Values, Integrity, and Good Governance, Not Valuations, Should Drive Indian Businesses in the Future

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If a leading organization in India that had a five-star Board -- which was supported by leading professional service firms, and had been known for exercising good corporate governance standards -- can mislead the world, what signal does it send to global markets?

Recent events in India clearly demonstrate that social responsibility is not always on the minds of some CEOs as firms are being accused of falsifying revenues and earnings in an effort to meet analyst and shareholder expectations and demands.

Such sentiments are reflected in a recent comment by a leading Chairman in India who suggested, "It was like riding a tiger, not knowing how to get off without being eaten".

The deception, hubris, and possible criminal fraud that has led to the decline and collapse of multiple firms around the world is bad enough; but just as disturbing is the lack of business judgment and oversight exercised by some boards of directors.

We hope the recent corporate governance scandal involving a major IT firm in India will redouble the efforts by other Indian firms to improve corporate governance practices.

As the ripples from recent scandals in India spread, what should Indian-listed companies be doing in response to the corporate governance issues that have been raised?

The reviews being undertaken by legislators and regulators in India will no doubt give rise to regulatory changes covering corporate governance, accounts, and auditors.

However, directors of listed companies should not simply wait for these regulatory reviews.

This article highlights key corporate governance issues that have arisen recently and outlines the range of matters that we think boards should be review more actively.

1. Board organizations and operation

Boards across the globe should focus on three main areas as it pertains to the Board organization and operations: Board independence; Effectiveness of Board meetings and group dynamics; and Board and Committee structure.

As shown in Figure 1, each of these areas involves topics that are crucial for a Board to uphold its duty to protect and represent shareholders' interests.

Today, much of the focus is on maintaining an effective balance of executive and non-executive directors. In particular, the combined role of CEO/Chairman has come under increased scrutiny.

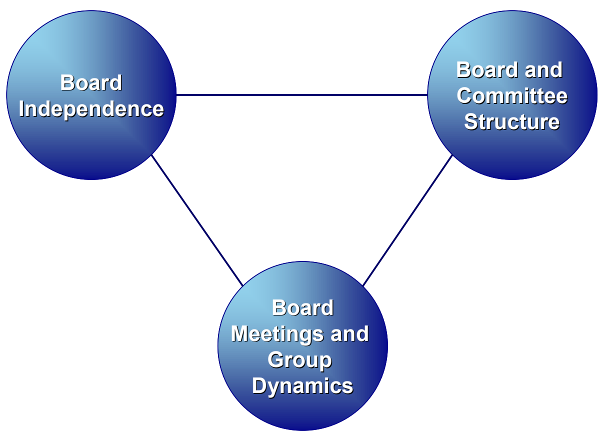
As Boards begin to review the basics of the board structure, we suggest thinking about the following questions:

- Is the balance and division of responsibility at board level clear and appropriate?
- Is the balance between non-executives and executives right?
- Does the board have a sufficient number of fully independent non-executive directors?

The focus is shifting from the technical concept of independence to the need for non-executives to also be truly independent and capable in the sense of a willingness to make contrary views known and to stand up to management.

- Are the skills and experience of the non-executive director's right for the company's business?
- Has a senior independent non-executive director been nominated and is that person a strong force within the board who takes the lead on important issues of concern to the non-executive directors (Lead Director role)?
- Does the Board regularly hold executive sessions without management present?

Figure 1: Board Organization and Operation Diagram



- Boards have several tactics to ensure their independence
  - Separate CEO/Chairman
  - Lead Director
  - Governance Committee
  - Strong committee chairs
- Most boards prefer a Governance Committee along with strong committee chairs
- In addition, outside directors often meet without management present two or three times a year

- Institutional investors generally favor annually elected boards, but there are still many proponents of a classified board structure
- Committees are being increasingly leveraged to perform more of the work of the board
- Core committees such as audit, compensation and nominating are comprised of only outside and independent directors

- Board meetings are formatted so there is more opportunity for informed debate and discussion, with meeting materials sent in advance
- Trend toward fewer board meetings and more committee meetings
- Off-site meetings are held once or twice a year to discuss weightier topics such as strategic issues and/ or senior management performance and succession planning

2. Board role and responsibilities.

To ensure maximum effectiveness in today's business environment, the Board needs to go beyond its traditional advisory role and actively oversee the company's strategy development and risk management to minimize business uncertainties and promote the creation of long-term shareholder value.

