BoardMatters Forum
India

BoardMatters Quarterly

Insights for boards and audit committees

Volume 2 | July 2014

In this issue

This second edition of the BoardMatters Quarterly highlights how whistleblowing is acquiring significance as a propellar towards ensuring a strong corporate governance and ethics framework. With the Companies Act 2013 and SEBI's Clause 49 putting onus on the board of directors to review, approve and explain transactions to shareholders that come under the purview of related party transactions, and in some cases seek their approval, creates a need to examine how boards need to effectively address this aspect.This edition also examines how the boards of publicly listed and other prescribed class of companies can harness the power of diversity by meeting the requirement to mandatorily have a woman director on the board. Ms. Kalpana Morparia, a prominent business icon, who is on the boards of many leading organizations shares her perspective.

Vigil mechanism

The Act has put considerable responsibilities on Audit Committee members, independent directors and board members to deliver a robust vigil mechanism that ensures effective reporting of frauds. The article examines aspects that companies need to consider for assessing the impact of the new Act which can help them develop a clear strategy on compliance and governance.

04 **Related party transactions**

Transactions with related parties are of vital interest to majority and minority shareholders alike and it is important that the interests of shareholders as a whole are fully protected especially when control of the company or the board resides with a single party. The article discusses key essentials of the related party transactions in India.

05 **International update: FASB and IASB issue new revenue standard**

Recently, in the United States, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) to issue a long-awaited standard that will replace virtually all revenue recognition guidance in US GAAP and IFRS. An update.

06 **Women directors on board**

SEBI's clause 49 mandates all listed companies to appoint at least one woman director on their boards by 1 October 2014. The article covers gender diversity in boards and challenges in its implementation.

08 **"Boards' diversity drives an enriching dialogue"**

Ms. Kalpana Morparia is the Chief Executive Officer of J.P. Morgan India. She also serves as an independent director on the boards of several leading companies. In a candid conversation, Ms. Morparia highlights the aspects companies need to consider for complying with diversity on the boards, in actual form and content.

Building a better working world

Vigil mechanism

The backbone of a good corporate governance framework for India Inc.

The rapid evolution of industry norms and reforms in a landmark legislation such as the Companies Act 2013 has led to the emergence of a "new" corporate India. Currently, organizations are increasingly embracing global leading practices, thereby enhancing their capability to deal with change, churn or crisis at a rapid pace. The provisions under global laws such as FCPA and UK Bribery Act have intensified the seriousness with which risks related to fraud and unethical practices are managed. Sound governance has also steadily taken precedence as part of boardroom agendas of many CXOs. Recent notifications under the Companies Act 2013 (Section 177 (9)) has further spurred this trend and outlined that every listed company or such class or classes of companies, as may be prescribed, should establish a "vigil mechanism" for directors and employees to report "genuine concerns". Therefore, it is no surprise that the concept of 'whistleblowing' is witnessing significant prominence in India and becoming a key propeller in developing a strong corporate governance and ethical framework

Role of independent directors (IDs) and audit committee

The Companies Act 2013 has paved the way for organizations to create an enhanced control environment, ensure increased transparency and aim for improved standards of governance. The rules have significant ramifications for the entire ecosystem and its impact is expected to positively affect the organizational culture. In addition, senior management are also making significant efforts to trickle the message to grassroots, advocating compliance and subsequent enforcement. In line with this, the role and relevance of IDs and audit committee has become critical in driving the organization to amplify its benefits through a robust governance structure.

The Companies Act lists key responsibilities of IDs as - "ascertain and ensure" that the organization has an "adequate and functional" vigil mechanism; ensure that interests of a person who uses the mechanism are not prejudicially affected and to report concerns with respect to unethical behaviour, actual or suspected fraud or any breach of the company's code of conduct or ethics policy.

On the other hand, audit committees are required to oversee the operations of the vigil mechanism. Their responsibilities include intake or receipt of genuine concerns, review and subsequent investigation of concerns, evaluation of investigation results to suggesting appropriate action and reporting to the board/external authorities/regulators or even auditors.

