Economics of Corporate Survival and Theory of Governance Gap vis-à-vis the Companies (Amendment) Act, 2017

Survival is the most dreaded term in the corporate world. Company boards discuss growth strategies but do not discuss survival; it is assumed. The focus remains on policy and strategy formation leaving implementation to the top management. Governance concentrates on strategic decision making defining core aspects – values, mission and vision. It is the “framework of accountability to users, stakeholders and the wider community, within which organisations take decisions, and lead and control their functions, to achieve their objectives”. Management, on the other hand, is believed to be concerned about working within the confines of strategies and policies. “The Board is responsible for the governance of the company but the Board does not look after the day-to-day management of the company. The Board of Directors meets periodically and makes policy decisions setting out the goals of the company. Achieving these goals effectively is the function of the management. The management function is left to the key officers of the company. In the business world, these key officers are commonly referred to as the top management. The top management shoulders the responsibility of all the functions of the company, be it administration, marketing, operation, finance, secretarial, human resources etc.” Corporate governance norms across the world support this practice. The scholarship available on the governance and management role restricts itself to this concept.

The Companies (Amendment) Act, 2017 has further liberalized the provisions making doing business easier reposing faith in democratic corporate set ups. The present article, while propounding a new ‘Theory of Governance Gap’ defining governance gap, indicating the stages involved and its components, examines how it affects the governance gap. The corporate survival depends on recognizing, identifying, considering and correcting the governance gap. The components of governance gap have been described with examples from real corporate world. The ultimate aim should be to bridge the gap to ensure best performance.

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1 United Kingdom Audit Commission, October 2003, Corporate Governance: Improvement and Trust in Local Public Services, p. 4.
2 Chapter 12 – Key Managerial Personnel, Corporate Directors – Roles, Responsibilities, Powers and Duties of Directors by Ashish Makhija, published by Lexis Nexis India.
GOVERNANCE GAP

Indisputably, there is separation between governance and management though “the boundary between governance and management is not hard and fast”. Corporate culture and structure determines the dividing line. It settles on its own over a period of time as an accepted norm. Typically, for effective corporate governance, the board functions include policy management, risk analysis, encouraging disclosure and transparency, oversight of management functions, protecting stakeholder’s interests and strategic guidance. Illustratively management functions include implementation of policies and plans, administrative control, compliances, communication and performance. In a way, Ordinarily, management functions start where governance ends with presumptions of no overlapping. In reality, however, there exists a gap between governance and management in every corporate entity, let’s term it as governance gap though the extent may differ. No one has ever realized that defining and assigning governance and management functions this way results in governance gap.

IDENTIFYING MISSING PIECES

The missing link between the governance and management belongs to governance gap. Smart governance may not result in smart management but it will definitely create an atmosphere of management accountability. The converse may not be true at all. On paper, the dividing line between governance and management looks judicious; no one trips over the other with the existence of recognised separation. The principle of separation has been articulated so well over the years that it now resides in the sub-conscious mind of every governance and managerial personnel. The scholarship on corporate governance elaborately deals with the subject to ensure that governance functionaries know their boundaries and the management personnel are aware that their functions start where governance ends. With this assertion over the years, governance leaders have realised that their role is restricted to strategic decision making in board or committee meetings presuming that the policies framed by them will be implemented by management functionaries. This approach is enthroned in corporate governance norms across the countries. The weakness of this approach is that it fails to recognise the existence of governance gap. The governance and management are not separated by a line but there exists a gap – governance gap.

STAGES OF GOVERNANCE GAP

Governance gap differs from one entity to another. Not only the size of governance gap may vary but also the elements constituting it. Ignoring governance gap may lead to disaster; understanding governance gap will reduce chances of its occurrence. The governance gap has four step routines called as governance gap stages. The corporates have to shift their focus on governance gap and they must deploy their resources to trace the gap through the stages.

STAGE 1 – RECOGNITION

The corporates have to recognize the governance gap. Recognising involves understanding the factors that contribute to governance gap. This understanding is possible with open discussion between those who govern and those who manage. Governance leaders have to take the lead and ensure that the management team gets a fair chance to state their views. Balanced discussion is the key. Expert involvement in the discussion should be encouraged. Recognising the existence of governance gap is the most difficult step as it calls for free and frank dialogue between the two sets of leaders. Board members should take care not to dominate the discussion.

STAGE 2 – IDENTIFICATION

Having recognized the existence of gap, the next step calls for identification of the missing pieces. It emerges out of the analysis of the discussion. The process of identification calls for impartial study of discussion points gathered during recognition stage. Firstly, on macro basis, broad categories of governance gap should be identified. Thereafter, micro level identification of the factors is required to be carried out.

