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Top 10 Issues in Corporate Governance Practices in India

Government

Corporate, Securities, and Governance

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Key Highlights:

- Companies in India should plan their board rotation to ensure continuity as many directors are set to retire in 2024 due to legislative requirements.
- Boards should be wary of superficial corporate commitments to ESG and DEI.
- The COVID-19 pandemic has highlighted the importance of business continuity and disaster recovery.

While corporate governance and its concomitant issues are fairly universal, certain challenges are specific to India given the unique setting with the promoter- or family-driven nature of most Indian businesses. Added to this is the mushrooming of investor-controlled entities in recent times.

With this background, below are the top 10 issues in corporate governance faced by companies in India.

1. Board succession planning

The boards of most Indian companies have several long-serving directors. While there is no tenure limitation or appointment barriers for executive or non-independent directors, there is a statutory limitation of serving a maximum of two continuous terms of five years each for independent directors (IDs). This being the case, most reappointed IDs are set to retire in 2024 as the extant law has come into effect in 2014 (Section 149(10) of the Companies Act 2013).

Colloquially described as the "great refresh," this will force most Indian companies to appoint new directors. For companies with a soon-to-retire flock of IDs, it is highly recommended to start the process of identifying their next set of IDs. This might be an uphill task given the increasing statutory responsibilities and liabilities of the IDs, uncertainty about exposure to personal liability, and a limited pool of suitable candidates.

2. Board continuity

Companies should plan or revisit their board strategy and consider adopting a "staggered board" model: a board with directors having overlapping terms such that there is a certain extent of continuity, and the entire board does not become due for retirement at the same time. This model has also proven to be an effective approach to defend against hostile takeovers.

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Separately, it would be worthwhile to have a policy in place for not only board member rotation but also committee chair rotation. The rotation frequency and related aspects would be specific to the company, as there is no "one size fits all" established practice. It is also worthwhile to periodically undertake an evaluation of directors and the board as a collective.

3. Board diversity and harmony

Board diversity is not only ideal but also a statutory requirement. It is mandatory to appoint at least one female director as a board member in listed companies and certain other companies based on metrics of paid-up capital and turnover.

Further, collegiality amongst board members is integral to effective governance. Director additions should be done while keeping the company's interest at heart, which is not just professional eligibility of the incoming director but also a fit with the prevailing board culture. This is not to infer that a "yes person" should be appointed, but to say that the incoming director should have the ability to “disagree agreeably."

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4. Remuneration under lends

While there are statutory limits on remuneration in terms of amount and the percentage it constitutes of the net profits, those limits can be exceeded with prior approval of shareholders and board at the recommendation of the nomination and remuneration committee.

There have been instances of proposed remuneration resolutions of directors being denied by the shareholders due to being deemed excessive or reflecting a skewed ratio of remuneration in favor of promoter directors as compared to other executive directors. To deal with this, companies should consider undertaking a benchmarking study of the remuneration paid by similarly placed companies and proposing a remuneration in the same range.

5. Increasing scrutiny by auditor

The statutory auditors have found themselves on the regulatory radar due to several factors. The law governing auditor-company relationship in terms of inter alia tenure, auditor fees, and restrictions on receipt of non-auditor services from entities related to auditor tightens. The onus on auditors increases by way of the Company (Auditor's Report) Order. Also, new regulatory authorities investigate fraud and auditors, such as the National Financial Reporting Authority and multi-disciplinary Serious Fraud Investigation Office, in addition to supervision by the existing professional cohort of the Institute of Chartered Accountants of India.


The auditing landscape is also set to see a few changes.
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This has a trickle-down effect on the company, as the auditor adopts a "play it safe" policy and begins nit picking into company's affairs, including certain matters involving purely commercial judgement, to ensure an elaborate audit trail should there be a forensic audit to be done later. This trend makes it tedious especially for the audit committee.

The legal regime for auditors is set for an overhaul, which might make the audit process even more cumbersome. There is a possibility that auditing itself might not remain a lucrative option for the "Big 4" audit firms, with non-auditing services being a better revenue stream, increased regulatory supervision on audit, increased uncapped auditor liabilities, and regulatory expectations of forensic audit in the name of statutory audit. The companies should prepare to brave the paucity of auditors in the coming future.

