# Is Indian Business Ready for a Brave New World of Tough Corporate Governance?

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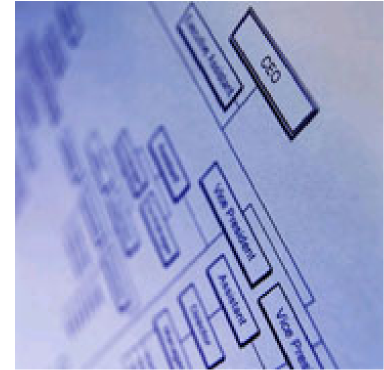

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As global business interest in India keeps growing, so does the expectation that Indian companies must play -- and be seen to play -- by rules that are clear to international investors. Demands have long been heard for greater transparency in the way Indian companies do business. Now, matters are about to come to a head. Ready or not, India's public companies must meet a January 1, 2006, deadline to comply with sweeping new corporate governance standards.

The reforms, ordained by the Securities and Exchange Board of India (SEBI), are laid out in amendments to Clause 49 of the companies' listing agreement with Indian stock exchanges, a section that pertains to corporate governance. Among the requirements: More independent directors on boards and audit committees; a code of conduct for board members; a larger role for the audit committee; mandatory risk assessments and certification by the chief executive officer and chief financial officer of the effectiveness of internal accounting controls.

Sound familiar? The reason is that many of these rules have been inspired by the Sarbanes-Oxley Act that was passed in the U.S. three years ago in response to governance scandals involving Enron and other companies. While U.S. executives have tended to grumble about the regulatory burden that Sarbanes-Oxley imposes on their companies, India's governance gurus have viewed the law as a promising template for their reforms.

Many Indian companies have been phasing in the requirements through 2005. Predictably, with the deadline looming large, some companies say they are not ready yet. Virtually all the laggards are large "public sector units" -- companies such as Bharat Petroleum and Steel Authority of India that are partially government-owned -- according to a recent tally by The Hindu group of publications. Among their concerns is an apparent dearth of candidates qualified to be independent members of their boards. That reason -- or excuse -- is unlikely to buy them more time. SEBI chairman Meleveetil Damodaran has warned in public remarks that there will be no extension of the deadline, and no exceptions from compliance for any company.

### Tough New Rules

What's behind this hard-charging resolve to bring corporate governance in India in line with the latest world standards? Clearly, the demands of increasingly global capital markets provide part of the answer. In addition, though, the resolve also reflects a shrewd recognition by Indian corporate leaders that greater transparency is in their self-interest, say two Wharton management professors, Michael Useem and Harbir Singh, and Govind Iyer, the India representative of the board consultancy and executive search firm, Egon Zehnder International. The three, along with management professor Jitendra V. Singh, are scheduled to be part of a Wharton executive education program in Mumbai, India, on Jan. 4, 2006, that aims to prepare Indian directors for the new era they are about to enter.

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"With the internationalization of equity investing, corporate governance reform comes along like day follows night," says Useem. Western institutional investors such as CalPERS, the giant California state pension fund, are being drawn to India as longstanding Indian restrictions on foreign capital are being lifted and investment returns in India's fast-growing economy appear attractive, Useem says. But these investors also are insisting on the same rigorous governance regimes they have campaigned for in their home countries.

"They can bring pressure to bear on company leaderships by selling stock, by supporting raiders, and by using the press to stigmatize poorly run or poorly performing companies. Big investors are not shy about telling directors to oust top management or face a proxy struggle to bring in a new board," Useem adds, noting that the rewards for good governance have been revealed in several U.S. studies. "Companies with better governance show higher market valuation and better year-over-year results and are better able to withstand crises and setbacks."

## Governance at Godrej

That is a scenario familiar to Adi Godrej, chairman and managing director of Godrej Consumer Products, one of India's largest manufacturers of personal care products such as soaps. The company has been an early and enthusiastic adopter of governance reforms, including independent directors. Six of the eight members of its board of directors are independent of the management. All four of its audit committee members are independent. Both are better ratios of independent to "executive" members than required under the new Clause 49. Other requirements, including the creation of a risk-management regime and certification of financial controls by top officers, are being put in place by a consultant, Godrej says.

"Our strong emphasis on corporate governance has helped us get high ratings on both corporate governance and shareholder value creation," Godrej adds, citing ratings given by the Investment Information and Credit Rating Agency of India. "I also feel that the markets have recognized and rewarded our pioneering corporate governance initiatives."

His company also expects a lot from its independent directors. Board memberships at Godrej and in a growing number of Indian companies, especially globally ambitious information-technology pioneers such as Infosys Technologies, are not given out as sinecures for industrialist friends of the CEO, bankers and retired generals. Board meetings at Godrej Consumer Products last for at least half a day and the company also organizes a two-day strategic meeting once a year.

