



**Showcasing
Best Practices in Corporate Governance by
Medium Sized Family Managed Public Limited Companies**

Three Case Studies

**A SPJIMR Study Sponsored by
National Foundation for Corporate Governance**



BHARATIYA VIDYA BHAVAN'S

S.P. Jain Institute of Management & Research

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Corporate Governance by Medium Sized
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Executive Summary

Background

SPJIMR, one of the top ten among 700 management institutes in India, has pioneered the Family Managed Business program since 1997. The institute has developed an insight into the management and performance of family managed business in India. Thus, when National Foundation for Corporate Governance (NFCG) accredited SPJIMR as an institute for carrying out research and training in corporate governance (CG), it had submitted to NFCG two research proposals :

1. Pilot Research Study on Corporate Governance in Medium-sized Family Managed Public Limited Listed Companies and
2. Show-casing Best Practices in Corporate governance by Medium-sized Family Managed Public Ltd. Listed Companies (Two/Three Case Studies)

The proposal for the second study was accepted by NFCG. SPJIMR, however, decided to take up both the studies, with priority given to the second (ie. present) study.

Objectives

The following objectives were identified for the present study:

1. To assess and evaluate Best Practices in corporate governance adopted by selected medium-sized family managed companies
2. To prepare Two/Three Case Studies to showcase Best Practices in Corporate Governance by these companies
3. To discuss these Case Studies in the National/International Convention/Round Table in the presence of the CEOs of the companies
4. To document and publish the Case Studies along with the proceedings of the Convention / Round Table for creating general awareness

The report is divided into two parts. Part I contains 4 chapters and Part II – the Three Case Studies.

Part I

Corporate Governance by Family Managed Business – A Global Perspective (Chapter I)

The study began with a review of the concept and evolution of CG practices in the developed countries, particularly UK and USA. This included a study of the events which brought into focus the need for better governance standards and the recommendations of various committees like the Cadbury committee in UK, the Cal PERS – California Public Employees Retirement System, the OECD Task Force and the Sarbanes Oxley Act in USA.

Recent global developments in CG and the issues and constraints faced by family managed companies were also studied through a review of published literature and empirical studies carried out by academicians and financial analysts.

Corporate Governance by Family Managed Business – Indian Approach (Chapter II)

The prevailing Corporate Governance practices in India were studied by reviewing the developments in CG in India and the evolution of the regulatory framework, which was largely based on the recommendations of various high level committees, notably the Kumar Mangalam Birla Committee, N R Narayanmurthy Committee and the J J Irani Committee. The present regulatory framework for CG in India viz the Companies Act 1956 (together with its 24 amendments), the new bill (2008) for its re-legislation, SEBI Clause 49 - of the listing agreement of the companies specifying detailed regulatory norms of CG, etc have also been discussed and commented upon.

This was followed by a quick review of the studies on best practices in CG as well as the imperatives for CG practices in the globalizing India.

Some of India's family managed companies demonstrated excellent CG practices even going far beyond mere compliance, while there were many companies which complied with regulatory CG norms only in letter.

The present SPJIMR study is unique in the sense that it has assessed CG practices of the selected companies not only relating to regulatory norms but has also gone further and assessed several other practices, which are beyond compliance norms.

Methodological Framework for Selection of Three Case Studies (Showcasing Best Practices in Corporate Governance - Chapter III)

Definitions

For the purpose of our study, the family managed companies have been defined as those with promoters' shareholding of 25% and above in the total shareholding of the company.

Medium-sized companies have been defined as those with value of total assets between Rs. 200 cr. to Rs. 2000 cr. in 2005-06.

In order to prepare three Case Studies to showcase best practices in CG within this group of companies, we selected three companies, which demonstrated visibly superior standards of CG compared to their counterparts.

Under the prevailing regulatory regime where all listed companies had to mandatorily comply with the prescribed norms of CG, a well defined framework had to be evolved for selection of the right companies.

The study is based on :

- (i) Secondary Research, which involved a detailed examination of all information relating to corporate governance and other related accounting, auditing and legal procedures as published in the Annual Reports and other data sources available in the public domain.

