control/Significant Influence:** Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies.
- **‘Point in time’ v/s over the relevant past:** If relationship at the point in time when transaction occurs is only to be considered, it may present an easy possibility to side step the ‘relationship’. Stipulating a reasonable immediate past may be a better response from governance perspective.



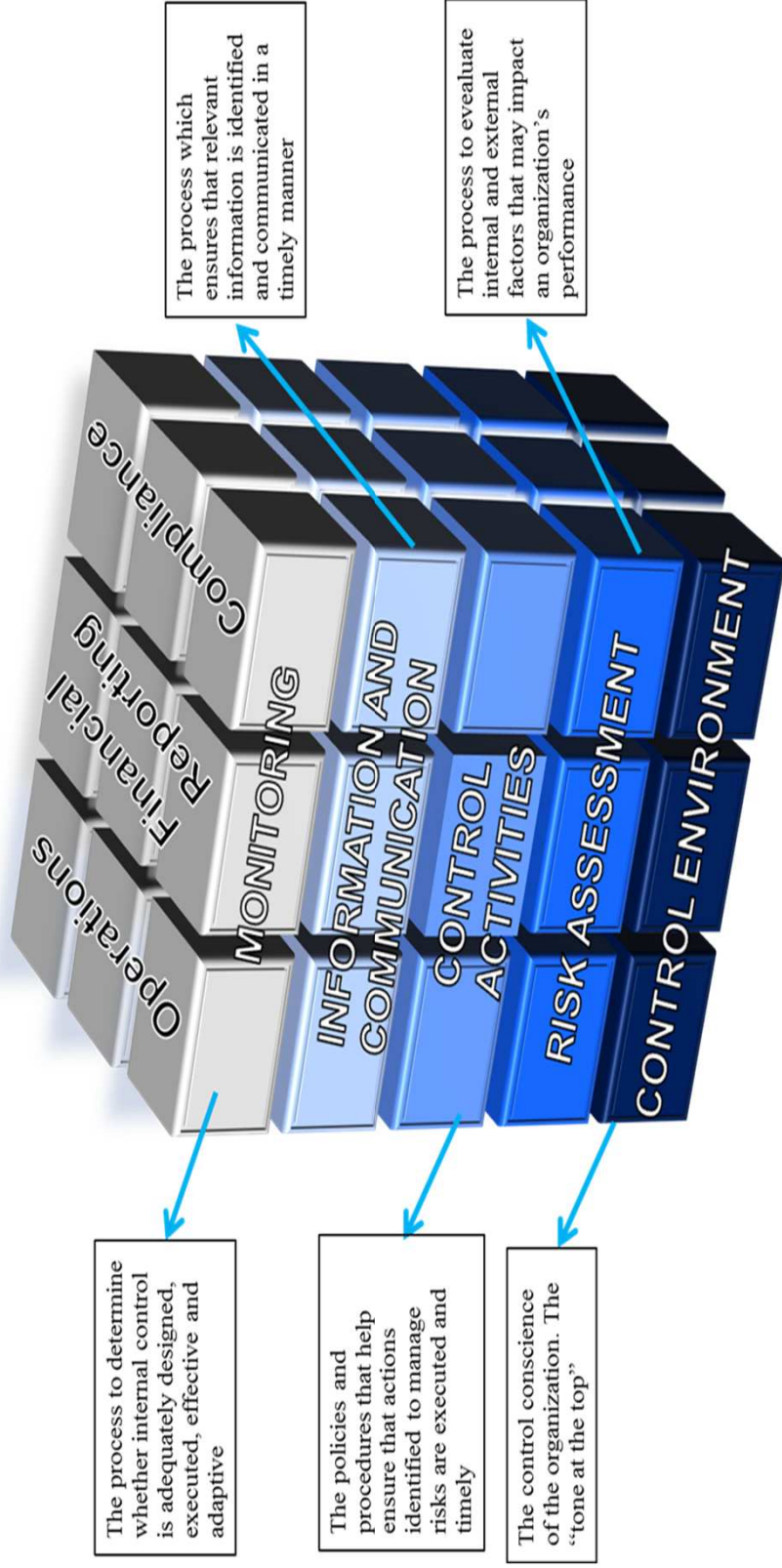
## **Concluding thoughts on way forward..**

- Even under INDAS 24/IAS 24 ‘relationship’ may be circumvented by use of Complex shareholding (eg. Beneficial ownership through blind trusts). Extending the meaning of RP in Clause 49 by bringing in the concept of shadow directors (as in Cos Bill 2012) may be helpful to some extent.
- Transactions which occur while the relationship exists are covered. Considering possibility of circumventing this, UK Listing Rules for instance, consider relationship in the 12 mnths preceding the transaction. Consensus on adopting a similar approach may be warranted.
- RP relationship may be abused even without ‘transactions’ – Abstaining from value creation opportunities (forward/backward integration) OR staying with sub-optimal business models (not entering a particular segment) to indirectly favour another entity. Mandated CG disclosures around such formal/informal arrangements and greater engagement by BODs in business/strategy formulation can address this better.
- The Companies bill does not use the ‘Arm’s Length Price’ definition as in Tax laws (based on OECD principles). Also, the focus is only on transactions which are not at ALP. Clause 49 may include this aspect to bridge the gap.

