"An Analysis of the report of the Standing Committee on Companies Bill, 2009"

The Companies Bill, 2009 (Bill) was introduced in Lok Sabha on 3rd August, 2009 and subsequently on 9th September, 2009, it was referred to the Standing Committee on Finance of Parliament (Committee) for its detailed examination and report. The report of Standing Committee was presented to the Lok Sabha on 31st August, 2010 and laid in the Rajya Sabha on the same date .

A new legislation, rule or regulation in a society usually seeks to ensure orderly, consistent and equitable conduct of its activities. Implementation of any new legislation, rule or regulation may require not only a radical change in the mindset of people to overcome the human mind's resistance to change but it may also require overcoming genuine bottlenecks that arise during the implementation process. Such implementation bottlenecks may either pose challenges cost-wise or unintentionally disturb an existing, well laid out system.

The essence of the Bill is to facilitate a comprehensive revision of the present Companies Act, 1956 with a view to promote self-regulation, eradicate unwarranted regulatory approvals, vest shareholders with greater powers and encourage greater transparency in the disclosures by corporate entities. Corporate governance is one aspect where heightened emphasis has been given to ensure accountability of individuals at the helm of affairs of a company.

In the following paragraphs, we have attempted an analysis of some of the principal changes relating to corporate governance that the Bill, read with the changes therein as agreed to by the Ministry of Corporate Affairs (MCA), seeks to bring about vis-à-vis the position obtaining as at present. The focus is primarily on proposals which have been significantly amended during the process of the Committee's consideration. The analysis identifies the proposed departures from the existing position, their potential benefits, and the challenges that those changes are likely to create. It may be worthwhile to add that the Report leaves many issues for further consideration of the MCA and therefore, there is a possibility of some further changes.

The report of the Standing Committee on the Bill contains a large number of recommendations. It is not possible to deal with each and every such recommendation due to limitation of space. The following discussion is, therefore, only with reference to some of the major recommendations and is by no means exhaustive.

Appointment of Independent Directors

Recommendations

- It is proposed that every listed public company having prescribed amount of paid-up share capital should have at the least one-third of the total number of directors as independent directors. The Central Government may prescribe the minimum number of independent directors in the case of other public companies and subsidiaries of any public company.
- A panel or a databank should be maintained by the MCA, out of which companies may appoint independent directors.

Departure from current practice

Appointment of independent directors is mandatory only for listed public companies and is made by the company.

Benefits

- Independent directors help to counterbalance the natural potential for conflict between the interests of executive directors and shareholders and other stakeholders.
- A central databank will provide a readily accessible pool of eminent qualified personnel and professional experts who would be able to share their enriching knowledge and provide valuable insights based on their experience from other reputed companies where they have served, or are serving, as independent directors. This will also facilitate incorporation of best industry practices.
- Whilst selection is to take place from the panel, the power to select or choose the independent directors still vests with the company and to this extent, there is no major change/dilution in the company's powers.

Challenges

- The proposal seeks to strengthen the independence of independent directors. However, the concept of independence is multifaceted, judgmental and highly subjective.
- Maintenance of a panel may give rise to concerns of favoritism and bureaucratic delays unless the empanelment criteria are objective and publicly known and other checks and balances are put in place.
- Evaluating a person's competence, integrity and commitment is not always possible on the basis of information available in a databank.
- It may so happen that certain highly reputed and eminent individuals fail to register their names either unintentionally or intentionally. This would prevent companies to choose such people because of the statutory requirement.
- Considering that the criteria for determining independence have in any case been specified, constitution of a panel may unduly complicate the appointment process.

Tenure of Independent Directors

Recommendations

Tenure of office of an independent director is proposed to be limited to a maximum of two tenures of six consecutive years each with a cooling-off period of three years between the two tenures. During the cooling-off period, such a person can not be inducted in the same company in any capacity.

Departure from current practice

- The Corporate Governance Voluntary Guidelines issued by the MCA permit three tenures (with similar conditions) for an independent director.
- Clause 49 of the Listing Agreement contains a non-mandatory requirement to the effect that an independent director cannot serve for more than nine years.

Benefits

- Having a limit on the tenure of office seems to have merit since the ability of an independent director to act independently may be impaired if the association with a company continues uninterrupted for a significant extended period. However, it is a moot point whether the limit of six years is the appropriate limit.
- A new set of people would have a fresh perspective and outlook to company's issues and would also be more likely to objectively evaluate the practices being followed.