It involved the scrutiny of published information relating to compliance with corporate governance regulations and other value creation activities of 150 family managed medium sized companies in the western region. These companies were short listed in a step by step manner from 1,166 companies listed on BSE and NSE in 2005-06. These were sourced from CMIE Prowess.

- (ii) Primary Research involved a Questionnaire based survey of 30 family managed medium sized companies located in Mumbai.

For conducting the survey, Questionnaires were sent to 109 companies in Mumbai (out of 150 in the Western Region).

After a persistent follow-up, positive response and cooperation were received from 30 companies. This is a good success rate of 28%.

Subsequently, personal interviews were held with the Chairmen/CEO/Company Secretaries of these 30 companies to assess their governance practices.

CG practices of the 30 selected family managed medium sized companies in Mumbai were assessed on the basis of two main criteria :

- (i) Compliance (both Mandatory and Non- mandatory) with the Regulatory norms for Corporate Governance as covered under the SEBI Clause 49 on Corporate Governance. Compliance was assessed on the basis of 13 major Mandatory criteria with over 21 sub – criteria.
- (ii) Eight Non-mandatory compliance criteria (eg. remuneration committee, whistle bowler policy etc) were also assessed.
- (iii) Over and above, 23 criteria relating to practices Beyond Compliance (like company philosophy, values and obligations, goals and objectives, companies’ image in the market, credibility of the board, role of promoter/ CMD/ MD in decision making, board level/ other committees, company evaluation, environment protection, innovation, CSR, etc) were also taken into consideration for the purpose of assessment.

Eventually, to select three companies with best corporate governance practices for preparation of the case studies, data / information relating to CG practices obtained from the 30 surveyed companies was analyzed along with all relevant published information. Based on this analysis, 10 relatively better governed companies were short-listed for further analysis. At this stage, due to certain compulsions relating to definition and performance, two of the short-listed companies had to be taken out.

A quantitative framework was devised for the selection of top five companies showcasing best practices in CG out of eight selected companies. This involved assessing the companies on the basis of the weighted average scores obtained by them under each of the criteria determined above namely – Compliance (Mandatory as well as Non-mandatory) and Beyond Compliance.

For the purpose of scoring, these criteria were sub-divided into a series of parameters and scores were assigned to each of these parameters on a Ten Point Scale to bring out the differences in the governance practices of the companies.

The scores obtained by each company, under each criterion were aggregated and appropriate weights assigned to the total value. A higher weight of 0.7 was assigned to the criteria of Compliance and a lower weight of 0.3 to Beyond Compliance.

Based on the total weighted average score obtained by each company and its percentage share to overall (aggregate) weighted average score, the eight companies were ranked from one to eight :

Box : Eight Companies Showcasing Best Practices in Corporate Governance

- | | |
|---------------------------------|------------------------------|
| 1. Godrej Consumer Product Ltd. | 5. Bajaj Electricals Ltd. |
| 2. Asian Paints Ltd. | 6. Marico Industries Ltd. |
| 3. Hexaware Technologies Ltd. | 7. Unichem Laboratories Ltd. |
| 4. Crompton Greaves Ltd. | 8. Joyti Structures Ltd. |

These eight companies were selected from 30 Family Managed Medium-Sized Companies from Mumbai, which were intensively surveyed based on a structured questionnaire together with a detailed analysis of information and data from available sources. However, according to our NFCG approved research project the scope of our study is limited to the preparation of three case studies. As such the top five companies from the list above were approached for the preparation of three case studies.

Three of these five companies gave a positive response for the preparation of the case studies. These are i) Godrej Consumer Products Ltd., ii) Bajaj Electricals Ltd. and iii) Hexaware Technologies Ltd.

Thus, Case Studies (modeled on certain globally reputed studies by Harvard Business School and those published by OECD) were prepared for these three companies after holding in-depth discussions with their Chairmen, Executive Directors and Company Secretaries. Discussions were followed up with a detailed analysis of all other information relating to the operations of the companies and their financial performance as obtained from published sources.

Thus Case studies as included in Part II of this report were prepared in close collaboration with the authorities in the respective companies and approved by the respective Chairmen.

