Investors' perspective on Corporate Governance

Implications from the Companies Act, 2013 and Clause 49

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Overview

The Companies Act, 2013 (New Act) and the recently revised Clause 49 have raised the bar for the Board of Indian companies. Several new concepts have been introduced such as: women directors on the Boards to bring in gender diversity, small shareholder director to give improved minority representation, restriction in the number of directorships so that the directors could devote more time to each Board, performance evaluation of the Board and of the individual directors to enhance Board efficiency, strong emphasis on related party transactions, internal financial controls and risk management oversight by the Boards, enhanced disclosures in the Board's report to shareholders, additional rigour in the Directors' Responsibility Statement and corporate social responsibility and class actions. Overall, the aim is to raise the governance profile of Indian companies and their Boards, at par with the roles and responsibilities assumed by Boards globally. One obvious implication of these changes is rise in investor expectations and the Boards being better prepared to cope with the enhanced level of expectations.

With a view to share the understanding of the investor expectations and to provide insights with respect to implications of the New Act and the Clause 49, the International Finance Corporation (IFC) in association with Indian Institute of Corporate Affairs (IICA) and the Confederation of Indian Industry (CII), with Deloitte Touche Tohmatsu India Private Limited (Deloitte) as their knowledge partner are organizing a one day seminar, "Investors' perspective on Corporate Governance - Implications from the Companies Act, 2013 and Clause 49.

This publication is aimed at providing brief overview of four aspects of the corporate governance framework laid down by the Companies Act, 2013 and the Clause 49 - 'Related Party Transactions', 'Measuring Board Efficiency, 'Internal Financial Controls' and 'Risk Management'.

Related Party Transactions
Expert Take

In the era of stringent interventions and detailed prescriptions by regulators aimed at empowering minority shareholders, abusive Related Party Transactions (RPTs) by controlling shareholders have gained prominence in terms of global regulatory scrutiny. Regulators are defining prescriptive compliance and disclosure standards around RPTs to ensure that such transactions do not obviate minority shareholder interests. In India, the Companies Act 2013, Section 188 (1) and SEBI's revised Clause 49 of the Listing Agreement ('Clause 49') are set to overhaul the existing regime on RPTs over and above Accounting Standard 18 disclosure and transfer pricing regulations.

Key highlights on Related Party Transactions:

- The new framework focuses on significantly enhanced oversight at the Audit Committee and Board levels as well as comprehensive public disclosures.
- Companies, interested Directors and Key Management Personnel (KMPs) are required to disclose their interest in RPTs to the Audit Committees, Board or shareholders and there will be disclosure of classified RPTs in Board's Report.
- The Clause 49 also requires that companies establish a policy on RPTs to guide identification, classification, approval, reporting and disclosure of RPT.
- Stringent penal provisions for directors ranging from disqualification from appointment as a director in any company to imprisonment of 1 year to fines up to Rs. 5 Lakh.

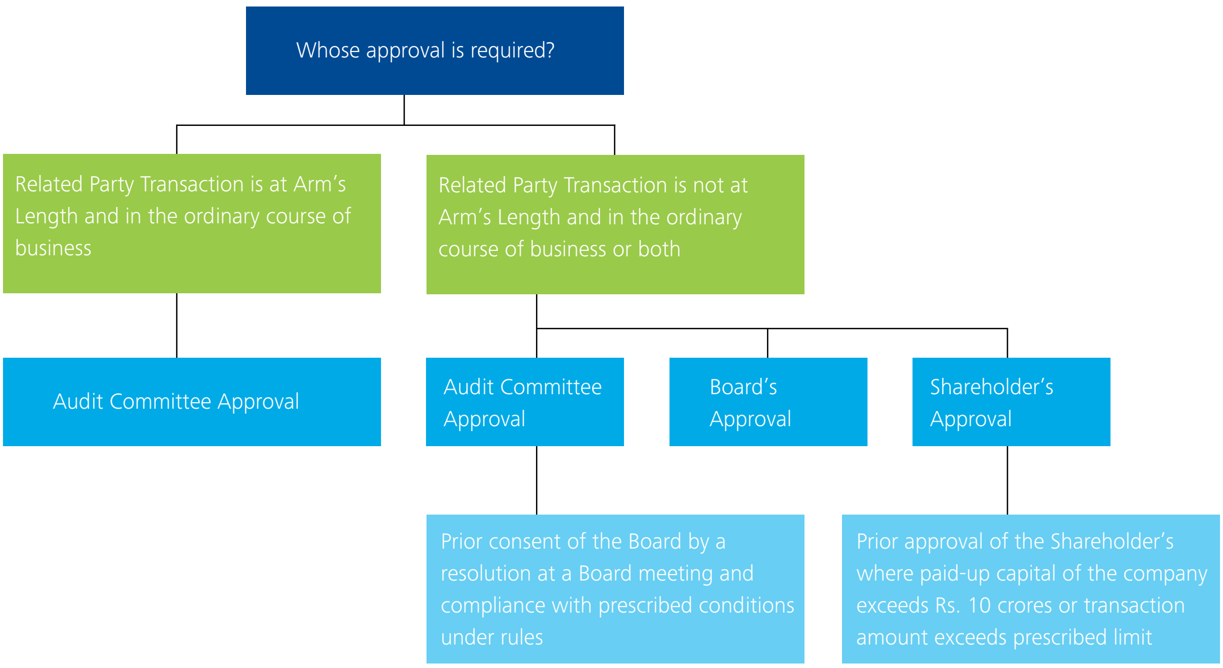
These new requirements will significantly affect intra-group transactions for Indian companies, especially the close-knit business groups and their various holding, subsidiary and associate companies.

