CORPORATE GOVERNANCE IN INDIA

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"Free Enterprise was born with man and shall survive as long as man survives".

— **A. D. Shroff**
1899-1965
Founder-President
Forum of Free Enterprise

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K. B. DADISETH*

Companies are microcosms of the countries and the societies they operate in. They are collective institutions of people, with diverse interests, but pursuing the common objective of growth, and the development of every individual involved.

At the outset, let me clarify that I view Corporate Governance in its widest sense, almost like a trusteeship. Corporate Governance is not simply a matter of creating checks and balances; it is about creating an outperforming organisation, which leads to increasing customer satisfaction and shareholder value. The primary need is to create a corporate culture of conscience and consciousness, transparency and openness. The Board should not confine itself to statutory functions alone, but become effective pivots ensuring management. Employees must not only feel empowered to take risks, but also be aware of the accompanying responsibilities.

Companies need to develop capabilities and identify opportunities that best serve their purpose. They need to leverage resources to translate opportunities into reality; to

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* The author is Chairman, Hindustan Lever Ltd. The text is based on the 32nd A. D. Shroff Memorial Lecture delivered under the auspices of the Forum of Free Enterprise on 24th October 1997 in Mumbai.

infuse people with a vision which sparks dynamism and entrepreneurship; to create a system of succession which combines stability with flexibility, and continuity with change. Above all else, they must balance individual interests with common goals and operate within accepted norms of propriety and justice.

Achieving this balance depends upon how accountable and transparent companies are. Accountability improves decision making. Transparency helps to explain the rationale behind decisions and build stakeholder confidence. In the West, where there is considerable segregation between management and ownership, companies have learnt to inculcate such a culture with immense benefit. In India, however, it is somewhat different. Recent events have triggered a debate on the lack of accountability and transparency in the average Indian company. The grievance more often than not is that companies give priority to short-term interests, sometimes for the benefit of controlling minorities, over the long-term interests of all.

Government policy, until recently, aggravated the malady. By taking on itself the role of controlling companies, the government created scope for such managements to abdicate what should have always been their responsibility. Financial institutions as significant shareholders could have intervened but chose to play a passive role.

All this together has led to faulty decision making, frequent mistakes and underperformance.

Corporate Governance quite simply requires that these anomalies need to be corrected if Indian companies are to become robust growth engines and responsible corporations, benefiting all stakeholders. Corporate

Governance provides the means to this end. It entails driving the corporation's strategy, managing the processes that implement strategy and overseeing the day-to-day business within each process.

Governance Codes : Collation of Best Practices

There is nothing radical about these ideas. They have been developed and practised by corporations, both here at home and abroad, with sustained success. The various codes of conduct that have been prescribed across the world are all expressions of these good practices.

These codes were formulated by and large as reactions to corporate disasters, the most recent being those in the UK. It is important to understand the fundamental reason behind the UK failures. In the late 1980s, the British economy was booming. Companies made significant strides taking full advantage of the opportunities. But the decade ended in recession. It was a sudden and unexpected change which some companies, including large organisations, failed to cope with. The immediate concern of the Cadbury Committee, which examined the issues, was that the financial reports and audit statements of these companies did not give any indication of impending disaster. This is particularly relevant in situations when fundamentals change (like in India), where the sudden recognition of the lack of competitiveness can bring about massive swings in performance.

However, the underlying anxiety was that these companies were large and their well-being had enormous impact on the British economy. Therefore, the committee also examined some of the fundamental management issues involved.

The Cadbury Code, or for that matter any other such prescription, addressed needs specific to its respective country. They are relevant to India only in providing some broad principles. The most important lesson they bear is that it is better to proactively set things right rather than react. We in India must therefore use the broad principles of these codes to evolve our own unique solution. The requirements in India are very different as we have yet to build, on average, basic capabilities in managing companies.

India : Changing Environment

India is undergoing change, the pace of which will only increase. The discontinuities between an inward-looking controlled economy and one that is globalising are sharp; they will become even sharper. There is an increasing awareness in the government that it should gradually shift its focus from the economic to the social sphere. Industry now fashions its own future. While this has unleashed enormous business opportunities, they have to be sought in a more competitive and aware environment — an environment which is demanding greater transparency and accountability. We have to sustain and increase our consumer base, benchmarking the best in the world, in quality and cost. We have to retain, reward and enthuse our human resources. We have to satisfy shareholders with increasing profitability. We have to create investor confidence so that funds are available for expansion. Our operations will have to be beneficial to all our stakeholders, the community and the nation at large. Most importantly, all of this has to be consistently achieved, irrespective of changes in the political and economic environment.