6. Proxy advisory and shareholder activism

With the increase in institutional investors and diverse holdings of such investors, proxy advisors, touted as "influencers of India Inc," have taken an important position as market intermediaries providing voting recommendations. Institutional investors, especially foreign institutional investors are generally aligned with the voting recommendations of the proxy advisor(s) in keeping with the stewardship code. However, recent instances have proven that investors do not blindly follow the voting recommendations.

Nonetheless, adverse proxy advisor recommendations are in a way stigmatic for a listed company.

Such a recommendation may result in the particular resolution being voted against and defeated by the shareholders, which may have a ripple effect on the company, impacting inter alia its share price, leadership, and business plans.

Companies need to better insulate against such occasions, by ensuring legal regulatory compliance and being mindful of the voting recommendations guidelines published by proxy advisors. Companies may also consider developing deeper bonds with their shareholders to tide over foreseeable adversities.

7. Commercial transactions under scanner

Related-party transactions ("RPT") have always been of keen interest for regulators. Recently, the laws were amended in respect of RPTs of listed entities, which has an overarching application to subsidiaries of the listed entities as well as cross-jurisdictional operation.

The extant law requires not only approval by the audit committee (which is now limited to voting only by the IDs), but also shareholder approval if the RPT breaches materiality thresholds in the transaction itself or if there is a change in a previously approved RPT.

It is further weighed down by increased disclosure requirements including line-item disclosures justifying the RPT. In such a rigid regime, it is important for the board to draw boundaries between the protection of shareholders and stakeholders' interest and the commercial viability and interest in running the company.

8. Values assimilation

Environment, social, and governance (ESG) and diversity equity inclusion (DEI) are trending topics in the board rooms. In many cases, companies are in a race to be sustainable and provide equal opportunity without fully understanding the meaning and implication of these terms. This has led to greenwashing, "wokewashing," and "rainbow capitalism," all of which are unethical and antithetical to ESG and DEI.

Separately, we have also noticed a recent trend in several Indian listed companies to voluntarily constitute ESG committee of the board either as a separate ad hoc committee or grouped with other existing statutory committees of the board like the CSR committee, the risk management committee, or the stakeholders relationship committee, to strengthen their resolve towards matters of ESG and DEI.

It would be worthwhile for companies to adopt a purpose-driven approach to ESG, DEI, and even the statutory requirements of corporate social responsibility, instead of surface-level efforts.

9. Resilience planning

COVID-19 brought the gaps in governance to the forefront. These were testing times for boards as each company was faced with its own peculiar set of challenges. A key takeaway from these times was the significance of business continuity planning, including disaster management and recovery, remote access technology, and digitization of business processes.

Directors under the Indian law hold a fiduciary duty and, by extension of that, are charged with the responsibility to undertake precautionary, preventive mitigation, as well as remedial measures, to ensure seamless operations and financial agility of the company.

Given this context, it is critical that the lessons learnt from these VUCA times (times of Volatility, Uncertainty, Complexity and Ambiguity) are not forgotten, and that business continuity planning becomes a periodic agenda for boards to deliberate on, such that companies are in a state of preparedness to deal with the next business disruption.

10. Human capital management

Among the many COVID-19 lessons, employee movement (whether “mass lay-offs” as a loss reduction strategy or attrition courtesy of the “great resignation” movement) became a cause célèbre. As anecdotal as it may seem, both events have an impact on the company, financially and otherwise, including a loss of morale and faith of the continuing employees. This brings to fore the importance of human resources and the need to manage them effectively, the onus of which would trickle on to the board.

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A corporate governance lesson in this case is to place emphasis on each employee of the company as a limb of the company, and not just limit the focus on the chief officers or the managerial level. The same can be achieved by ensuring employee retention, hiring in line with the company’s goal, mission, vision, and values, and providing non-statutory employee benefits like mental health leave and therapy access as a matter of business continuity planning. It would be worthwhile to revisit the company’s policies and code of conduct, give flexibility where required and possible, and ensure real time change and not just a policy update.

The future of Indian corporate governance

India is conscious of its perception on the “Ease of Doing Business” index. For Indian start-ups, companies seeking investments, and promoters planning diversification of their group’s portfolio, the issues listed above are items to be kept in mind. The regulatory regime and scrutiny are set to only increase with time, as government poises itself to adopt and inculcate the spirit of sustainability and higher benchmarks of corporate governance.

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