STAGE 3 – CONSIDERATION

Having identified the categories of governance gap broadly, the next stage involves analysing the causes of governance gap. What has triggered the governance gap is the question that needs to be answered in this stage? It is the reflection on cause and effect relationship. The analytical study of reasons behind the governance gap are bound to provide a useful insight. The evaluation of the causes should also be an independent exercise having unbiased view of the situation. Preferably, it
should be carried out by an outside expert.

STAGE 4 – CORRECTION
Correction involves joining the dots. Corrective measures will help in bridging the governance gap. The smaller is the governance gap, the higher will be the efficiency, performance and growth. Corrective steps mean paying special attention to the causes and finding out the specific solution. It may not be possible to remove altogether the causes but an attempt should be made to reduce the gap over a period of time. Correction also includes watching the impact of corrective measures.

GOVERNANCE GAP COMPONENTS
Unique in its design, the stages will reveal causes of governance gap. The task of identifying the factors will be followed by categorization of these factors into components of governance gap. The reasons will be unique to each company. Much would depend on existing governance and management structure of the company. Broad categorization is necessary to understand the root of the problem. Once this exercise is over, micro level identification is necessary being an essential element to bridge the gap.

First Component - Perception Gap
Intuitive understanding and insight creates a veil of perception. The greater degree of difference of opinion between governance leadership and top management is the root cause of perception gap. The documents containing vision, mission and objectives of a corporate are ornamental pieces with elaborate use of elegant phrases which turn out to be confusing at the best. The top management’s perception of goals must be in sync with the governance leaders. The board of directors in their role of governance may envision company goals in a different perspective than the management leaders. Opinions may differ but understanding of the strategy calls for perfection. A Company, for example, in its manifesto, may have the mission to keep its ‘Customers First’. While it sounds good from governance perspective, the management team must know its elements to achieve it. Whatever the management does, they must keep this goal in view. The governance leadership must realise that they cannot remain detached but must ensure that their mission of keeping customers happy is implemented by carrying out with random scrutiny of execution steps. The perception gap is the most difficult to decode. This calls for constant discussion and understanding of the perception of each set of leaders.

Second Component - Communication Gap
The governance leaders usually come only for board or committee meetings with little interaction between two sets of corporate leadership. It results in non-meeting of minds with ever widening gap of communication. Board members rightly perceive themselves as non-interfering in the day-to-day functioning of the company, yet this does not mean that there should be a communication break between the two sets. The communication between the board members usually happens only when the board or committee meetings are organised. Communication link breaks no sooner the board or committee meeting is over. Consistent and effective communication will keep governance leaders abreast of company’s functioning on a continuous basis. Regular communication also helps in changing the perception. In India, for example, a board meeting of a company can be held at a maximum gap of 120 days. Ordinarily, the time of communication between the board and management starts with sending out board meeting notice and agenda and ends with minutes being circulated. There remains no communication in between the board meetings. ‘No communication’ for over three months is a sure recipe for disaster.

Third Component - Strategy Gap
The corporate strategy flows from the top. The goals are defined once the strategy is known. Strategical policies should be concrete, realistic and implementable. Understanding the intent behind the strategy is the key. Strategy gap will breed disastrous results more often than not, strategy documents contain objects ignoring practical considerations. Governance and management leaders must understand each other’s view point. Policy implementation is dependent on and follows strategic management. For example, a company with five subsidiaries may decide, as part of strategy, to merge all subsidiaries with the parent company to reap tax benefit. But implementation may pose difficulties as each company may have different management style and culture. While finalising strategy, the governance leaders ought to consider the anticipated problems in implementation rather than merely looking at tax angle. The strategy gap can be understood to be the gap between ‘framing’ and ‘implementation’ of the strategy. Policy framework should be flexible recognising the real-world difficulties. Management leaders have a dominant role to play in the strategy gap. Lucid explanation of the complications involved in accomplishing the goals may become necessary for the governance heads to understand. The extent and severity of the problem is to be understood by the board members in the way the management team perceives it. Of all the components, strategy gap remains the most prominent.