If the corporation has to prosper in this changing context, governance must transcend beyond the Boardroom and permeate the organisation as a totality, through every employee and function. Corporate Governance therefore hinges on creating an ethos around values shared by every employee. It must find expression in every decision and transaction within the organisation. It must equally influence the interface of the organisation with the external world of investors, customers, suppliers, the community and the nation at large. We in India therefore cannot confine our model of Corporate Governance to only the hardware of rules and regulations, like committees and numbers of non-executive directors. More crucial is the software - creating a corporate conscience and consciousness; the culture of transparency and openness in the organisation; the confidence that every person in the corporation will know and do on his own, what is right.

Competitive advantage will demand constant innovation so that new products, safe on users and the environment are brought to the market with speed. Sourcing and supplies need to be made available in the right quality, quantity, timing and price. Assets need to be put to use for maximum commercial advantage. Financial planning will have to ensure that there is no mismatch between resources and requirements; financial reporting, backed with information processing, must be accurate so that actions are timely and appropriate. Failure to address any of these issues, will erode the company's ability to remain vibrant, protect shareholder interest and meet obligations to other stakeholders.

The tasks involved are no longer the jobs of compartmentalised functions operating as cocoons. They can best be achieved through processes, which integrate individual competencies into corporate capabilities. Governed corporation's —are people's corporations — people who are empowered to take decisions and aware of their responsibilities. This balance can be achieved only when companies are sensitive that those charged with setting boundaries do not stifle creativity and functional excellence.

The ultimate purpose of governance should be to create a self-driven, self-assessed and self-regulated organisation. This is the principle which corporate governance models the world over underscore and this is what companies in India will need to imbibe, whether in strategy or implementation.

It is said, "For forms of government, let fools contend; whichever is best administered is best." This is equally true of a company. The ills in an Indian company will not disappear if we simply replace the controls of the past with new checklists. The Indian company will have to recognise that it is rewarding to be better governed and managed, and on its own adopt and practice what best addresses its specific needs. The markets have already started distinguishing between the good and the bad. Financial commentators and analysts now talk about real value creation, not just published results. The story that such statements tell can be illuminating. Therefore it is ultimately in the enlightened self-interest of the company to survive this test. The Working Group on the Companies Act and the Confederation of Indian Industry (CII) have already taken significant steps to generate awareness of this urgent need.

Board : 'The directing mind and will'

The Board of the company evolves strategy and reports back to shareholders on performance. But that is not all. Between these two ends, lies the Board's most important task — to become the pivot, steering, supporting and supervising people to translate strategy into action.

Company Boards have received close scrutiny and notice because of the general perception that they neither display enough enterprise, nor do they provide proper support to people in implementing action-plans. The key imperative before the Board is to be demonstrably effective in improving shareholder value, and being transparently accountable to all those on whom the company has any impact. The different codes all over the world and, now in India, have prescribed guidelines to help the Board shoulder this responsibility. However, these cannot be general remedies — eventually companies have to evolve a structure and system specific to their needs .

The issue, in India particularly, is not only what law requires, but what the Board should actually focus on. Law requires the Board to decide on borrowing, lending or investment of funds, adoption of report and accounts and recommending dividend. While these are important, are they the iimits of involvement ? Quite clearly, they are not. In successful companies, the Boards discuss annual operating plans, capital budgets, monitor results against preset targets, review competition and economic and political events — and accordingly steer the business processes and infrastructure. Their focus should at all times be on service to the customer and the consumer, thus creating shareholder value.

Is the company's innovation compatible with strategic plans? Are brand strategies consistent with consumer requirements? Does the supply chain meet requirements of quality, quantity, timing and price? Are assets being put to optimum use? Does the company's financial structure protect shareholder interest? Are all legal requirements and obligations being met? Is the existing human resource base capable of adapting to change? Above all, is the company attracting new talent?

These are the questions being addressed at the Boardrooms of India's well-governed companies. Effective answers to these questions stem from intimate knowledge and deep experience, built over long years of involvement in the company's operations. The care and precision with which the Board performs its role thus ultimately depends upon the executive members, including the Chairman, who have grown with the company. Therefore, rather than depending upon only external directors to lend expertise, a greater imperative before Indian companies is to professionalise their executive managements. This should be supported by proper succession planning. Succession planning cannot be stressed enough. Constant renewal of the Board ensures energy, vibrancy and creativity and motivates the management team to aspire to become Board members.

For us in Levers, the great advantage of constant renewal is that managers do not rest on their past achievements, and succeeding generations strive to outperform. Fresh leadership creates discontinuity and new ambition.