A threefold framework with an effective integration of people, process and technology provide the Audit Committee and the Board, the required assurance on compliance with stipulated provisions governing RPT and disclosures. The key changes and what these changes imply for the Boards and the KMPs are evident from the following charts:

Key Changes in RPT Process and disclosures:

	From	To
Regulations	Income Tax and AS18	Income Tax, AS 18, Companies Act, SEBI
Definition	Few Parties Qualify	Wide definition covering several parties
Materiality Consideration	Only Material Transactions	All transactions to be considered
Timing	Lag- Only Disclosure Purpose	Lead Pre-Approval
Approval	Nil	Audit Committee, Board and Shareholders
Involvement	Mainly Finance	Finance, Business Functions and Secretarial

Approval of RPT under the New Act:



'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.

'Disclosures' is details of contracts/arrangements/transactions not on arm's length basis and material contracts/arrangements/ transactions shall be disclosed in the Board's report.

Deloitte had carried out a CFO Survey this year. In the Survey, responses were sought from over 100 CFOs, spanning listed and unlisted companies, across sectors, with revenues of less than INR 500 crore to larger companies with revenues greater than INR 1,000 crore.

Deloitte Survey Relevant Highlights:

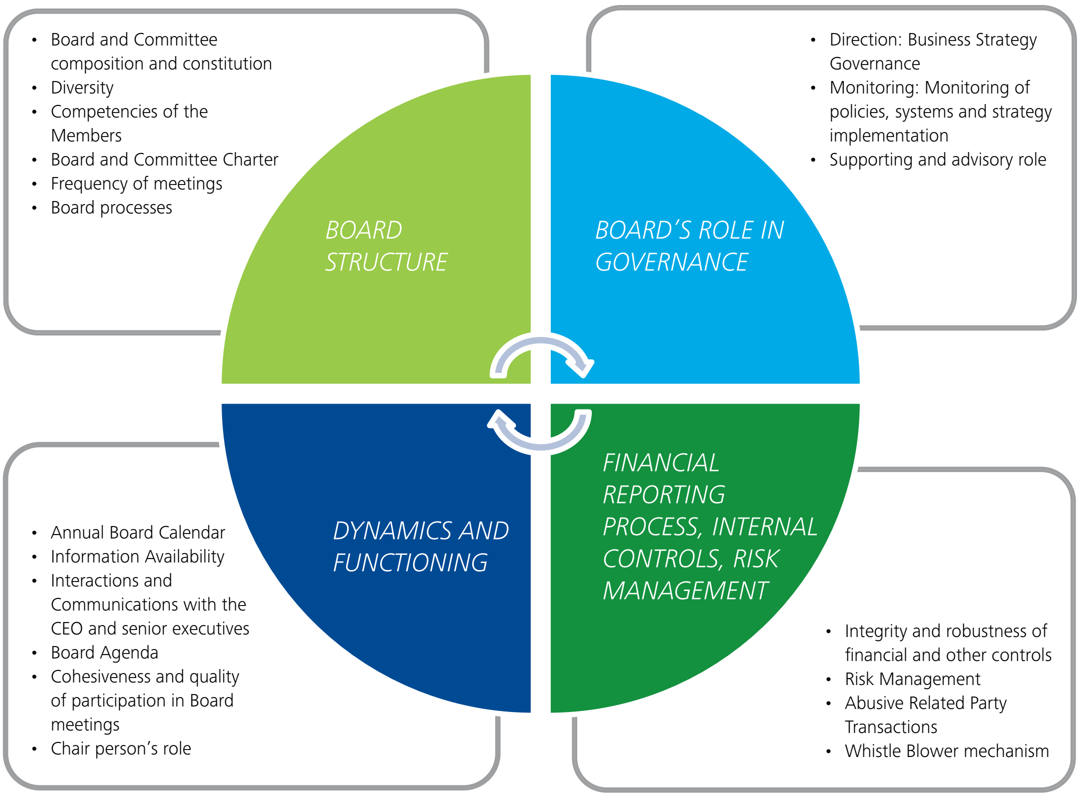
Deloitte India CFO Survey 2014: Hope prevails
Almost 98% of CFOs are of the view that the new Companies Act would affect their roles in different ways. Disclosure and approval of Related Party transactions has been considered as the most impactful provision by 53% CFO respondents.