Findings of the Study (Chapter IV)

Our survey of 30 family managed companies has revealed that though the family owned companies are progressing towards better governance practices and ensuring compliance with most of the provisions of SEBI clause 49, there are as yet several areas of governance which need further strengthening:

(i) *Compliance with SEBI Clause 49*

All the surveyed companies had fully complied with all the mandatory provisions of the SEBI clause 49 relating to corporate governance, though compliance with non-mandatory provisions, with the exception of the formation of the Remuneration committee, was observed in case of only a few.

Again with respect to compliance, the measures adopted for adherence to various provisions varied significantly across companies. Well governed companies had set up appropriate systems, at times sophisticated IT related infrastructure and even appointed consultants and specialists to derive maximum benefits out of them. The rest of them had declared compliance in their corporate governance reports but the procedures adopted were not documented and the responsibility was largely assigned to the respective committees or internal auditors.

(ii) *Role of the Board and Independent Directors*

In nearly 60% of the surveyed companies, promoters held the majority shareholding of over 50%. The shareholding with the public was lower being less than 20% for majority of the companies, while the shareholding of FIIs/NRIs/OCBs was comparatively higher, going up to over 30% in some cases. This indicates the increasing interest of foreign investors in well governed family managed companies.

With higher stakes in equity, there was a tendency for the promoters to exert greater influence on the Board decisions. This was visible in nearly 40% of the surveyed companies particularly the smaller sized promoter driven companies. Here, the Board played a more passive role and the independent directors restricted their contributions essentially to issues relating to finance and accounts, legal and compliance.

In contrast, in the remaining 60% of the companies, a consultative approach had been adopted for all Board decisions. These were the companies where the Chairman or the CEO encouraged active involvement of independent directors on all major issues – financial, legal and even strategic, which indicates a positive shift towards better governance practices. A few of these had appointed professional experts or independent directors as their CEO or Non-Executive Chairman to lead the company.

Under Clause 49, the independent directors are expected to perform multifarious activities as members of the Board and as members of various committees. Being on Boards and Committees of several companies, some of them have faced constraints of time and are unable to attend to matters other than finance, accounting, legal and compliance with regulatory requirements.

Lack of adequate and timely information has also posed a major constraint. At times, their long tenure on the Boards, over 10-15 years, might have affected their role as watchdogs for the company. Moreover, the dominance of promoters and at times family councils on the Boards, especially in strategic and operational decisions, lack of proper demarcation of responsibilities and the absence of a well communicated succession policy have posed major constraints to the independent directors

Training of Board members and evaluation of non-executive directors' contributions, both non-mandatory provisions, were not undertaken by majority of the companies. Some of the companies, around 43% had, however, evolved an informal framework for evaluation of all their directors. Some of them had even laid down the parameters for evaluating the directors, which were later examined by the Remuneration committee

Some of the companies had gone beyond compliance and appointed more than the stipulated number of independent directors and even set up additional Board level committees for the specific tasks of Risk Management, Corporate Governance Compliance, Investments and Borrowings, Share Transfers, etc. indicating greater involvement of independent directors.

(iii) Risk Management and Internal Controls

An effective risk management framework was high on the agenda of majority of the surveyed companies. The companies, particularly those operating in the global markets, had developed a formal Risk Management Model and had also constituted a separate Risk Management Dept. The others had identified the risks facing their companies and had at least framed a Risk Management Policy for monitoring and mitigation.

The internal control framework in majority of the surveyed companies needed further strengthening and this fact was recognized by most of them. Over 30% of the companies interviewed had made the extra efforts and invested in an ERP based system for maintaining continuous checks and balances in all their transactions. Nearly half the companies had assigned this task to independent auditors.

(iv) *Disclosures and Related Party Transactions*

Transparency in transactions results in increased accountability and this is another area of concern in the family managed companies. Only around one-third of the surveyed companies had gone beyond compliance and declared their material transactions in detail for each individual party in their Annual Reports, along with their relationships with the parties. Majority of the companies had presented their transactions in a combined manner for each group of related parties, declaring that they were in the normal course of business.