Charting a course

A close scrutiny of the documentation and analysis of interviews may be sufficient to broadly check the efficacy of the mechanism in place. However, to determine whether it is "adequate and functional", IDs will need to closely examine any concerns received by the audit committee, what investigations have been initiated, corrective action taken and reporting if any. This may also require a review of adequate and auditable documentation of all concerns received, minutes of deliberations, investigation working papers and so on for all cases reported.

It may be practically difficult for the audit committee or even a director who may have been nominated to oversee the role of the above mentioned activities. Hence, companies and boards will need to formulate a charter of responsibilities of the audit committee/nominated director for overseeing the operations. The charter will have to include a clear mandate for the audit committee, delegation of responsibilities for handling the above mentioned activities to the senior management (normally a cross functional committee of senior leadership and sub-committees there under). It also involves the institutionalization of a Fraud Response Plan, listing procedures to be adopted on receipt of concern, guidance for categorisation or prioritisation of concerns, investigation, documentation standards and other relevant matters. This charter will have to be approved by the board, and its compliance vetted by various stakeholders and regularly monitored by the audit committee/nominated director.

The roadmap ahead

The 2014 Global Fraud study by ACFE *Report to the Nations on occupational fraud and abuse* has aptly captured the direct impact of a sound vigil mechanism in mitigating fraud risks. It states that organizations with hotlines were much more likely to catch fraud by a tip, which their data highlights to be the most effective way to detect fraud. The organizations who experienced fraud were 41% less costly and they detected it 50% more quickly. Investigations also increased when organisations had a hotline in place. This trend is expected to continue as organizations take significant strides in protecting their reputation, minimising losses and abiding by global laws and policies. The role of the IDs, audit committee and board cannot be undermined in the road to compliance, and they will take centre stage as custodians of corporate integrity.

01

Case Study 1

An employee found it peculiar that one of his colleagues called him regularly at a certain hour in the day. The conversation always included references to specific products of the company and also to competing firms. Being overly cautious, he reported this through the hotline of the company and chose to identify himself. When questioned, he offered details. A preliminary investigation revealed that the company had lost substantial business to competition for those specific products that were referred in the conversations of the suspect. The suspect had commercial and pricing information on these products.

A further in-depth investigation revealed that the suspect had passed on pricing information to competition, which the latter misused to win tenders against the organization. The suspect had shared information by forwarding it from his official to his personal email id.

The incident would have caused more losses to the company, if not highlighted by the cautious employee. This also resulted in the organisation introducing an email policy and instituting checks wherein emails forwarded to personal email ids were monitored and scanned, if required.

Take-aways for various stakeholders:

Independent directors	Audit committee	Board of directors	Auditors
What does the law require?			
• "Ascertain and ensure" that the organization has an "adequate and functional" vigil mechanism • Ensure the interests of any persons using the mechanism are not prejudicially affected • Report concerns with respect to unethical behaviour/actual or suspected fraud/ breach of code of conduct or ethics policy	• Oversee the operations of the vigil mechanism	• Ensure the establishment of a vigil mechanism • Details displayed on the website and in their report	• Report any matter to the board/audit committee and subsequently to the central government, if they have sufficient reason to believe that an offence involving fraud has been or is being committed against the company by employees or directors.
What do they need to do?			
• Spend time in reviewing the adequacy of the mechanism, documentation evidencing the functioning of the mechanism (complaints received, action taken, disposition) • Conduct interviews of relevant stakeholders (maybe cause to conduct surveys to ascertain effectiveness of the mechanism) • Review the risk management process, internal financial controls, internal/special/statutory audit reports • Ask questions to the management of various decisions taken	• Ensure that the management institutes an adequate and a functional vigil mechanism • Review and approve the delegation charter and fraud response plan • Review the functioning of the cross functional committee that is delegated the responsibility of operating the mechanism • Take appropriate action, including hiring external experts, for investigations • Report cases to the board, auditors, regulators, if required	• Ensure that the management institutes an adequate and a functional vigil mechanism • Review and approve the delegation charter and fraud response plan • Ensure adherence to all the requirements of the Companies Act 2013	• Extend their review to include an evaluation of the genuine concerns received through the vigil mechanism of the company to identify any instances of fraud

Related party transactions

02

Related party transactions (RPTs) that treat shareholders inequitably or oppress minority, tend to damage the integrity of the capital market. Therefore, RPT's covering both equity and non-equity transactions, is an important corporate governance and regulatory issue, dogging the mind of the government. Every jurisdiction has, over a period of time, developed its own mechanism to minimize the abuse of RPT's, though there is wide variability in their respective approach.