Measuring Board Efficiency

Globally periodic evaluation of the performance of Board and the directors has been considered as a useful way to enhance the efficiency of the Boards and the directors. Companies Act, 2013, Section 134 (3) (p) and the revised Clause 49 of the Listing agreement now require an annual evaluation be carried out of the performance of the Board, Committee and individual directors. The process and methodology of evaluation has been left open to the Boards but the responsibility has been assigned to the Nomination and Remuneration Committee as per the New Act, Section 178. This is in line with the global practice.

Evaluation Parameters

The evaluation of the performance of the Boards is essentially an assessment of how the Board has performed on identified parameters. Some of the parameters are as shown below;



The evaluation process (whether conducted in-house or using an external facilitator) can typically involve, identification of areas for evaluation, designing the rating scale based on the parameters, formulating a questionnaire on the areas for evaluation, obtaining responses of individual directors to the questionnaire on a rating scale, conducting interviews with individual directors and analysing the responses to the questionnaire and interviews; and reporting the findings resulting from the analysis to the full Board. The Board can then deliberate on the report, develop an action plan and periodically review the progress of implementation. Without the last step, the exercise will lose value for the company and the investors.

However, checklist reviews should not remain as a tick-a-box exercise, where, although it does allow some level of formalisation, its limitations include a parochial approach in assessing if a company has an effective Board (or not), restricted to the variables in a particular checklist. There is a risk that, such an approach may overlook company specific situations or circumstances.

Benefits of conducting performance evaluations

Well conducted evaluations have the potential to achieve various benefits, helping the Board to:

- Gain assurance that it has a suitable balance of skills and other attributes and focusing attention on the attributes required in any new director;
- Focus on any inadequacies;
- Identify strategic priorities;
- Develop skills, knowledge and understanding in the individual directors;
- Review its practices and procedures and thus to become more efficient and effective;
- Justify recommending the re-election of the director (where appropriate).

Fairly conducted performance evaluations contribute largely in strengthening stakeholder confidence in the functioning of the company and its short and long term improvement strategies.

Deloitte Survey Relevant Highlights

A Survey, “2012 Board Practices Report Providing insight into the shape of things to come” was conducted by the Society of Corporate Secretaries and Governance Professionals (“the Society”) and the Deloitte Center for Corporate Governance. Survey responses were sought from nearly 200 companies represented in the Society’s membership.

- **Room for improvement in Board diversity:**
More than 80% of respondents say that the percentage of women and minorities on their Boards is at most 25%, and less than 15% say that the percentage has increased since last year
- **Industry knowledge tops list of desired director experience:**
The type of skill and experience most desired for Board success in the next two years is industry knowledge, followed by C-level experience, international business exposure, technology/IT, and operations
- **Variation in risk oversight practices:**
How Boards are assigning risk oversight for the organization’s risk management program varies. Only 7% say they have a Board risk committee, and the remaining responses display little variation in those saying the responsibility is spread across all Board committees; to the Audit Committee; and to the full Board
- **Increase in shareholder engagement:**
More Directors report having direct contact with shareholders or share¬holder groups — 42% this year compared to 36% in the 2011 survey

Advanced Internal Financial Controls

Internal Financial Control (IFC) is not a new concept in India for listed companies. Clause 49 of the Equity Listing Agreement requires certification by the CEO/CFO stating that they have accepted responsibility for establishing and maintaining internal controls for financial reporting, evaluated the effectiveness of internal control systems of the company pertaining to financial reporting. The Clause also requires them to disclose to the Audit Committee and the auditors, deficiencies in the design or operation of such internal controls, if any, of which they are aware and the steps they have taken or proposed to take to rectify those deficiencies.