A major challenge for the Board is to establish the right balance of responsibilities between the role of non-executives and role of management, especially the CEO.

There are five main areas of responsibilities for Boards to focus on:

- First, directors regularly review and approve the strategic direction of an enterprise. The Board needs to ensure that corporate resources are used most effectively and efficiently to achieve the strategy.
- Second, the Board plays an essential role in selecting, monitoring, counseling, and advising the senior executive team, including the CEO.
- Third, directors are watchdogs for uncompensated or excessive risk and guardians for compliance around major financial issues.
- Fourth, Boards are responsible for ensuring that the company gets a fair return for the compensation paid to the executives of the firm.
- Fifth, Boards are responsible for evaluating themselves relative to governance standards and objectives set at the beginning of the performance period.

Figure 2 below highlights these five areas of responsibility and suggested activities relative to each.

Figure 2: Board Roles and Responsibilities

3. Board compensation.

In the most simplistic way, Board compensation should reflect the critical accountability of the Board members.

Historically, Board directors have been compensated through a combination of retainer and/or meeting fees and annual or periodic stock option grants.

There has been little differentiation between those with leadership and general membership roles.

Cash compensation has been set to pay for the activities and services of the board members. Stock option awards have attempted to align board decisions with shareholder interests, and provide the competitive total compensation necessary to attract new members. However, in leading industrialized nations, we have seen a shift away from stock options and towards full value shares for independent director pay.

While Board compensation is philosophically similar to executive compensation, there are some fundamental differences. They are similar in that each program includes cash and usually some form of equity-based compensation for services rendered. It is different because there is often little differentiation between members, the amount one receives is not based on performance, and there are concerns about inherent conflicts between current pay programs and the fiduciary responsibility of the Board.

It is critical that a Board seek the help of a neutral, independent, and competent advisor while reviewing the compensation programs of its directors.

While the overall role and responsibilities of Boards have not changed, the work they perform and the consequences they face for their decisions have changed dramatically.

"Social responsibility other than to make...money for stockholders…is a fundamentally subversive doctrine."

Milton Friedman

The requirements and roles for directors have increased significantly. Investor and shareholder advisory groups are closely scrutinizing governance practices and how board members are compensated.

As part of the re-examination of corporate governance for the organization, Boards need to assess the philosophy, basic architecture, actual amounts, and decision process for compensating directors.

There are three primary aspects to be covered while determining the appropriate compensation.

These areas are:

I). **Define the framework for determining the structure, mix, and levels of compensation for directors.**

- Should the board be compensated for its activities (e.g., meeting fees) or their responsibilities (e.g., retainers)?
- Should the total compensation for the chair of the committees be different from that of others on the board?
- Should directors receive equity-based compensation for their services (and, if so, what

form of equity) or should they receive only cash compensation?

- What mix best reflects their services as well as their fiduciary responsibilities to the shareholders and executive management?
- Should there be any special conditions related to a director's compensation?

ii). **Determine the frame of reference for the appropriate amount of compensation.**

- What should constitute the "marketplace" from which the corporation needs to draw directors, and what is the desired level of competitiveness?
- Should there be a difference between new members and well-established members; between current shareholders and board members with limited holdings in the company?
- Should corporate performance impact director compensation, and if, so how?

iii). **Provide on-going reviews and support to decisions that fulfill legal, ethical and strategic requirements.**

- Should the current director compensation programs be modified in light of the emerging changes in governance requirements, the board structure, and the membership of the board?
- How should these changes be implemented and in what timeframe?
- How often does the board need to examine its own compensation, and how should it make and document these decisions without being seen as self-serving?

Companies in India have made great strides in addressing the need for good corporate governance practices. We believe that the recent governance scandals in India will serve as a signal for organizations to conduct a strict due diligence on their current governance programs and process and will accelerate the adoption of best principles in governance across the country.

We should remember that, when corporate governance is effective, it helps safeguard shareholders, customers, and employees without hindering appropriate risk-taking.

But when it is ineffective, it can have a disastrous impact on these key stakeholders and on the long-term viability of the enterprise.

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