India is characterized by concentrated ownership and by the widespread use of company groups, often in the form of pyramids in many different activities and companies and with a number of levels. One study of the 1470 NSE companies indicated that as of March 2010 promoters held 57% of all shares and institutional shareholders about 20% (Bhardwaj, 2011). Therefore, the possibility of abuse of minority is increased manifold.

The principle wherein minority shareholders approve a RPT that is not in the ordinary course or at arm's length is a very good principle. Take an example of a technology company buying a real estate company. This apparently does not appear to be in the ordinary course, and may be abusive. Hence minority shareholders should be provided with the power to veto. However, this power should be granted by exception rather than as a rule; else there would be chaos, and companies will find it difficult to function.

Both the Companies Act, 2013 and clause 49 deals with this issue, but have very divergent requirements. The definition of related parties contained in the Companies Act and clause 49 require substantial modification. For example, under the Companies Act, there is no concept of reciprocity. Therefore, for an investor an associate is a related party but not vice-versa. If a company's director is a director in a public company and along with his relatives holds 2% shares, that public company becomes a related party. On the other hand, if the director of the company was not a director in the public company, but his wife owned 100% of that public company, that public company will not be counted as a related party!

According to Clause 49, the definition of related party, which is based on IFRS, is more robust. However, under IFRS that definition is used for disclosure purposes. Therefore, a provident fund trust of a company will be a related party of that company. The consequence of bringing in a related party definition meant for disclosure purposes into Clause 49, which is meant for disclosure and approval by shareholders is that contribution to provident fund beyond a threshold will need minority shareholder approval! Therefore, the IFRS definition will need some bit of tweaking for Clause 49 purposes. Furthermore, under both the Act and Clause 49, the definition of relative goes beyond financial dependents and hence, compliance will become impractical.

Whereas the Companies Act requires all RPT's to be approved by the audit committee, Clause 49 requires prior approval. While challenges of a prior approval can be dealt with through master service agreements and circular resolutions, the moot question is should audit committees be approving RPT's. By requiring independent directors to approve RPT's, they will be essentially stepping in the shoes of the management and will no longer remain independent.

Under SEBI regulations there is no exception created for minority shareholder approval based on arm's length/ordinary course. However, the materiality limits are high. On the other hand, under the Companies Act, there is an arm's length/ordinary course exception, but the materiality limits are very low. One of the materiality limits under Companies Act is paid up share capital of Rs 10 crores. Firstly, in the context of RPT, materiality limit should be based on transaction value rather than share capital. In addition, by setting a materiality limit on paid up share capital of Rs 10 crores, many immaterial RPT's will get covered.

In many jurisdictions, where minority shareholders are required to approve a RPT, the requirement is for a simple majority of minority. Under Companies Act and Clause 49, a special resolution of minority shareholders is required. This may be seen as a very stringent requirement.

While the MCA has taken certain steps to resolve some of the challenges in section 188 of the Companies Act, what is required is a re-writing of the requirements and complete consistency between clause 49 and Companies Act, 2013. That is the best way forward.

Things that audit committee should consider

- Has the audit committee agreed with management on an overall framework with respect to identifying related parties and transactions with these parties and the approval mechanism?
- In providing its prior approval to a related party transaction, has the audit committee agreed with management the level of documentation and evidence required to substantiate 'arms length' price and 'ordinary course of business'?
- In supporting the 'arms length' price has the audit committee agreed with management the level of involvement of external advisors?
- In case of unanticipated non-routine transaction, which are urgent, has the audit committee considered the possibility of prior approval through circular resolution?

FASB and IASB issue new revenue standard

03

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) recently issued a long-awaited standard that will replace virtually all revenue recognition guidance in US GAAP and IFRS. Therefore, now is the time to begin planning for a smooth transition to the new model.

The new standard will supersede nearly all industry-specific and transaction-specific standards and interpretive guidance. Most companies will be affected in some way or the other. The new standard is effective for calendar year-end public entities for the first time in the first quarter of 2017, but companies may need to start tracking revenue under the new standard as early as 2015.

