Corporate Governance Challenges

T.V.Mohandas Pai
Director
ManipalUniversalLearning

Rajesh K.Moorti
Aarin Capital Partners

The Indian economy grew at almost 8% p.a. over the last ten years and most of us came to believe that 8% p.a. growth in the current decade too is a given. Corporations grew rapidly and this period was marked by growth of the infrastructure and natural resource companies. It also saw some Mega Mergers and India Inc investing massively overseas such that for a couple of years overseas investment almost overtook FDI.

If the 1990's were the decade of technology companies which saw a massive rise in market capitalisation and then sobered down after the dot com bust, the last ten years saw a different kind of companies. Growth was heady except for the last two years. The retrograde tax and fiscal policies of the Government, inability to control runaway subsidies and various scams shattered our economic growth. The GDP growth rates plummeted quarter after quarter and after almost a decade we witnessed a sub 5% GDP growth in a quarter. The doom and gloom in the global economic scenario did not help either.

Corporates boards have to wake up to the challenges of doing business and guiding companies in the "new normal" low growth environment. Some companies which raised money in the stock markets at high PE's and with massive growth projections suddenly found themselves growing at a much lower rate resulting in a significant drop in share prices. Many promoters resorted to financial engineering which they thought would bail them out of their troubles. Many tried to manage regulators to soften the blow. But one can't underestimate the power of the markets, it smelt that some things were wrong and punished such companies for their misdeeds.

Things also went wrong because of greed and abuse of power by a few promoters / senior most executives who were supposed to protect the company's interests. They were extremely focussed on the immediate / short term/ personal benefits and as a result, caused irreparable loss to their own companies and investors. Many corporate Boards were mute observers to the downfall calling into question the independence of the Board and whether independent Board Members were really independent. It is very evident from these cases that one can institutionalise corporate governance only when the promoter and the core team of the company has the will and desire to run the business in the "right" way. No amount of rules and regulations can achieve that objective nor can the institution of the Independent Board Member remedy the situation.

The last few years also threw up new challenges in corporate governance, some of which are discussed here.

a. Succession planning for management and board
b. Response towards failed mergers and acquisitions
c. Response towards conflicts of interest
d. Equity in Managerial remuneration

Succession planning for boards and management

This issue has come to the fore in the recent past with the return of an eminent person to head one of India's most well-known companies due to a failed succession. We have seen a few other companies where the executive chairmen have hung on to power, changing the rules of succession, supported by pliable and aged Boards and with a Chairman even going on record to say that none can replace him!

Is it wrong to "recall" the retired CEO or the Chairman of a company? While the answer is obviously "no", one should also verify whether the company has any succession planning process in place. Re-appointment of retired CEOs or Chairmen may not necessarily guarantee success but it is important that the Board makes that informed call keeping in mind the immediate pressing requirements of the organisation while accepting responsibility for failed successions. The challenges of present day business and failed successions may require return of people who are held in very high esteem to rally the troops and regain the lost glory.

The key question for the board to ask is whether the company has a clearly documented and transparent succession planning policy. In the United States, though succession planning is not mandated, shareholders can require companies to disclose and even put to vote the succession plan of the listed companies. The UK Corporate

Governance Code recommends that 'the board should satisfy itself that plans are in place for the orderly succession for appointments to the board and to senior management'.

The Board should ask the management to formulate a succession planning policy at the level of the Managing Director, Chief Executive Officer, Chief Financial Officer, other key executive positions and two levels below. The policy should consider the availability of key people within the organisation and whether they have the relevant skill-set. The policy should provide challenging rotation opportunities for grooming employees and help them grow in the organisation, which would also provide the company an opportunity to assess their ability to deliver results under different circumstances / in different roles. Retention plan should also be formulated for high performers so as to create a talent pool from which senior most roles can be filled. Lastly any policy document has to be updated regularly to be relevant and to be in tune with the changing business environment. A lack of good succession planning can expose the company to the risk of a sudden unplanned for gap in leadership, loss of talent / knowledge and a declining business.