Global investors are looking for greater transparency in the balance sheets of family managed companies, some of which have a large number of subsidiaries and associate companies and family holding companies which may not be listed.

(v) *Whistle Blower Policy*

Family managed companies had begun to appreciate the benefits of this mechanism and one-third of the companies surveyed confirmed that if not a formal policy, a similar informal mechanism had been put in place for reporting of frauds and unethical practices.

(vi) **Value Creation for Stakeholders**

Majority of the surveyed companies had declared enhancement of company value and shareholder value as the focus of their long term goals. While good financial performance ensured shareholder value, specific initiatives had been taken by majority of the companies for creating value for their customers, employees and society. These were reflected in their well conceived Human Resource policies aimed at retaining talent and upgrading their skills, continuous product improvement, diversification and quality up-gradation for greater consumer satisfaction, environment protection and welfare of the society through various action-oriented social service activities.

Concluding Observations & Some Pertinent Issues (Chapter V)

i) **Concluding Observations**

A number of key observations with respect to Corporate Governance Practices of Family Managed, Medium Sized Companies have been made in our study :

- ◆ Our study of the 30 Family Managed Medium sized Companies has brought to light several disparities in the responses of the companies to the increasing emphasis on

better Corporate Governance practices. While some companies (essentially the eight selected companies) have already showcased best corporate governance practices, there are others which are yet to fully recognize the spirit of good governance, which has to go beyond mere mandatory compliance.

At the same time, an increasing number of Family Managed Medium Sized Companies have realized that it is not the financial performance alone but also the enhancement of company value and value for all its shareholders that will earn them greater investor confidence.

- ◆ A major motivating factor behind the adoption of better Corporate Governance Practices is the growing global exposure of these companies.
Our study has shown that the relatively larger sized firms which have gone in for expansion through global acquisitions and diversification into advanced/emerging markets through subsidiaries and joint ventures, have developed sophisticated models for risk management, information dissemination and internal controls.
- ◆ It was also observed that the majority of the surveyed companies had commenced Corporate Governance Practices in a formal manner only after the first announcement of SEBI Clause 49 in 2000 and completed the process only after compliance was made compulsory since January 2006. Thus, the mandatory compliance to Corporate Governance Practices is just two years old.
- ◆ However, prior to this, some of the larger sized Family Managed Companies had taken some initiatives like setting up an audit committee or appointing independent directors on their Boards or restriction of insider trading.
- ◆ The survey has brought to light the frequently discussed issue of the relationship of the promoters – usually Chairman and Managing Director – with the other Board members, essentially the independent directors. Balanced Boards with active independent directors have been able to steer their company towards its identified goals in an effective and ethical manner.
- ◆ In some companies the longer tenure of all the directors including the Chairman, and even independent directors, has deprived the Boards of fresh ideas which might have, at least to some extent, slowed down the improvements in governance practices. Training and evaluation of Board members is hardly visible except in an informal manner by a few companies.
- ◆ Due to the absence of a succession policy and well-defined criteria for appointment of successors, the senior management personnel and independent directors refrain from proposing long term policies, which would have an impact on company's operations.

- ◆ It was only in a few larger sized companies that the Chairman had engaged the independent directors in strategic decisions relating to the growth and expansion of the company.
- ◆ Companies in which the Chairman had reduced his influence on Board decisions and imbibed a consultative board culture were able to record a better performance – both financial and operational. These were also the companies which had attracted global investments at a higher premium.
- ◆ The shareholding pattern in Family Managed Companies surveyed has been more skewed in favor of the promoters. As the shareholding with the public is small and shares are not frequently traded in the market, there is a dearth of vigilant and active shareholders.

Some of the more serious governance concerns in family managed companies surveyed were lack of clarity regarding the ownership of the company, its relations with other unlisted companies in the Group or holding companies, the dominant influence of family councils on board decisions, the tendency of the promoter CEO to avoid losing control on the Board and the difficulty in ascertaining the actual status of independent directors.