Independence of judgment is also a capability which should ideally be built within the organisation — and all successful companies do so — without depending only on external directors. At any given time, the different divisions and functions should and will provide many solutions to issues before the Board. However, the executive members themselves must together possess the wisdom to assess all these options and collectively arrive at a decision which best advances the company's progress.

The Chairman (CEO) must act as the first amongst equals and take the lead in encouraging a participative style. There should be free debate, but once a strategy has been adopted, everyone must steer the same course. The Chairman is the custodian of corporate ethics and leads by example, on issues of morality and business principles. Commitment to values and ethics must be paramount without any subservience to expediency. He ensures that the Board and the company's top management have the right balance of knowledge and competence to set strategies and lead the organisation. He must challenge Board members to stretch their ambition and help them attain their full potential and excellent results; simultaneously, he must act as the reality check and temper plans where necessary. The Chairman must create a compelling and challenging vision for the corporation — a vision which his Board colleagues and all the employees are motivated by, identify with, and rally behind. One of his key roles is to ensure that resources, and particularly human resources, are allocated in line with needs. Management development to realise the full potential of people, is of particular importance; renewing top talent on the Board and planning for his own succession are key tasks. Equally, the Chairman must intervene, and intervene decisively where the strategy is off beam.

On the external front, the Chairman plays an active role as the company's primary link with shareholders. He must effectively communicate the corporate vision and ambition and the rationale of its decisions to all other stakeholders, policy makers and administrators; this will ensure that the organisation enjoys a supportive environment. In India, the Chairman is seen as the personification of the company. He must, therefore, mould his operating style and personality to one which is in consonance with corporate character and image. Most importantly, the Chairman has to balance the short term with the long term so that the organisation that he hands over is stronger than the one he inherits !

The non-executive directors, when carefully chosen, can complement the Board's overall strength with their knowledge of best practice outside the company. Their role should not be to do the job of the executive but to act as candid counsellors to guide the company in benchmarking standards and its level of ambition. This is a function not of numbers but calibre. Non-executive directors must concentrate on a few companies rather than being involved with upto 20 companies which the Companies Act permits. That is how the non-executive director's contribution can become useful in complementing the executives' competence, making the Board, in the celebrated words of Viscount Haldane, "the directing mind and will of the corporation."

Employees : Sharing Risks and Responsibilities

The Board's mind has to express the corporate purpose. The Board's will has to become a shared understanding, for the corporate purpose to be translated into action. The Board must actively build an ethos, which emphasises that corporate growth depends upon every individual's responsibility towards excellence in quality, cost-effectiveness and consumer and customer service. Only through such a culture can a company ensure long-term success and shareholder value. A good practice is to consistently and continuously communicate the corporate purpose to people in the organisation, so that everyone is motivated to achieve the common aim of accelerated growth and responsible performance; thus supporting the Board in becoming effective and accountable.

People must be encouraged to seek and allowed to test new ideas to continuousiy improve the processes they are involved in. New learning has to be woven into the fabric of the company to achieve professionalism across all functions. That is how a company can convert every employee into a self-driven entrepreneur willing to take risks, a quality so essential to achieve long-term success.

Risks, however, should not become gambles. Therefore self-drive must be accompanied equally with sharing the responsibilities that guide the company's actions. That is where the need arises to abide by a set of common standards. As the Cadbury Committee report says, "It is important that all employees should know what standards of conduct are expected of them. (It is a) good practice for Boards of Directors to draw up codes of ethics or statements of business practice and to publish them both internally and externally." In Hindustan Lever, we have a Code of Business Principles and it is available with and followed scrupulously by every manager.

Communicating these inviolate beliefs and values is not enough; they have to be understood and actually observed by each employee. Reputation is ultimately how a company respects the interests of those outside the company with whom it has relationships — shareholders, consumers, customers, suppliers and the communities among which they operate. The relationship does not only depend on the Board; it is a sum total of the decisions and transactions taking place across the organisation.

Therefore the communication from the Board has to be visibly transparent so that employees can literally read its mind. Only then will they recognise that individual actions together sustain and build the company's reputation. The Board, on its part, must reiterate that no employee will ever be censured for adhering to corporate principles, irrespective of commercial disadvantage. It is only out of such an understanding, that a code can become an effective tool for self-assessment and self-regulation — and self-regulated employees will together make a self-regulated company.

Audit : Fault finding to Positive Assurance

Just like empowerment, self-regulation also needs an enabler. Audit can become the barometer, which alerts management much before a surprise becomes overwhelming.