The Board should also make sure that succession is purely on merit, based on the best available talent. They should be independent in decision making and not unduly influenced by Promoters, controlling shareholders or succumb to pressure. Being listed entities, Boards have a fiduciary responsibility and failure in this area would be a breach of their obligations. We have clearly seen failure in this area as Boards have appointed children of controlling shareholders, members of founding groups, close relatives of controlling shareholders or have acted as rubber stamps of existing Chairmen who prolong their rule. There is clearly failure of corporate governance in this area in India.

Succession planning process is not only relevant at the management level but also for the board members. SEBI guidelines require that at least one half of the Board is made up of independent directors if the company has an Executive Chairman or at least one-third, in all other cases. To ensure that the company is steered by the competent and knowledgeable directors it should have complimentary talent and experience, a rotation policy and a defined term for each director. Some of India's best companies have Boards where members remain for 15/20/30 years and never seem to retire with the average age pretty high. The recommended practice of retirement of independent Board Members after a tenure of maximum 9 years is hardly followed. Continuous membership of Boards and lack of a retirement policy deprive companies of fresh ideas, more independent members and lack of new perspectives in an increasingly competitive environment and often lead to a cosy relationship between management and Boards. It strikes at the root of corporate governance that Boards control, supervise and guide management. This also leads to long tenures for CEO's showing mutuality of interest! It does not mean that there is abuse everywhere or that reputed individuals are unworthy of longer tenures but that the greater cause of good Corporate Governance needs adherence to sound principles to ensure sustainability and protection of shareholders.

Not only does this issue prevail but a serious issue of Gender Discrimination is writ large amongst indian corporates. A study undertaken by the Centre of Corporate Governance, Institute of Public Enterprises on the "Board Diversity in India" in 2011 came up with some startling conclusions. This study examined the board diversity of Indian companies on several parameters – gender, nationality, tenure, age and experience.

It said "gender" diversity can be said to be absent in Indian boards. Half the boards do not have a woman director and of the women on the board, scarcely any are in an executive role. No board is led by a woman. Women directors are mostly from the banking, investment or financial sector. This blatant discrimination against women needs a legislative response as done in Scandinavian countries. It is difficult to believe that companies in existence for 100/75/50/25 years have not found a single woman over their existence to serve on the Boards. It reinforces the belief that Boards are bastions of male privilege, closed groups, cosy old boys networks and self-perpetuating entities and not Boards that are purely merit based, open and relevant. Ignoring and not representing 50% of our consumers seem a strange way of governance!

Indian companies are globalising in a big way and have been very aggressive in the recent past in acquiring / setting up businesses overseas. However, Indian boards are yet to be global. Only 7% of directors are non-Indians. Only foreigners who are connected or have expertise that is directly related to company business are appointed as directors.

The life span of directors in India is fairly diverse. The average tenure of directors in India is 8.4 years with the maximum being 48. About 10% of directors are veterans with more than 20 years' experience on boards.

The Government is also stepping in to make boards more diverse and the new Companies Bill provides for appointment of at least one woman director in prescribed class or classes of companies.

Response to failed mergers and acquisitions

In the pre Lehman Brothers and global financial crisis era, we witnessed a significant increase in mergers and acquisition activity. Indian companies also took advantage of the liberalised regime and poured billions of dollars to acquire businesses across the globe, using the most optimistic growth assumptions. Five years later, in an uncertain global scenario with very low growth and immense volatility, most of these acquired companies have become millstones around the neck of the acquirers calling for urgent remedial measures. For example, an Indian

steel company acquired a European steel manufacturer many times its size at a top price for over $ 12 billion to achieve scale, acquire technology and geographical diversification. With a significant drop in global commodity prices and significant reduction in demand in the western world, the losses in the acquired business have ballooned dragging the Indian arm of the business down, as well. The leader amongst Telcos acquired a pan African business at a high price which has clearly failed to deliver.

In such cases, what should be the response of the board? The American examples clearly show that the boards have taken decisive action instead of vacillating, have fixed responsibility on the senior management members of the team after thorough evaluation of the failed acquisitions and have sold the business or taken a accounting charge by writing off goodwill or the carrying value of the assets. In order to prevent such mishaps, it is important that the board seeks an independent opinion / gets an independent due diligence done instead of blindly depending on the recommendations or diligence done by management. This will help the board to ask searching questions on the unrealistic assumptions, if any, made by the management to justify the acquisition. Post such an exercise, a fall back option or Plan B can also be developed by the company to counter unknown developments. History is replete with examples of how M&A activity has destroyed significant value in many companies and board needs to get actively involved to prevent this and preserve shareholder value.