- ◆ The role of the Institutional Investors and Analysts has gained significant importance with more detailed information being demanded by them which is a healthy trend and has lead to greater transparency.
- ◆ The Corporate Governance Practices which need further strengthening by the Family Managed Companies are risk management, internal controls and disclosures of transactions with related parties.
- ◆ Finally, compliance is important and is ensured but when there is a slippage there is no mechanism for holding the errant person accountable. Continuous monitoring of compliance procedures is required and offenders need to be held responsible for non-compliance. The family managed companies need to strengthen their accountability norms.

ii) **Some Pertinent Issues**

Some pertinent issues have been raised in our study together with our suggestions :

- ◆ In SEBI Clause 49, there are a large number of parameters of Corporate Governance, including the mandatory and non-mandatory ones. These are to be complied with by all

listed companies. As a result, some of the smaller sized companies are not able to comply with all the stipulations of this 'One Size fits all' type of Clause. Smaller sized companies having asset size of say Rs. 3 cr. may not be able to invest in the type of systems, procedures and manpower required to comply with all the requirements in the same manner as say Infosys or Reliance.

The study has also highlighted the problems relating to compliance with all the stipulations by the medium-sized companies.

A detailed study of the application of Clause 49 with a differential approach for companies in smaller size groups, or age or types of operations needs to be carried out. NFCG may consider organizing a brainstorming seminar or workshop on these issues.

- ◆ Issues regarding the role of the independent directors on the Boards of listed companies were discussed at length. These have also been brought out in our Study. Issues regarding the role and responsibilities of independent directors and the effectiveness of their contributions need to be further looked into.

NFCG may consider sponsoring a study to assess the contributions of the independent directors on Boards of listed companies through a survey of independent directors.

- ◆ Disclosures and related party transactions in family managed businesses, where other unlisted companies or holding companies control the listed companies, the concept of lead independent directors, or greater involvement of independent directors is called for. This could be facilitated by dissemination of detailed information on all relevant issues to the independent directors. Besides, the training and evaluation procedures of the independent directors also need to be strengthened. Succession policy related issues are also important.

These are also important and relevant areas of future research to be sponsored by NFCG.

Future Outlook

At present SEBI Clause 49 and the Companies Act 1956 form the architecture for Corporate Governance norms. The overall regulatory structure relating to Corporate Governance has been evolving since 2006. It is yet too soon to evaluate whether all the listed companies are able to comply with all the regulations of SEBI.

Meanwhile, some regulations with respect to Clause 49 are also being reviewed by experts. The Bill (2008) for re-legislation of Companies Act 1956 is yet to be placed before the Parliament. Once the new legislation is enacted the regulatory mechanism for Corporate Governance practices would be well placed.

At this stage, there is a need to evaluate the existing mechanism for compliance so as to add value and bring in greater flexibility and hence, compliance in spirit, and not just in letter.

Part II

Three Selected Companies Showcasing Best Practices in Corporate Governance Practices (Chapters 6 to 8)

All the eight companies as mentioned in Box above, have stood out among the 30 surveyed companies for compliance with Clause 49 as well as for practices beyond compliance. Relatively superior corporate governance standards were reflected in their philosophy on Corporate Governance, focus of their goals and objectives with emphasis on value creation for all stakeholders, greater independence of the board, active involvement of independent directors in all issues concerning the company and various other voluntarily adopted practices.

First five of these eight companies were approached seeking their association and cooperation in the preparation of Case Studies. Of these three companies responded positively and extended full cooperation. These were **Godrej Consumer Product Ltd., Bajaj Electricals Ltd. and Hexaware Technologies Ltd.** Hence, Case Studies were prepared for these three companies (according to the terms of our project for which was approved by NFCG).

These are the companies which, apart from complying fully with Clause 49, had extended beyond compliance in their corporate governance practices by adopting more advanced systems and procedures like ERP SAP for their core functions. Initiatives taken by them for assessing Economic Value Added (EVA), obtaining Corporate Governance Rating from reputed agencies and acquiring national and international recognition for superior governance practices are some of the achievements which have set them apart for best practices in Corporate Governance.

These are also the companies, which had put up a good financial performance, creating value for their shareholders and made commendable efforts for enhancing value for all other stakeholders including employees, customers, suppliers and society at large.