Challenges

- Having a restricted tenure could prove to be counter-productive since the knowledge gained through experience may not be fully put to use in a shortened tenure.
- A restricted tenure could also affect the enthusiasm and effectiveness with which an independent director provides suggestions for high-level decisions to be taken by the Board.
- There exists no uniformity in various regulatory guidelines with respect to maximum number of years as tenure by an independent director and there is genuine doubt on what is an appropriate period.
- Given that a director would usually take a year or two to be familiar with the dynamics of a company, the functioning of the board etc., a term greater than six years or a term which may be fixed (within reasonable limits) by the company may be more appropriate.

Corporate Social Responsibility (CSR)

Recommendations

Every company having net worth of INR 500 crores or more, or turnover of INR 1,000 crores or more or a net profit of INR 5 crores or more during a year shall be required to formulate a policy to ensure that every year at least 2 percent of its average net profits for the three immediately preceding financial years are spent on the CSR activities as may be approved and specified by the company. Appropriate disclosures by directors to be made in this regard in their report to members. In case any such company does not have adequate profits or is not in a position to spend prescribed amount on CSR activities, the directors would be required to give suitable disclosure/ reasons in their report to the members.

Departure from current practice

As per the Corporate Social Responsibility Voluntary Guidelines, 2009 issued by the MCA, companies are encouraged to allocate specific amount in their budgets for CSR activities. The Guidelines also suggest disseminating information on CSR policy, activities and progress in a structured manner to all stakeholders and public at large.

Benefits

- This would ensure that a company spreads the benefits generated from its operations across the overall society to which it belongs, thereby achieving a macro level objective of contributing to the society.
- This would facilitate effective initiatives by public-private enterprises jointly coming together instead of only the state being made responsible for the welfare of society.
- The requirement for a company to give adequate disclosures on its CSR initiatives or reasons for non-compliance would keep the shareholders and other users of financial statements sufficiently informed.

Challenges

- Companies do business to create value addition to their shareholders. This has to be the first and foremost objective for any company. Mandating the CSR initiatives could result in conflict between the economic and social objectives of a company.
- Companies already cater to the needs of various sections of the society by providing employment, paying taxes to government, sustaining developmental activities in the surrounding areas etc. To thrust more responsibility on them by way of mandatory CSR initiatives could discourage corporate world.
- Effectively, this would amount to corporate income tax rate going up by 2 percent.
- Mandating a specific budget for CSR initiatives may be counter productive. Companies should be encouraged to voluntarily adopt good governance and corporate social responsibility practices, rather than be legally compelled to do so.

Rotation of Auditors

Recommendations

The Bill originally did not contain any proposal for rotation of auditors. However, it is now proposed that audit partner and firm will be required to be mandatorily rotated once every three and five years respectively with a cooling off period of three and five years for the partner and firm respectively.

Departure from current practice

ICAI Quality Control Standards require that an audit firm should set out criteria for determining the need for safeguards to reduce the familiarity threat to an acceptable level when using the same senior personnel on an assurance engagement over a long period of time. For listed entities, it mandates that that the audit partner should be rotated after a pre-defined period, normally not more than seven years.

- The voluntary guidelines on corporate governance issued by the MCA require that to maintain independence of auditors, audit partner and firm may be rotated once every three and five years respectively with a cooling off period of three and five years for the partner and firm respectively.

Benefits

The proponents of rotation argue that rotation increases auditor's independence and will .provide opportunities to a larger number of accounting professionals.

Challenges

- Experience with mandatory auditor rotation in practice demonstrates that it reduces audit effectiveness, increases the costs of doing business and diminishes the quality of audit services. Audit firms may lose incentive to develop domain knowledge and may not invest in related resources. Compulsory firm rotation also increases the costs of doing business by distracting non-executive directors and senior company management as new auditors must be familiarised and brought up to speed on company operations.

- Professional standards already provide strong safeguards to address the threat of the auditor's over-familiarity with the client, including rotation of the lead partner on an audit as well as other restrictions that enhance audit independence and quality in a more cost-effective manner.

- In practice, such a measure may result in auditing firms being split into smaller firms. This will particularly militate against creation of vast knowledge databases and specialised expertise.

- There is no empirical support for the argument that rotation increases auditor independence by removing the incentive to sacrifice current judgments for the promise of long-term revenues from a client.

- If implemented, the provision will cause greater difficulty for global corporates, as they will have to change their audit firm for their Indian subsidiary while having a separate auditor for rest of the globe.

- Only a handful of countries (notably Indonesia, Italy, Poland, Saudi Arabia and Singapore) currently require some form of audit firm rotation after a predefined period. Numerous examples of countries introducing audit firm rotation only to reverse their positions after implementation of the regime reveal that rotation creates more problems than it solves.