"Independent directors are supposed to provide tremendous value to the company's performance. We compensate them well and expect them to spend quality time with the company," Godrej says. Infosys pays its directors one of the highest annual retainers in India -- nearly $45,000 a year. In return, it demands a lot of its directors, including requiring them to participate in a peer review and an annual self-assessment of their contributions to the company.

Such reviews of board members' performance are a growing trend worldwide, says Iyer of Egon Zehnder, a firm with a decade of experience in India recruiting and training directors for top domestic and multinational companies. "There is no point just hiring independents. They need to use their independence and knowledge to add value." To that end, directors need to improve their interpersonal behavior even as they leverage their individual strengths. Iyer notes, however, that the demand for directors with financial savvy may be off the mark. "It's more important to know what questions to ask, and a doctor or a marketing guy could ask good questions" as well as an accountant.

Godrej points out that most Indian public companies are working diligently toward implementing the revised Clause 49 by January 1. They are being helped by the Confederation of Indian Industry, a corporate association whose governance council is headed by Godrej. "Once the revised Clause 49 is implemented, we feel Indian companies will meet most sensible standards of corporate governance," he adds, expressing concerns about the high costs being borne by U.S. companies for implementing the more


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extensive provisions of Sarbanes-Oxley.

Harbir Singh says that one key area in which Indian companies generally lag the best international standards is in "the amount of disclosure of strategies and priorities" to shareholders. He attributes that to a corporate culture in which Indian chief executives have greater longevity and therefore wield more influence than their Western counterparts. A shorter tenure, or at least the fear of it, encourages more accountability. Singh also cites the relative lack of influence exerted by institutional shareholders. There just aren't that many yet.

## Family Business Practices

One corporate-cultural idiosyncrasy in India is that a large proportion of Indian public companies, including Godrej, are family dominated. That can make for corporate governance calamities, as witnessed most recently in a bitter and unusually public falling out between the two Ambani brothers -- Mukesh and Anil -- over control of the Reliance conglomerate built by their father, Dhirubhai. Other shareholders watched as the two finally broke up the business empire, which had previously been India's largest business group.

Iyer believes that CEOs and other top leaders at India's family controlled firms will have to get with the program or pay the price. "In the end, their companies' share performance is dependent on their empowering the board. If not, their companies' value won't grow," he says.

But family dominance can also be a source of strength for the company, Singh points out. Management teams in these companies are likely to have closer relationships with the main equity holders in the family, and "that provides less of an agency problem in which management and shareholders have divergent interests," he says. Adding the disclosure requirements from the American context would be a good blend, he says. "Corporate governance is really about making management more accountable to shareholders. If management's actions are not geared to the interests of shareholders, then they must be held accountable. In the Indian context, there are many stakeholders, but the problem is how to align their interests with those of shareholders. One powerful incentive for that seems to be the growing desire of Indian companies to get access to global capital markets by gaining listings on international stock exchanges."

Useem says "there is a kind of emergent world standard" of governance. While there are national peculiarities, such as combining the chairman and CEO functions in one person in the U.S., "there is a basic notion worldwide for good transparency; reliable reporting of financials and risks, and boards that have the independence and strength of purpose to be able to do all this."

Developing strong governance standards means helping directors appreciate what board practices "make for good governance and great performance," he says. "What kind of relationships do they need to develop with senior management? What contacts should they have with big investors? Should they never speak directly to investors or should they have a dialogue?" When carefully done, with the collaboration of senior management, director-investor contacts can be helpful, Useem says. Then there are the seemingly mundane but critically important skills directors, especially those on the audit or compensation committees, need to have: How to read financial statements and know the principles of incentive-based compensation.

## Search for Independent Directors

And what about that alleged shortage of candidates for independent directorships? Under the new Clause 49, one-third of the board must be composed of independent members if the chairman of the board is not also an executive of the company, and half of the board membership must be independent if the chairman is an executive. According to rough estimates, just the top 500 listed companies, with an average of nine members on their boards, will need to find 2,500 new board members. They would qualify as independent


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only if they have no material financial relationship with the company and were not employed by the company in the previous three years.

Godrej says he is not concerned about the lack of qualified people to fill the post of independent directors. A website has been set up to recruit independent directors. The effort has been sponsored jointly by the Bombay Stock Exchange, the National Stock Exchange and the Confederation of Indian Industry. It already has identified about 3,000 candidates, Godrej says, and "more are being listed each week."

When all is said and done, Singh says, Indian companies will have to identify their own system of corporate governance, one that is appropriate to the Indian context and takes into account the merits of their history and their experience. "They don't necessarily need to imitate everything in the U.S."

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