The process of auditing, in India and abroad, is frequently seen as interference and often leads to defensive employee responses. Here again a cultural shift is necessary to reorient the role of audit. It must start with internal audit; this is indeed a management responsibility.

If employees have to take risks, they must be assured that the actions they are taking are within commonly understood self-regulation standards. Internal audit must therefore shift from merely a detection mode to providing assurance that the actions do not expose the corporation to disproportionate risk and losses, and do not have the potential to damage the company's reputation.

Once employees perceive this shift from fault finding to value addition, the internal audit system can actually maximise business benefits. It becomes a joint initiative of operating management and internal audit. They together assess the effectiveness of existing practices, identify areas of improvement and re-engineer the business processes, wherever necessary.

The activity should not only look at the reliability of accounting and reporting; it must cover all relevant business processes from brand management to customer service. For best results, operating management should be given an opportunity to assess the effectiveness of this assurance mechanism for the cross-fertilisation of ideas. Such an approach actually enhances the efficiency of operations and delivers tangible gains to the company.

The task that internal audit and also statutory audit perform at an operational level, should culminate in the Board. Out of its interaction with internal and external audit teams, the Board, with the help of its Audit Committee (and this need not be formal), should adopt systemic improvements for long term assurance. Self-drive, self-assessment and self-regulation thus gets reiterated at the strategic level, completing the circle. In the process, the company acquires the confidence to stand up to public scrutiny as a trusted corporate citizen.

Disclosures : Communicating Trustworthiness

Trustworthiness ultimately gets communicated through public disclosures. Trust is at the core of Corporate Governance. Shareholders provide funds. But they cannot run the affairs of their company and therefore leave it to the executive management to make best use of their funds and then report back on how well the task has been accomplished.

On matters of public disclosure, companies operating in India have been disadvantaged. The government has historically emphasized quantity rather than quality of disclosures. Disclosure requirements, like licensed capacity, employee particulars, remuneration details or energy consumption, have been designed to allow unnecessary interference by regulatory authorities; disclosures should instead provide transparent and relevant data to help shareholders, creditors and other stakeholders. In the absence of meaningful disclosures, companies in India, specially those in the private sector, have been suspect in the eyes of public opinion; and this suspicion has only increased as companies are now seen to have relative freedom. Without going into the debate of how justified such a perception is, companies in India will do well to furnish such data which communicates their trustworthiness.

The Cadbury Committee report succinctly states what the character of reporting should be: "...a coherent narrative, supported by figures, of the company's performance and prospects. Boards should pay particular attention to their duty to present a balanced and understandable assessment of their company's position. Balance requires that setbacks should be dealt with as well as successes, while the need for the report to be readily understood emphasises that words are as important as figures."

The Working Group on the Companies Act has suggested a wide ranging set of disclosures. The CII's Draft Code has supplemented them. The suggestions of the Working Group include preparation of annual accounts on a 'going concern' basis and a specific statement of directors' responsibilities. These suggestions will indeed go a long way, particularly in assuring shareholders of their Boards' fiduciary responsibilities towards them.

There are also proposals to give shareholders and other stakeholders an adequate and easily understandable picture of the current position of a company, its different businesses and subsidiaries and a reasonable idea of future prospects. They allow the company to highlight its strengths, and more importantly give it scope to share its concerns. Companies must make full use of the opportunity to project their competitive advantage as trustworthy companies. They must equally use the scope to give a realistic appraisal of their concerns so that there is no gap between the environment's expectation, and what actually they can achieve. Any such gap will almost surely backfire.

Conclusion

Governance of companies in India does not mean just replicating systems prevalent elsewhere. The Indian environment is changing, the pace of which will further increase. Therefore, it makes good business sense to evolve our own unique solution to manage this change, using the bedrock principles of international Corporate Governance. Companies must inculcate a culture of transparency and accountability which must permeate the entire organisation; a sacrosanct code of business ethics must be woven into the very fabric of the company. Audit should shift attention from fault-finding to assuring employees of a balance between risks and responsibilities. Disclosures should focus on quality of data, rather than quantity. Boards must be energised, professionalised and renewed to have the right balance of expertise, experience, knowledge, wisdom and dynamism.

Laws cannot predict the future of businesses and bourses. With increasing awareness, investors will no longer depend on regulators to protect them. Guided by unforgiving stock markets, they will on their own shift allegiance and do so overnight to companies which maximise shareholder value. The key differentiator, with everything else being common, will be the ability to create selfdriven, selfassessed, self-regulated organisations with a conscience. That ultimately is what Corporate Governance in India has to be all about.

The views expressed in this booklet are not necessarily those of the Forum of Free Enterprise.

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good".

— **Eugene Black**

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