The New Act has given additional requirements in terms of directors' responsibility towards internal financial controls, definition of internal financial controls itself and responsibility of the auditor for expressing an opinion on internal financial controls.

Clause (e) of Sub-section 5 of Section 134 of the Companies Act 2013 describes 'Internal Financial Controls' as: "the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information."

The COSO (Committee Of Sponsoring Organisations of the Treadway Commission) framework describes 'Internal Control' as: "Internal control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance"

Executive Responsibilities towards IFC:

- Directors' Responsibility: Clause 134 (5)(e) requires the report by the Board of Directors (BoD) to include a statement ensuring implementation of adequate internal financial control and adherence of policy and procedures adopted by the company with an objective of orderly and efficient conduct of its business, safeguarding company's assets, prevention and detection of frauds, for accuracy and completeness of the accounting records and timely preparation of reliable financial information.
  Rule 8(viii) of the Companies (Accounts) Rules, 2014 requires the Board Report of all companies to state the details in respect of adequacy of internal financial controls with reference to the financial statements.
- Independent Director's responsibility: Schedule IV (II) (4): Independent Directors shall satisfy themselves on the integrity of financial information and that of financial controls.
- Audit Committee's responsibility: Clause 177 (4) (vii) requires every Audit Committee shall act in accordance with the terms of reference specified in writing by the Board which shall inter alia and include evaluation of internal financial controls and risk management systems.
- Auditor's responsibility: Clause (i) of Sub-section 3 of Section 143 of the Act requires the auditors' report to state whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.

Implementing internal financial controls:

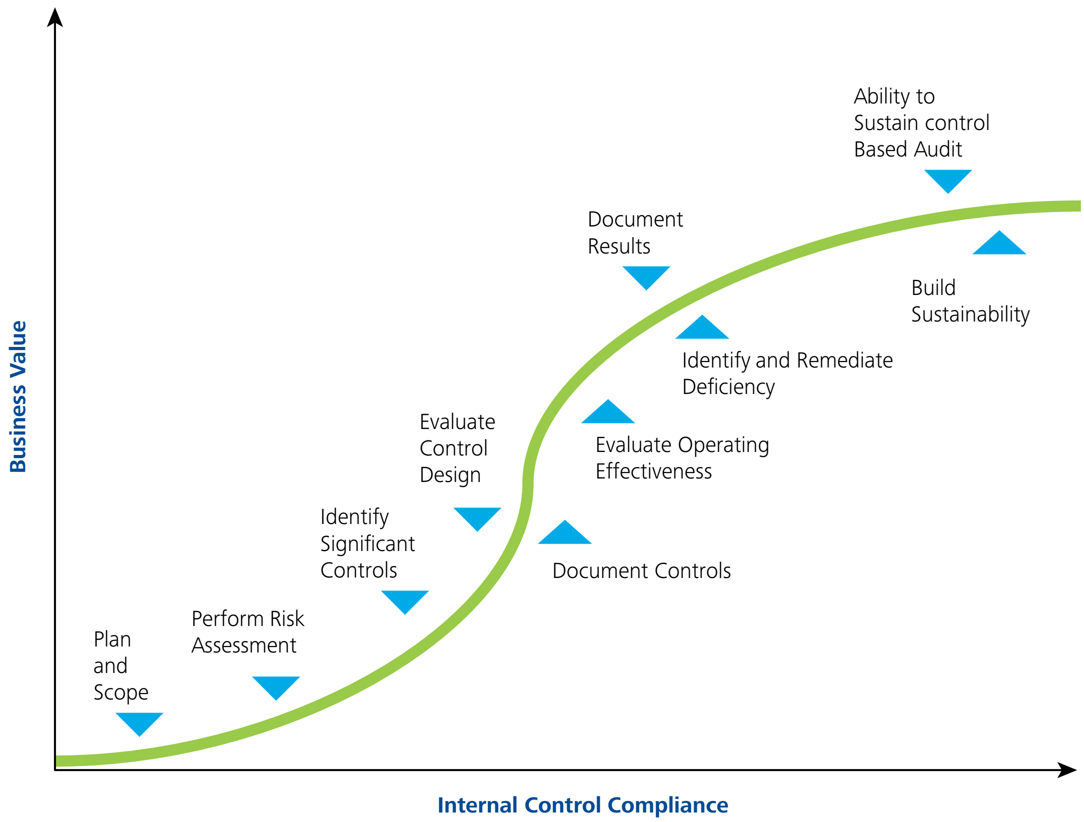
Internal control frameworks enable organisations to effectively and efficiently develop systems of internal control that adapt to changing business and operating environments, mitigate risks to acceptable levels, and support sound decision making and governance of the organisation.