Today we have these two large failed acquisitions where the Boards have yet to demonstrate leadership in decision making, destroying shareholder value. If the Boards do not turn around these acquisitions, sell them or write them off and fix responsibility on management they would be falling short on discharging their fiduciary responsibility, a classic case of non-assertive Boards.

Response towards conflicts of interest

The guiding principles of good corporate governance practices seek to protect and facilitate the exercise of shareholders' rights and ensure the equitable treatment of all shareholders. This is all the more important when large controlling shareholder(s) enter into transactions and relationships with another company where they have substantial interests.

The independent directors need to ensure that the company has a clearly defined policy and disclose the same when dealing with such conflicts where a) the company seeks to acquire such other company, b) the company enters into business transaction with the other company and c) when there is a proposal to divest stake in a significant subsidiary d) or where there is a transaction with the controlling shareholder or entities which are connected.

Transactions with controlling shareholder should be conducted at arm's length and on normal commercial terms and controlling shareholder must abstain from doing anything that would have the effect of preventing a listed company from complying with its obligations under the Listing Rules.

Some developed countries follow the practice of approval of major Related Party Transactions by 'Majority of the minority' or disinterested shareholders. The new Companies Bill contains a similar provision prohibiting interested shareholders from voting in Related Party Transaction approvals.

Transactions with conflict of interest are disclosed to the stock exchange only annually. This limits the effectiveness of the disclosure as the information reaches the investors much after the transactions were carried out. Many jurisdictions have provisions mandating immediate disclosure of the material transactions. This would help in better scrutiny of the transactions by investors, public, regulators and the media thereby limiting scope for abusive related party transactions. Focus should not be on making approval norms stringent but on making disclosure norms effective.

Equity in Managerial remuneration

Most of the Indian companies are managed by promoters and this raises the concern of excessive managerial remuneration to promoters and executives forming part of promoter group, which assumes the nature of an abusive related party transaction. We have a number of examples of promoters paying themselves astronomical salaries, as the promoter and his wife in a media / entertainment company, as well as in a steel and power company, both of them having political connections and a promoter group of an automobile company. A few years ago, a promoter of a well-known telecom company went public stating that he had voluntarily decided not to accept an increase awarded to him by the board due to adverse market conditions when he was already drawing compensation in excess of Rs. 20 crore p.a. And the next highest compensation was way behind.

On an average, the remuneration paid to CEOs in certain Indian Companies is far higher than the remuneration received by the second most highly paid employee, the huge gap in pay between the promoter and the professional manager itself points to abuse of power. The "Nomination and Remuneration Committee" of the board should ask the management to draw up a remuneration policy for the directors, key managerial personnel and other employees. As per the Companies Bill, listed companies need to disclose in the Board's report, the ratio of the remuneration of each director to the median employee's remuneration and such other details as may be prescribed.

Many examples clearly show the impact of pliable and non-independent Boards. It is impossible to believe that the gap in pay between the promoter and the No 2 is so huge and that the promoter brings so much to the table that the

gap is justified. This is also a testimony to the fact that many companies in the infrastructure or natural resource area have promoters with political influence who get juicy deals using their connections. Whatever may be the political links of the promoter, the Board would be failing in its duty if it were not to reduce such disparity.

To ensure that there is equity in managerial remuneration, SEBI should ask companies to furnish details of the top five or ten highly compensated employees, the ratio of compensation paid to a promoter or a non-promoter executive director or key management personnel, the logic or justification for unusually high remuneration paid to promoters etc. It is important that the board provides adequate oversight and prevents abuse of power.

In conclusion, the board in general, and independent directors, in particular, have to be alert to the rapid changes in the business environment, its consequences on the business and how the lack of oversight even for a short period can destroy the value even in the well run companies. The need for proactive engagement of the board with the management and the need for independence has never been higher than today.