- In 2002, the Naresh Chandra Committee on Corporate Audit and Governance had rejected the proposal for rotation of auditors and had instead recommended rotation of audit partners.

- The best alternative measure would be to legislate for audit partner rotation according to international norms and to introduce effective and independent auditor oversight, just as it occurs in the EU, the US, and around the world.

Independence of Auditors to be ensured by Audit Committee

Recommendations

The audit committee comprising independent directors be made responsible to ensure that the auditor remain independent and are organisationally and professionally competent to discharge their responsibility.

Departure from current practice

Whilst the existing law or regulation does not explicitly stipulate this requirement, one of the implied functions of the audit committee is to ensure that auditors remain independent of the company.

Benefits

The requirement would ensure that the audit committees develop procedures to regularly review whether the auditor has remained objective and independent in discharge of his duties.

Challenges

Independence being a subjective concept is difficult to establish. The ways and means by which audit committee can ensure independence are limited. Many audit committees may just obtain a letter from the auditor regarding compliance with independence requirements.

Responsibilities of Chief Financial Officer (C.F.O.)

Recommendations

- It is proposed to recognise CFO as a key managerial personnel. Companies belonging to such class or description of companies as may be prescribed must have whole-time key managerial personnel.
- The CFO shall be responsible for the proper maintenance of the books of account of the company, and shall ensure proper disclosure of all required financial information indicated in the prospectus or any other document, risk management, internal control mechanism, and also ensure compliance of the provisions relating to preparation and filing of annual accounts of the company.

Departure from current practice

The present Act does not specifically recognise the position of the CFO. However, the SEBI listing requirements stipulate certain specific functions for the CFO. In practice, CFO is responsible for most of the above activities and reports to the Board.

Benefits

- Mandatory requirement for prescribed classes of companies to have a whole-time CFO is a recognition of importance of finance function. With the aspects of internal control, risk management, finance and accounts brought under the purview of the CFO, a clear-cut definition of roles and responsibilities of the CFO and appropriate reporting structure would emerge in many organisations.
- Presence of a whole-time CFO, with clearly defined roles and functions, would provide added comfort to stakeholders.

Challenges

- Responsibility and authority complement each other. The CFO would need to be adequately empowered to take decisions instead of merely being an executor of directions given by the Board. It should not so happen that the Board is vested with powers to make decisions and the CFO being held responsible for consequences of such decisions.
- Functions such as risk management are areas wherein specialised expertise is required to mitigate the company’s business risks, market risks, etc. in addition to financial risks. In large organisations, there exists a separate risk management department headed by an expert who specialises in financial risk management. CFOs often place reliance on the work carried out by the risk management experts of the company based only on a broad overview. The CFO may not be in a position to exercise hands-on control in aspects such as risk management as compared to that of functions like accounting, finance and internal control.

Auditors’ Report

Recommendations

- The Bill proposes that the audit report should explicitly state compliance with auditing standards.
- Further, in case of the listed companies, the auditor should also state whether the company has complied with the internal financial controls and directions issued by the Board.
- It is also proposed that the auditor’s report should specifically state whether the balances exceeding INR 5 lakh in respect of every debtor, creditor, loan and advance, investment and bank balance have been confirmed by the respective counterparty.

Departure from current practice

No such requirement exists under the current practice both in terms of usage of language in the audit report on compliance with auditing standards and on financial controls in case of listed companies.

Benefits

Listed companies are expected to have robust internal controls in place particularly over financial reporting. By having the auditor report on company’s compliance with the financial controls framed by the Board, an independent evaluation of compliance with prescribed internal controls would be done.

Challenges

- Whilst ensuring compliance by a company with the internal controls framed by the Board of Directors is an effective governance measure, it would be useful if the auditor’s are also asked to comment on whether the internal financial controls as prescribed by the Board of Directors are themselves adequate. In other words, the design deficiencies in internal financial controls as laid down by the Board should also be required to be brought out.
- The scope of the expressions ‘internal financial controls’ and ‘directions issued by the Board’ is too wide and needs to be restricted to those relating to financial reporting and any other aspects which are directly relevant to the functions of the auditor.
- As regards the proposed assertion relating to confirmation of specified balances, auditing standards (which are now proposed to be recognised in the law itself) already lay down the overall framework within which an audit needs to be conducted. Within this overall framework, the exact methods of obtaining sufficient appropriate audit evidence relating to an item in the particular facts and circumstances of a case should be left to the professional judgement of the auditor rather than being prescribed under law.