In India we do not have a specific guidance framework for IFC. Internationally, there are several frameworks that provide guidance to entities for developing and establishing their internal control systems. Some of the commonly applied frameworks are:

- Internal Control-Integrated Framework issued by Committee of the Sponsoring Organisations of the Treadway Commission (COSO Framework)
- Guidance on Assessing Control published by the Canadian Institute of Chartered Accountants
- Report published by the Institute of Chartered Accountants in England & Wales "Internal Control: Guidance for Directors on the Combined Code" (known as the Turnbull Report)

Once the organization has chosen an appropriate framework, it needs to embark on a risk based internal controls journey.

The diagram below depicts the typical steps involved in implementation of IFC:



Potential threats to IFC implementation:

- Lack of an enterprise-wide, executive-driven internal control management program
- Lack of a formal process and fraud risk management program
- Inadequate controls associated with the recording of non-routine, complex, and unusual transactions
- Ineffectively controlled post-merger integration
- Lack of effective controls over the IT environment
- Ineffective financial reporting and disclosure preparation processes
- Lack of formal controls over the financial closing process
- Lack of current, consistent, complete, and documented accounting policies and procedures
- Inability to evaluate and test controls over outsourced processes
- Inadequate Board and Audit Committee understanding of risk and control

Deloitte Newsletter Relevant Highlights:

The extract from 23rd whitepaper in Deloitte's series on Risk Intelligence:

Risk Intelligent governance in the age of cyber threats - What you don't know could hurt you:

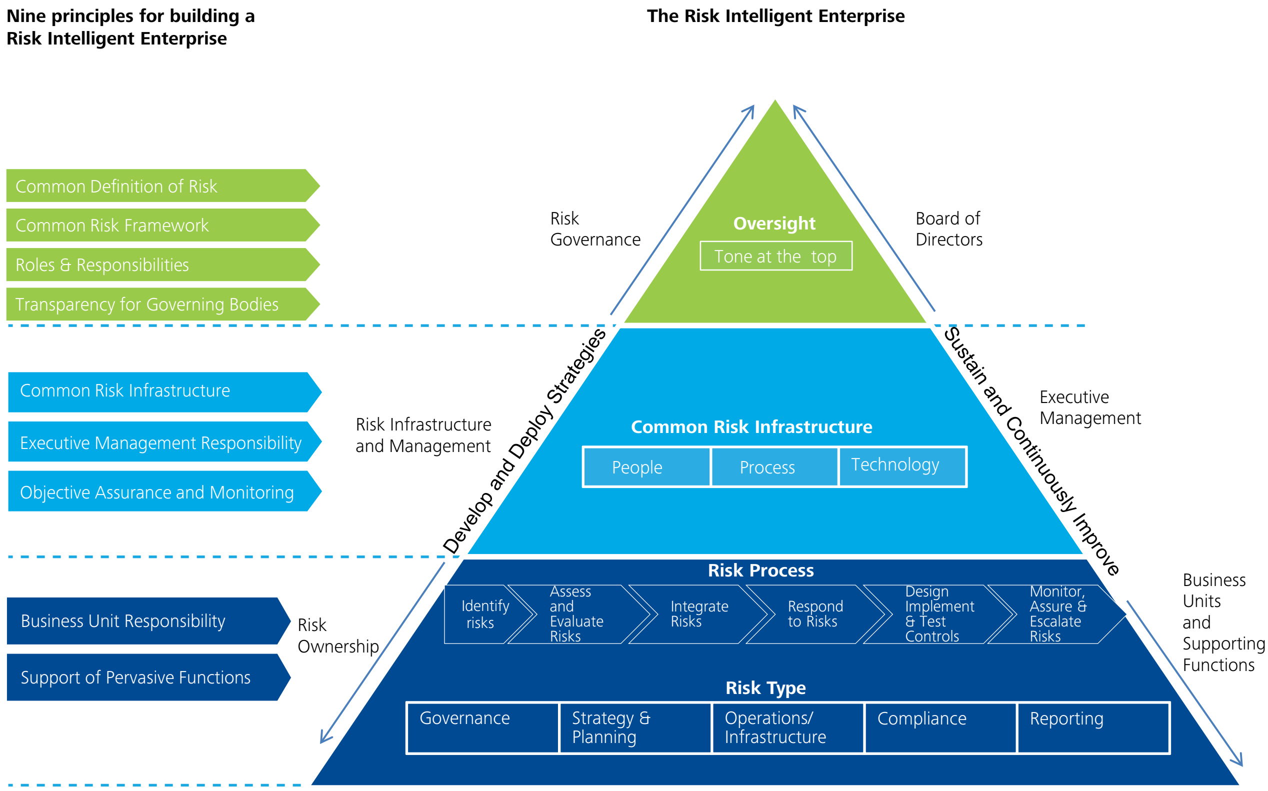
- Fifty businesses participating in a 2011 study on cybercrime experienced an average of more than one successful cyber attack per company per week – a 44 percent increase over the 2010 rate.
- A 2010 survey of data breaches in 28 countries found that more than 721.9 million data records were compromised over the five years ending December 31, 2009. This works out to the inadvertent exposure of 395,362 records every day.2
- In November 2011, a leading cybersecurity company reported detecting four times as many "targeted" cyber attacks as it detected just 11 months earlier, in January 2011