Companies should begin preparing now because the standard will likely affect their financial statements, business processes and personnel, and internal control over financial reporting. While some companies will be able to implement the new standard with minimal effort, others may find implementation to be a significant undertaking.

Companies with more work will need to move rapidly and may need to consider adding resources. An early assessment is key to managing implementation. Companies should begin taking a measured and thoughtful approach in preparing for adoption now because this may help to keep costs down and ensure a successful implementation.

Overview of the new standard

The standard's core principle is that a company will recognize revenue when it transfers goods or services to customers at an amount that reflects the consideration to which the company expects to be entitled to in exchange for those goods or services.

In doing so, companies will need to make more estimates and use more judgment than under the US GAAP currently. These judgments may include identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation.

With more than two years until the effective date, it may appear that companies have ample time to prepare. However, the potential changes to revenue recognition and related policies, procedures and business practices for some companies may be significant, and therefore, it is important for companies to get started immediately. Here's what boards need to be aware of as companies begin to implement the standard.

Transition method and disclosures

The new standard allows for either "full retrospective" adoption, meaning the standard is applied to all the periods presented, or "modified retrospective" adoption, under which the standard is applied only to the most current period presented in financial statements.

A decision about which method to use will affect a company's implementation plans. Once they choose a transition method, public business entities will need to disclose it in registration statements and reports they file with the SEC. In addition, SEC Staff Accounting Bulletin (SAB) Topic 11.M requires companies to disclose in management's discussion and analysis (MD&A) and the financial statements the potential effects of recently issued accounting standards, to the extent those effects are known. Calendar year-end public business entities will have to provide these disclosures for the quarter ending 30 June 2014.

The new standard also requires significantly more interim and annual disclosures. Companies should carefully consider whether they have the information needed to satisfy new requirements or whether new processes and controls must be implemented to gather the information and ensure its accuracy.

Implementation considerations

The new standard will likely affect the measurement, recognition and disclosure of revenue, frequently an entity's most important financial performance indicator, for all entities.

(An excerpt from BoardMatters Quarterly, US Edition, June 2014)

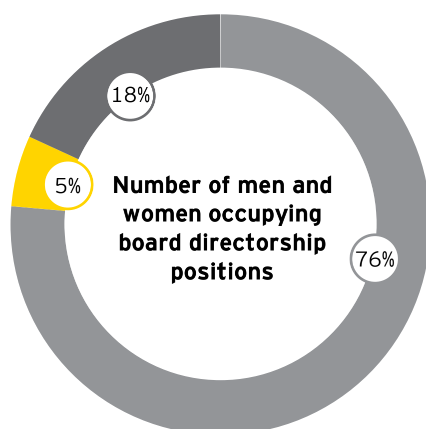
Questions for the Board to consider

- Has the company developed an implementation plan?
- How many different revenue streams does the company have?
- Which performance metrics will be affected?
- What other metrics are tied to revenue? Is your company considering changing compensation packages or other areas of your business that are tied to revenue?

Women Directors on Boards

SEBI's Clause 49 had set a task to all listed companies - to get at least one woman director on their boards by October 2014. Moreover, according to the new Companies Act 2013, companies with paid-up share capital of more than 100 crore and with a turnover of above 300 crore must appoint at least one woman director.

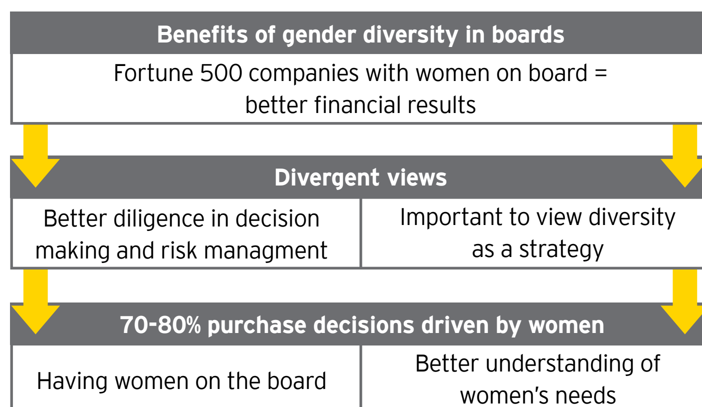
With less than 3 months to go, listed companies are far from reaching this target. According to indianboards.com, a joint initiative of Prime Database and NSE, roughly two-thirds of Indian companies (approx. 900 out of the 1,456 NSE-listed entities) do not have a woman director. Furthermore according to Forbes, there are approx. 9,000 persons occupying a total of 11,596 directorships in NSE-listed companies. However, of these, only approx. 600 positions are held by women, a mere 5%. Between February and June 2014, 78 women have taken up 84 board positions in various listed companies.