# Internal Controls

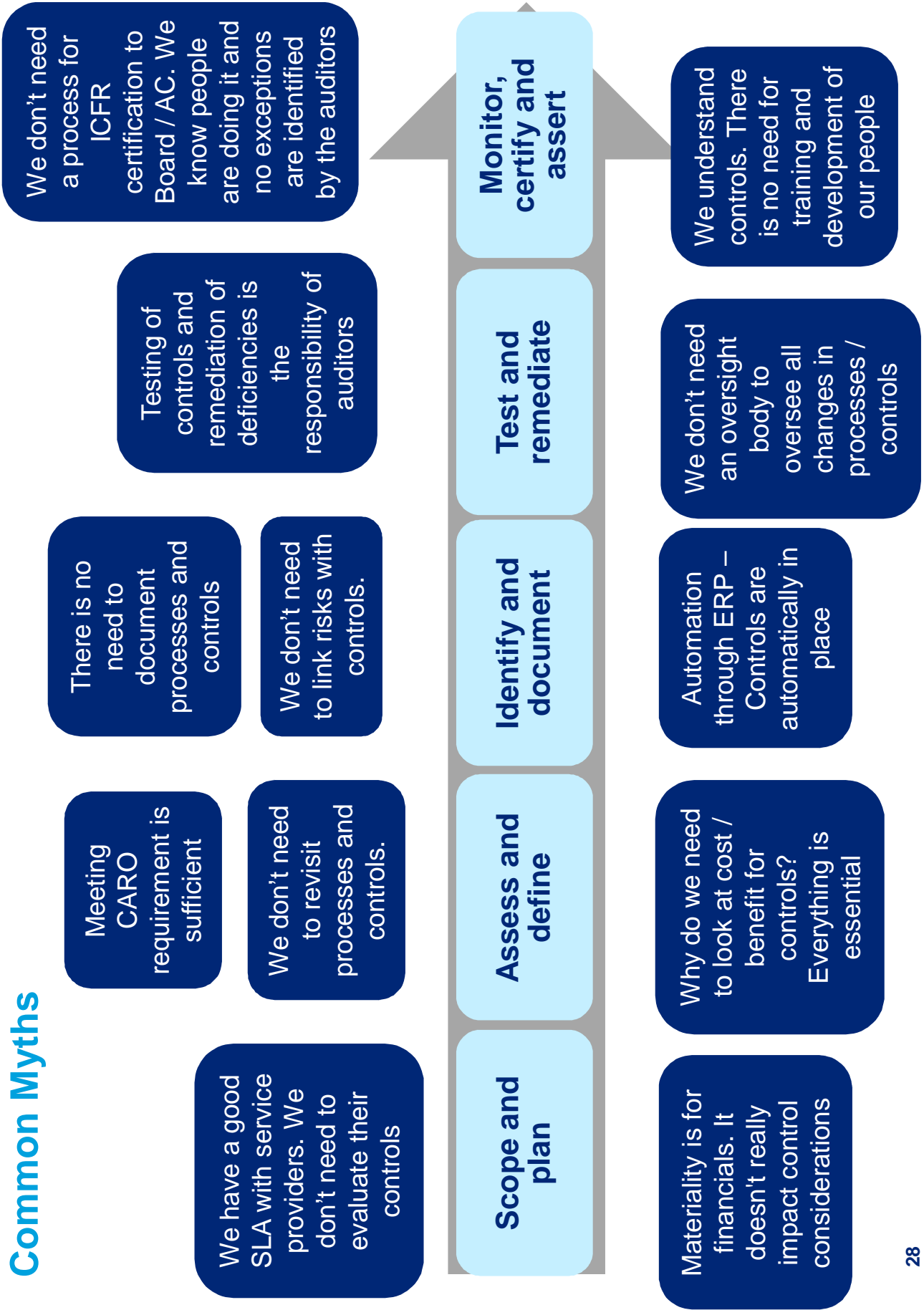
# Internal Financial Controls

A comprehensive global framework is required to be implemented that addresses Internal Control needs across businesses and geographies. COSO 2013 is one such framework