Fourth Component - Performance Gap
Unarguably, management is responsible for operations and performance. The governance team, drawn from diverse vocation, has limited awareness how the business is run. They are experts in their own domain but not necessarily in the business of the company. Imperfect knowledge of corporate functioning leads to uncertainty. The governance theories, thus far, propagate ‘non-interference’ of governance leaders into management domain. The corporate governance regulations across the world are based on the doctrine of non-interference. Advancing this opinion for over a quarter century now, it has turned into conviction and a mandatory principle. The oversight of performance functions calls for thorough business understanding. Questioning operational style does not necessarily mean interference. Contrarily, the management style will undergo improvement, if judged by the governance leaders. For example, mere appointment of a professional CEO does not absolve the governance leaders
with their oversight responsibility. Let the governance leaders understand the specific action planned by CEO for achieving the goals. Performance would improve if the board members understand the modus operandi adopted by the management in achieving the company’s goals. The board members have to shed their inhibition of extremely publicised norm of ‘non-interference’. Governance styles are not iron cast. Breaking free from dogmatic principles is the key to achieve higher trajectory growth. The governance leaders must, however, respect the independence of the management team. Governance does not involve monitoring on daily basis. Performance gap can be closed with effective understanding of the management approach.

**Fifth Component - Compliance Gap**

Compliance failure is the greatest indicators of corporate failure. Management team is primarily responsible for compliances but under the governance regulations those responsible for governance become liable for non-compliances. The governance leaders cannot be mere spectators to non-compliances. The delinquency in compliances is bound to be problematic for those in-charge of governance. The directors are under the threat of being responsible for something they did not bargain⁶. Rules of compliances must be understood by them and close interaction with the management at short intervals will keep them abreast of non-compliances in the company. More often than not, bank defaults are not immediately brought to the notice of the governance leaders. Keeping them under wrap till the last moment makes it difficult for the governance leaders to take corrective measures. The management filters the information supplied to the board in the hope of a correction in a short time. Such filtered information serves no useful purpose and affects decision making by the board. Corrective steps are not possible if the information about defaults of the company is concealed. Due diligence at regular intervals will reveal the existence of veil. The due diligence must, however, be carried by independent experts directly reporting to the committee chairs or the board. For example, secretarial due diligence must be carried out by the qualified company secretaries in practice with straight reporting to the audit committee or the board. “The directors must build a safety net around them for protection. The safety net is a conscious effort on the part of directors to protect themselves from the legal penalties and liabilities under [the laws of any country]. The safety net is essentially an attempt to save the directors from unsolicited troubles. The safety net may work towards protecting the directors from the acts of omissions or commissions for which they are not party or have no role to play”⁷.

**Bridging the Governance Gap**

Bridging the governance gap calls for seriousness to look within and take corrective steps. Once the factors causing the governance gap are determined, component stacking would make it easier for corrective action to follow. Ignoring the governance gap may continue to cause conflict between those charged with governance and those charged with management. Understanding the governance gap theory will lessen the impact of friction between two sets with positive consequence of better governance and better management. “The directors should adopt ‘liberalative approach’. It is a rare combination of rich board experience and knowledge of systems, business and regulations. It is gained and earned through classroom environment and exposure to real business situations⁸. The earlier the gap is bridged, the better it is for the functioning of the company. The corporate survival hinges on early closure of governance gap.

**Impact of Companies Amendment Act, 2017 on Corporate Survival and Governance Gap**

The Companies (Amendment) Act, 2017, assented to by the President on 3rd January 2018 makes pragmatic changes in the Companies Act, 2013 to address the issues of corporate governance, survivability and gap that occur in governance. The amendment in the definition of key managerial personnel permits those charged with governance to designate any officer in whole-time employment as key managerial personnel. This is step forward towards bridging the governance gap. The amendments also repose confidence in the board of the companies to decide remuneration payable to the managerial personnel. It cuts the power of the Central Government to sit in judgment approving the remuneration. This empowers the board of directors who can incentivize the good performance of managerial personnel. It helps in lessening the gap as it encourages open and deeper communication to understand the working of managerial personnel. The provision relating to evaluation of performance of the Board, under the amendment Act, permitting an independent external agency to carry out such evaluation is a measure which will help weed out underperforming and passive directors thereby improving the quality of the board members. Such an exercise will also keep the directors on their toes making them understand their role to make a discernible effort to curtail the governance gap.

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¹ Chapter 26 – Safety Net, Corporate Directors – Role, Responsibilities, Powers and Duties of Directors by Ashish Makhija, published by Lexis Nexis India.
² Chapter 26 – Safety Net, Corporate Directors – Role, Responsibilities, Powers and Duties of Directors by Aishah Makhija, published by Lexis Nexis India.
³ Chapter 19 – Corporate Governance – Practice and Procedure, Corporate Directors – Role, Responsibilities, Powers and Duties of Directors by Ashish Makhija, published by Lexis Nexis India.