Women - 600
Men - 8400
Unoccupied - 1996

Benefits of gender diversity in boards

According to a 2007 Catalyst report, Fortune 500 companies with more women on their boards turned in better financial results than those with fewer women directors. Research also indicates that divergent views encourage increased diligence in decision making and risk management and hence diversity needs to be viewed as strategy. Also, since around 70-80% of purchase decisions are driven by women, it makes business sense to have women on the boards as they are more likely to understand women's needs than men.



Challenges in implementation

Although countries world over are very actively spearheading the cause of bringing gender diversity in boards, the percentages have increased only marginally in the last decade. The Catalyst Census 2013 reported that 16.9% of boards were constituted by women globally, a percentage that has been stagnating for the last three years. In spite of government mandates and regulations in India and abroad, introducing diversity in corporate boards appears to be challenging due to many reasons:

- Although the participation of women in the labour force has increased over the years, the percentage of women in top positions is still very low. This means that it will be difficult for companies to find women with the right qualifications to occupy their boards.
- Neither the Companies Act, 2013, nor the SEBI guidelines specify that women directors should occupy independent directorship positions. This could make companies achieve compliance by appointing women from among families or friends of promoters.
- Even if companies appoint one woman director on their boards, it does not ensure inclusion. Research indicates that at least 3 women directors are required to make boards effective. In such companies, return on equity was 16.7% as compared to the average of 11.5%; return on sales was 16.8%, as compared to the average of 11.5%; and return on invested capital was 10.9% as compared to an average of 6.2%.

04

Challenges of appointing women directors

Finding the right candidate	‣ Percentage of women in top positions still low ‣ Difficulties in finding women with the right qualifications
Ensuring proper compliance	‣ Lack of clarity on the occupation of independent director positions by women ‣ Compliance can be achieved through appointment of women among families or friends
More than one woman director	‣ Atleast 3 women should be on the board to ensure board's efficiency ‣ Such companies have better ROE, return on sales and return on capital invested.

Efforts across the globe

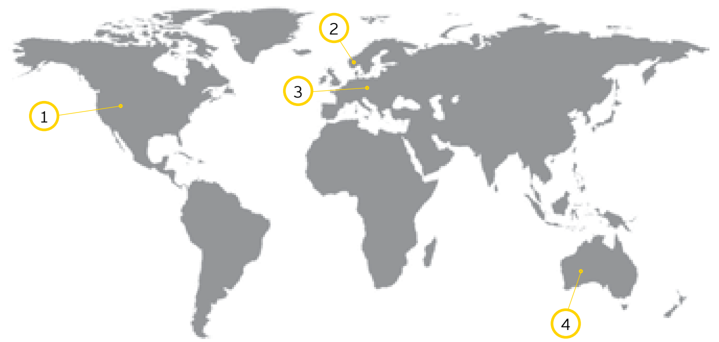
The last decade has seen significant activity in most companies to increase gender diversity in corporate boards. Countries have adopted many ways to go about this - from legislative implementation of quotas to regulatory agency reporting requirements.

In 2003, the Norwegian Parliament passed a law requiring publicly listed companies to fill at least 40% of seats with women by 2008. The country achieved the target, by 2009. More than 1,000 women in Norway now have board experience, and although the number of female chief executives is still low, it has increased since 2008.

Some European countries, including Spain and France, have introduced mandatory quotas for female representation on boards. The European Commission recently adopted a law which aims to attain a 40% objective of women in non-executive board member positions in large publicly listed companies by 2020.

In Australia, the ASX Corporate Governance Council had introduced recommendations for listed entities to set measurable objectives for, and report on, gender diversity.

In the US, there have been no quotas to increase gender diversity in boards, but instead, some institutional investors are pushing for a market-based solution through engagement and shareholder proposals seeking enhanced gender and ethnic diversity on boards. While the number of these proposals reaching proxy ballots is low, or less than five per year since 2005, shareholder support is relatively strong.