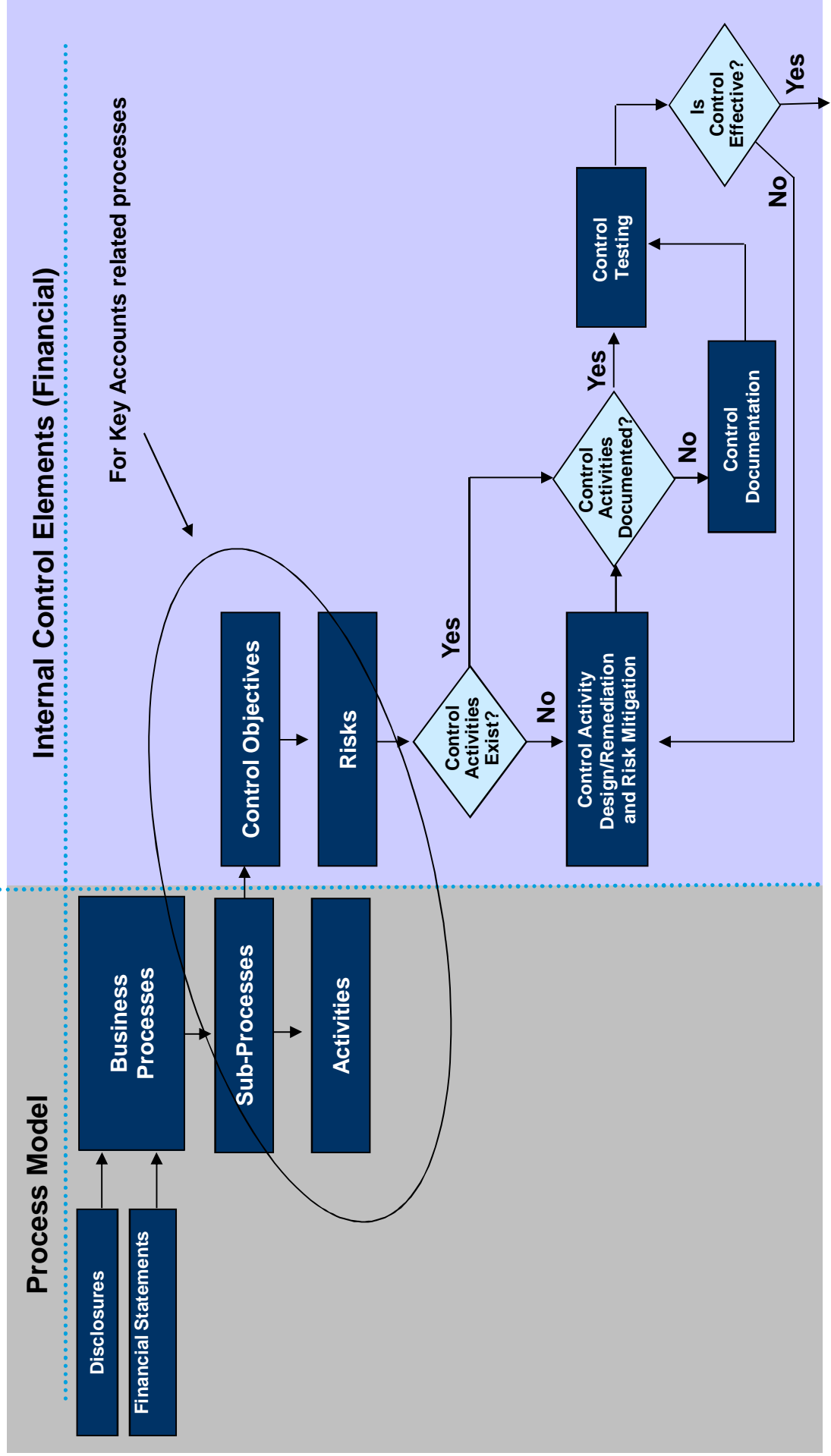


# ICFR – Why Clause 49 requirements are not effective

## Common Myths



# Understanding ICFR – Internal Controls Process Flow



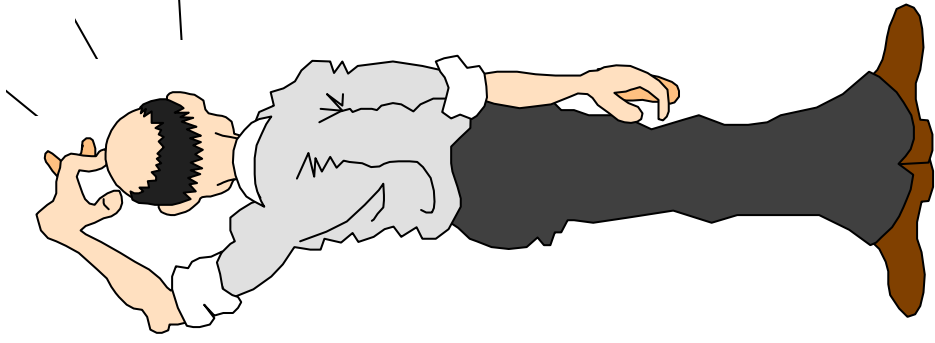
# Internal Controls Maturity Model

	Unreliable	Insufficient	Reliable	Optimal
<b>Documented controls, policies &amp; procedures</b>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
<b>Disclosure creation process</b>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
<b>Formal Responsibility for Control Activities</b>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
<b>Assessment of Controls</b>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
<b>Identification &amp; Remediation of Control Deficiencies</b>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

<input type="radio"/>	Does not exist	<input type="radio"/>	Exists but not fully documented	<input type="radio"/>	Exists & adequately documented	<input type="radio"/>	Use of Technology, Existence of preventive controls, & adequate documentation
-----------------------	----------------	-----------------------	---------------------------------	-----------------------	--------------------------------	-----------------------	---

Attributes



*Questions?*

*Thank You*

Email: [rdkamat@gmail.com](mailto:rdkamat@gmail.com)