Risk Management
Striking a Delicate Balance

Risk management is emerging as one of the important organizational process and a key tool to aid decision making at all levels. Many large and listed companies have established risk management processes for regulatory compulsions as well as changing business landscape. Newer regulations such as the Companies Act 2013, Section134 (1) (n) have enlarged the ambit of risk management requirements by mandating the Boards of even private limited companies to establish risk management frameworks.

Deloitte's concept of the Risk Intelligent Enterprise integrates nine principles related to the responsibilities of the Board, senior management, and business unit leaders into a cohesive risk management framework. Risk governance is at the apex of the framework: the unifying touchstone and guide to all of the organization's risk management efforts.

The Nine Principles of building a Risk Intelligent Enterprise™



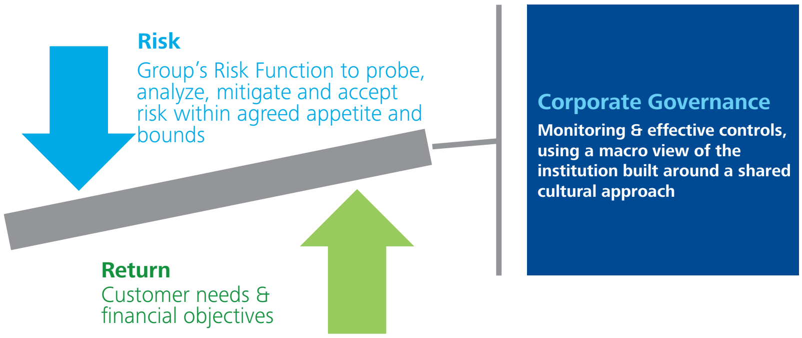
On a more detailed level, what does effective Risk Intelligent governance entail? Based on our experience working with Boards in their risk governance efforts, we have identified six distinct actions a Board can take to help enable a Risk Intelligent governance approach and thereby gain investor confidence:

1. Define the Board's risk oversight role
2. Foster a Risk Intelligent culture
3. Help management incorporate Risk Intelligence into strategy
4. Help define the risk appetite
5. Execute the Risk Intelligent governance process
6. Benchmark and evaluate the governance process.

How do we strike that delicate balance?

Company must focus on achieving growth and profitability within appropriate risk/control boundaries

Risk and Return - A Question of Balance



Deloitte Survey Relevant Highlights:

In a spring 2012, Deloitte and Forbes survey of 192 U.S. executives from companies in the consumer and industrial products, life sciences, health care, and technology/media/telecommunications industries, insights found that many are still working hard to make sense of this environment:

2012 Aftershock - Adjusting to the new world of risk management

- A vast majority of respondents (91%) said that their companies plan to reorganize and reprioritize their approaches to risk management in some form in the coming three years, with a majority (55%) saying that these changes will occur over the next 12 months
- The biggest group of respondents (26%) said that the primary responsibility for overall risk management belongs to the CEO and the second-largest group (23%) pointed to the chief financial officer (CFO)/treasurer as the executive responsible for risk management. Chief risk officer (CRO)/ head of risk came in third (19%).