1

- No quotas to increase gender diversity.
- Institutional investors seeking gender and ethnic diversity through engagement and making shareholder proposals.

2

- Norwegian Parliament passed a law in 2003 to fill at least 40% of seats by women in publicly listed companies by 2008.
- More than 1,000 women in Norway today have board experience.

3

- Mandatory quota for female board representation in Spain and France.
- European Commission adopted a law to attain 40% representation of women in non-executive board positions by 2020.

4

- ASX Corporate Governance Council introduced recommendations to set measurable objectives for, and report on, gender diversity

Way forward: diversity to inclusion

While there have been significant developments across the globe, a considerable amount needs to be done to have inclusive corporate boards. These efforts should happen at 3 levels - country, corporate and individual. At the country level, efforts such as the new Companies Act need to continue with further emphasis on performance evaluation of boards and qualifications of directors. Meanwhile, organizations need to consciously advance women at all levels. At the individual level, women need to be aware of and create opportunities for themselves.

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Board readiness workshops for women

- **New Delhi Thursday 28 August 2014**
- **Mumbai Thursday 25 September 2014**

You can nominate a woman director who has recently joined a board or is likely to be inducted on the board shortly. Self-nominations from suitable candidates may also be considered.

To make a nomination, contact
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“Boards’ diversity drives an enriching dialogue”

In conversation with Kalpana Morparia

Ms. Kalpana Morparia is the Chief Executive Officer of J.P. Morgan, India. Prior to joining J.P. Morgan India, she served as Vice Chair on the Board of the ICICI Group. Ms. Morparia serves as an independent director on the boards of several leading companies.

In a conversation with us, Ms. Morparia shares her experience of being a woman on the board of leading organisations and why beyond just a gender specific aspect, how one complies with diversity in actual form and content is what will truly help deliver it on the boards in an impactful manner.

In your view, what makes for a high performance Board?

Kalpana Moparia (KM): Boards need to represent different skill sets and ensuring diversity on the board is one key aspect that can deliver such diverse skills. I tend to define diversity much more broadly – which isn’t limited to just gender or nationality, but all-encompassing and also takes into consideration different academic backgrounds. Diversity therefore is essential to a high performance Board.

Another important element is the Board’s relationship with the senior management. The senior management’s perspective on how it intends to benefit from the value that the Board can deliver is really important. There are some management teams that might believe that inducting well-known names is sufficient to create a Board as it helps them meet a statutory requirement. In such a case, the management considers itself adept at running a company. On the other hand, there is another set of management that does not view Board members as facilitators but instead challenges them on strategy and execution. In the latter case, not only do the management teams get the statutory cover of the Board but are also able to tap into the intellectual capital of the people around the table, with a focus on delivering sustainable business value.

What are some of the challenges that you might have faced from being a woman on a Board and how did you overcome them?

KM: I have never faced a challenge because of being a woman in my entire professional career. I’ve clocked many decades in my professional career but not once have I ever felt that I was at a disadvantage because of my gender.

Would it bother you if someone approached you for a Board role just because you were a woman?

KM: Yes I think I would be a little disappointed if being a woman were to be the only reason for my being approached for a Board role. I would probably evaluate the company closely to determine if I would like to be on that Board or not.

05

Also, I would not be as excited about it as I would have been when there was no mandatory requirement to appoint a woman on the Board since I believe that at that time they would've approached me because of my ability to complement the other skill sets they already had on the board rather than now.

Do you feel that you have brought a very different perspective to the Board?

KM: I would say yes, but I don't know whether it's a completely unique thing. I am sure professionals from different industries bring different skill sets to the table, such as someone with retail and marketing experience will always have a very different way of looking at some parts of the business when compared to a finance professional on the Board, and so on and so forth.

Being a finance professional myself, I believe my perspective on a given situation may be different or unique in its own way. However I don't know how much of it can be attributed to my being a woman and how much it is to do with my job experience.

Please share a perspective of how your being on the Board has contributed to it?

KM: I believe the role that I play on each Board is very different. For instance, the experience of being on the board of an unlisted company will be vastly different to that of being on the board of a listed company. The engagement differs from board to board -- while on some boards the focus is on ensuring good board procedures, for others, the focus is more pronounced on the financial performance.