Participation of Directors in the Meetings

Recommendations

Provision is sought to be made for participation of directors in a Board meeting either in person or through video conferencing or such other electronic means as may be prescribed which are capable of recording and recognising the participation and for recording and storing of such participation.

Departure from current practice

At present, participation in a Board meeting can be only by personal attendance.

Benefits

Participating by video conferencing (or similar means) is a very welcome step and would ensure greater participation of directors and also save time and cost.

Challenges

The Board meetings are forums where directors carry out numerous discussions on the company, all of which may not be recorded for various reasons.

No Employee Stock Options for Independent Directors

Recommendations

An independent director shall not be entitled to any remuneration, other than sitting fee, reimbursement of expenses and profit-related commission as approved by the members. Thus, stock options have been removed from the allowable forms of compensation of independent directors. It is proposed to allow payment of higher sitting fee to independent directors and to have Rules to prescribe different slabs/categories for payment of sitting fees to different class or classes of companies on the basis of net worth and/or turnover.

Departure from current practice

Stock options can be given to directors including independent directors. The SEBI guidelines also permit this subject to shareholders' resolution.

Benefits

- Stock-option compensation can have negative effects since it could compromise the independence of independent directors by shifting their focus on short-term stock price movement instead of promoting long-term interests of stakeholders.
- The mechanism of stock options is such that lower the stock price on the grant date, more likely the recipient would be to gain. This may lead in some cases to time the grants in such a way so as to suit the convenience of directors.

Challenges

- The present practice is stringent enough, requiring wide-ranging disclosures in company's financial statements and other public documents, for stock options given to the directors including the independent directors. More importantly, these stock options are subject to approval of the shareholders of the company.
- If it is argued that independence is enhanced by preventing independent directors from having stock options, questions arise as to why only independent directors should be prevented from having stock options and why not other directors who form part of the board and who have greater powers in driving the operating policy decisions of the company.
- Various countries (USA, UK, Canada, Australia, Singapore, Hong Kong to name some) do not prohibit stock options for independent directors. Considering that stock option consideration is growing in popularity, it may be more appropriate to place restrictions either on the total amount of options or on the manner of vesting and exercise of such options and sale of resultant shares.

Uniform Financial Year

Recommendations

All companies would have a uniform financial year which would be ending 31 March, with the Company Law Tribunal empowered to grant exemption to a company upon application for following a different period as financial year.

Departure from current practice

Presently, no requirement of a uniform financial year exists in the Companies Act.

Benefits

- Brings about uniformity which would facilitate better comparison of financial statements of companies.
- The Income-tax Act, 1961 has already brought in the concept of a uniform financial year of April – March consequent to which most of the companies already have April–March as financial year.

Challenges

- Global companies generally follow calendar year as their financial year. Also, Indian companies with subsidiaries across the world could have different financial years across these subsidiaries. The proposed recommendation could lead to problems in consolidation process.
- The proposed change allows companies to make an application to Tribunal and seek its approval for following a different period. In today's world, companies look towards support from the state in reducing administrative hassles involved in obtaining approvals from government regulatory bodies. This change would largely be looked upon by the corporate world as increasing their burden.

Restriction on Step-Down of Subsidiaries

Recommendations

With a view to prevent diversion of funds, it is proposed to prohibit a subsidiary company from having its own subsidiary.

Departure from current practice

There is presently no such restriction on subsidiary having further subsidiaries.

Benefits

The intention of the proposed change is to prevent siphoning-off of funds and protect interest of shareholders which should add the comfort level of shareholders.

Challenges

- Most companies have already created structures to suit their operational convenience within the framework permitted so far. Foreign companies carry out their operations in India through the concept of step down subsidiaries in many cases. The concept of single tier of subsidiaries could lead to severe administrative hassles for both domestic and foreign players who intend carrying out business in India.
- This could have severe impact on certain industries such as infrastructure industry. The mechanism of investments in infrastructure industry is that a holding company would invest in various projects through various subsidiaries. This ensures separate funding of different projects through a chain of subsidiaries and step-down subsidiaries.
- The proposal would create problems for realty companies where there is limitation on holding land beyond a specified limit as per the land regulation statutes in India.
- The proposal is too drastic to be enacted without adequate debate. It will have far-reaching consequences on foreign investment and growth of industry.
- The proposal would create almost impossible implementation issues particularly because at present, many large companies operate through multiple tiers of subsidiaries.

Summary

Given the Likely pervasive impact of the provisions of the Bill, the need of the hour is to strike the appropriate balance to achieve the twin objectives of improving corporate governance without creating undue bottlenecks. It is expected that the benefits and challenges of the new proposals will be appropriately deliberated prior to enactment of final legislation.