Deloitte survey conducted to understand the state of risk management in the global financial services industry. The following findings are based upon the responses of 86 financial institutions from around the world, across multiple sectors, representing a total of more than US$18 trillion in combined assets:

2012 Global risk management survey, eighth edition - Setting a higher bar:

Most institutions have either fully or substantially implemented some of the basic steps in an operational risk management program by identifying risk types (81%) and gathering relevant data, such as key risk indicators and loss data (60 percent). However, no more than about half the institutions had taken other necessary steps: standardizing documentation of processes and controls, developing operational risk mitigation strategies.

The following extract is from the 26th quarterly The Deloitte CFO Survey 2013, Q4, which took place between 22nd November and 9th December, 122 CFOs participated including CFOs of 32 FTSE ('Financial Times and the London Stock Exchange') 100 and 41 FTSE 250 companies]:

The Deloitte CFO Survey 2013, Q4 - 2014 Outlook: Expansion, Investment and Hiring:

A record 57% of CFO says this is a good time to take risk and business optimism is running at the highest level in three-and-half years.

Conclusion

Regulatory requirements coupled with investor activism have raised standards for Corporate Governance in Indian companies. Boards of the organisations will need to go beyond compliance to derive greater value and trust. In doing so, they need to embrace the change and make their organisations ready by implementing effective and transparent processes that govern not only Management but also the Boards themselves. There are many aspects to improving Corporate Governance however, to lay a foundation of building long term investor confidence; Boards need to take steps in the areas discussed in the document.

- **Accurate Related Party Disclosures**, providing assurance to investors that the dealings with related parties are fair
- **An effective Board Evaluation**, assuring investors that Boards are taking conscious steps to improve their efficiency and oversight responsibilities
- **Advanced Internal Financial Controls**, demonstrating that adequate controls not only exist but operate effectively and thereby provide reliability on financial reporting
- **An Efficient Risk Management**, representing organisation's ability to spot future dangers and taking steer clear of them, assuring longevity to investors.

About CII

The Confederation of Indian Industry (CII) works to create and sustain an environment conducive to the development of India, partnering industry, Government, and civil society, through advisory and consultative processes.

CII is a non-government, not-for-profit, industry-led and industry-managed organization, playing a proactive role in India's development process. Founded in 1895, India's premier business association has over 7200 members, from the private as well as public sectors, including SMEs and MNCs, and an indirect membership of over 100,000 enterprises from around 242 national and regional sectoral industry bodies.

CII charts change by working closely with Government on policy issues, interfacing with thought leaders, and enhancing efficiency, competitiveness and business opportunities for industry through a range of specialized services and strategic global linkages. It also provides a platform for consensus-building and networking on key issues.

Extending its agenda beyond business, CII assists industry to identify and execute corporate citizenship programmes. Partnerships with civil society organizations carry forward corporate initiatives for integrated and inclusive development across diverse domains including affirmative action, healthcare, education, livelihood, diversity management, skill development, empowerment of women, and water, to name a few.

The CII theme of 'Accelerating Growth, Creating Employment' for 2014-15 aims to strengthen a growth process that meets the aspirations of today's India. During the year, CII will specially focus on economic growth, education, skill development, manufacturing, investments, ease of doing business, export competitiveness, legal and regulatory architecture, labour law reforms and entrepreneurship as growth enablers.

With 64 offices, including 9 Centres of Excellence, in India, and 7 overseas offices in Australia, China, Egypt, France, Singapore, UK, and USA, as well as institutional partnerships with 312 counterpart organizations in 106 countries, CII serves as a reference point for Indian industry and the international business community.

Confederation of Indian Industry
The Mantosh Sondhi Centre
23, Institutional Area, Lodi Road, New Delhi – 110 003 (India)
T: 91 11 45771000 / 24629994-7 • F: 91 11 24626149
E: info@cii.in • W: www.cii.in

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Reach us via our Membership Helpline: 00-91-11-435 46244 / 00-91-99104 46244
CII Helpline Toll free No: 1800-103-1244

The Deloitte Story

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