Do you think being a woman on a Board tends to define the nature and quality of the debate that takes place?

KM: I certainly believe so. I think the diversity you have on the board makes for a far more enriching dialogue and discussion.

Do you think there are any qualities that women can particularly bring to the board?

KM: I think women, in general, are better at multi-tasking. Their focus also tends to include softer issues much more, such as culture aspects, HR organisation, people and talent development. Sensitivity to these nuances is increasingly important.

If you could change one thing that could help improve board performance, what would that be?

I would say that companies should hire professional third party consultants to identify potential candidates. If one were to rely only on the word of mouth, it would tend to restrict the slate of people. That would mean consciously excluding many deserving people who need to be considered.

Have you ever seen any boards that have taken action on any of their own initiatives to create diversity?

Yes, I believe some boards most definitely do that. My being selected on the board of Philip Morris International is a case in point, as it was not through word of mouth that I was considered for a position on the board. It was definitely a conscious move to seek diversity on the board.

In terms of the Board Chair, what role do you think they play in ensuring more diversity?

I believe not just the Board Chair, but the Nominations and the Governance Committee Chair who are tasked at the first level with identifying a slate of directors as also all the members of the board are just as critical to ensuring diversity.

I believe gender alone as a criterion will not help drive diversity or deliver a dramatic change. But much more important is how one complies with diversity in actual form and content, as that is what will truly help deliver diversity in an impactful manner.

Disclaimer: Views expressed in the interview are personal

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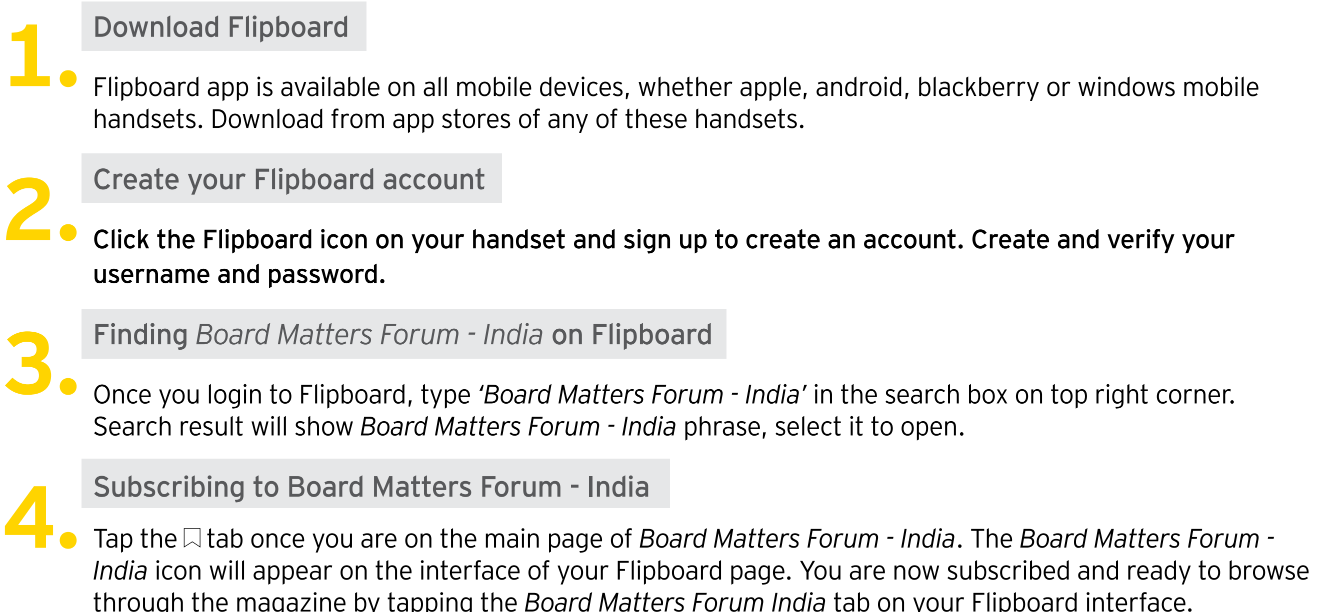

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