

Concerns around corporate governance

What is the issue?

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The growing concerns around corporate governance call for greater examination of the role of directors and audit firms.

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What are the related incidents?

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- Recently MD & CEO of ICICI Bank Chanda Kochhar requests for an early retirement from the leadership of India's second largest private bank.

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- It was on the backdrop of the allegations went against her including not disclosing conflict of interest caused by certain transactions between certain borrowers of the bank (Videocon group) and entities controlled by her spouse.

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- Propriety demanded that she disclosed the conflict of interest to the board and recused herself from the loan committee at the outset.

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- But by not stepping down when the controversy broke out even after an independent committee headed by BN Srikrishna was formed to probe the matter, she only stoked concerns over corporate governance standards at the bank.

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- In the [IL&FS case](#), the auditor has drawn attention to the fact that a subsidiary of IL&FS has incurred large losses which could impact the continuance of the subsidiary as a going concern.

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- However, the audit report does not either name the subsidiary or the even the extent of losses.

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What are the concerns?

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 - The ICICI Bank episode, along with the turmoil at private sector banks such as YES Bank and Axis Bank shows bank boards in poor light.
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 - Ever since the bad loan crisis unfolded, it has been PSBs that have been accused of crony capitalism and weak governance.
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 - But as has been evident over the past one to two years, the books of many private sector banks too have been overstated.
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 - For ICICI Bank, its profits have shrunk by a third over the past five years, while for Axis Bank, its earnings are less than a tenth of what they were five years ago.
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 - Bad loans for these banks have grown 5-10 fold in the past five years.
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 - Also, audit reports in India are structured with a lot of disclaimers and worded so cautiously.
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 - This makes it difficult for shareholders to form an opinion whether the financial statements present the actual picture of the company.
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 - In the IL&FS case, the auditors may claim that the issue was a case of cash flow mismanagement, which is not a part of their scope of audit.
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 - Critics of the auditors reject this by stating that the concept of true and fair and going concern would include basic concepts such as cash flow mismanagement.
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 - This leads to the question whether the auditors are getting too cosy with the management, which leads to the issue of whether too few auditors are doing too many audits.
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 - In most markets including India, the Big 4 auditing firms dominate the cream of audits.
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 - The system of rotation of auditors introduced by the Companies Act, 2013 has not helped smaller firms because most of the audits rotated within the Big 4 accounting firms.
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 - Since most of these firms have similar cultures, swapping the firms doing the

audit may not bring fresh perspectives to audits since the individuals invariably rotate within the Big 4.

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- The growing concerns around corporate governance at banks in particular and systemically important financial entities like IL&FS in general, call for greater examination of the role of directors and audit firms.

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What are the related proposals by the Uday Kotak committee?

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- SEBI has already accepted about 40 of the 80 recommendations, set out in the Uday Kotak Committee on corporate governance and some of them includes -

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- **Separation of roles** - Listed firms with more than 40% public shareholding should have separate roles of chairperson and MD/CEO and chairmanship should be limited to only non-executive directors.

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- Also, no person who is a part of the promoter group can be appointed as an Independent Director.

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- Also, a listed entity has to mandatorily disclose consolidated quarterly results with effect from Financial Year 2019-2020.

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- **Augmenting board strength and diversity**- The top 1000 listed entities (by market capitalization), and the top 2000 listed entities, have to mandatorily have a minimum of six directors on their boards.

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- The top 500 listed entities (by market capitalization) and the top 1000 listed entities have to have a minimum of one-woman independent director.

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- **Number of Directorships**-No person will be allowed to hold the office of director in more than eight listed entities at the same time (of which independent directorships are capped at seven).

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- However, implementation of these provisions in spirit and not merely in letter is the key.

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What lies ahead?

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 - One possible solution could be to ask auditors specific questions such as possibility of fraud, ability to repay loans, robustness of internal controls and corporate governance processes.
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 - Their responses should be either Yes or No or rated on a scale of 1 to 10.
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 - In turn, the audit firms should be rated based on how their ratings panned out.
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 - If companies are given the freedom to choose their auditors, they would naturally choose ones with the best ratings, irrespective of whether they are a part of the Big 4 or the Smallest 40.
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 - An audit should provide value-added information to the shareholder instead of telling him that everything is fine till someone other than the auditor discovers otherwise.
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 - If this is combined with a truly independent audit committee, corporate shocks such as IL&FS can be handled much more professionally.
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 - Also, the banking system's crisis of the missing talents for critical positions, needs to be addressed, not just at PSU banks but private sector lenders as well.
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 - The ICICI Bank episode shows that a much longer tenure of officials at private sector banks could be damaging.
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 - Re-examining the manner in which these critical positions are filled is essential to prevent a repeat of ICICI Bank-like episodes.

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Source: Business Line

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