CORPORATE GOVERNANCE

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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

INTRODUCTION

The Forum of Free Enterprise has been organising the Bhogilal Leherchand Memorial Lectures since 1988 at the instance of Bhogilal Leherchand Foundation. This year's Lecture was delivered by Mr. Adi B. Godrej, Chairman of the Godrej Group, on 8th December 2003, in Mumbai, on "**Corporate Governance**".

Corporate governance has assumed great importance in the last few years. The crisis of confidence created in the United States as a result of failures of several leading corporations has heightened the interest in the subject. In India Securities & Exchange Board of India (SEBI) has evolved a code and some amendments are proposed as a result of the Naresh Chandra Committee Report.

Mr. Godrej has articulated several salient aspects of corporate governance. He has rightly stressed that corporate governance *per se* has no relevance unless it is backed by sound corporate performance, good human resources management and a participative culture within the organisation. Mr. Godrej has also pointed out that corporate governance is not only limited to the highest levels of the company but is the responsibility and privilege of each and every shareholder. What makes the booklet very interesting reading is the examples he has given of the various tools practiced by his own group in this area.

Minoo R. Shroff
President
Forum of Free Enterprise

Mumbai
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Corporate Governance

by

Adi B. Godrej *

The extraordinary events in corporate America during the last three years have renewed widespread, worldwide interest in corporate governance. The present crisis of confidence in corporate leadership owes its origin to the failures of seemingly-infallible corporations like Enron, Arthur Andersen, Tyco, Global Crossing, Adelphia and Worldcom. The recent U.S. Mutual Fund problems have further added to the interest.

Public interest in corporate governance is nothing new – it dates back to the 1970s when, in the wake of the Watergate scandal legislation specifically mandating the establishment, maintenance and review of internal controls was passed in the United States. Subsequently in 1985, the Treadway Commission was formed following the savings & loan crisis. In the 1990s, the Cadbury Committee's code of best practices in the U.K., the Combined Code of the London Stock Exchange, the Blue Ribbon Committee of the U.S., the OECD's Code of 1998,

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** The author is Chairman, Godrej Group. The text is based on the 15th Bhogilal Leherchand Memorial Lecture delivered in Mumbai on 8th December, 2003, sponsored by Bhogilal Leherchand Foundation and arranged by the Forum of Free Enterprise jointly with All-India Rubber Industries Association, Bombay Chartered Accountants' Society, Bombay Chamber of Commerce & Industry, Bombay Industries Association and Indian Merchants' Chamber.*

and the joint efforts of the World Bank and the OECD to develop benchmarks in corporate governance have kept public interest kindling.

There has been significant debate and discussion on the subject of corporate governance in India, too. The Kumar Mangalam Birla Committee appointed by SEBI, the R.H. Patil Advisory Group on Corporate Governance, the M.S. Verma Advisory Group on Banking Supervision, the Consultative Group of Directors of Banks and Financial Institutions under Dr. A.S. Ganguly, and the more recent Naresh Chandra committee have all shaped our collective thinking during the last decade.

Many believe that corporate governance is just another management fad. They are wrong on two counts. One, there is nothing *new* about the concept of corporate governance - it has been around since the time ownership and management in companies were separated. Two, the recent spate of serious corporate malfeasance means that corporate governance needs to be taken much more seriously.

I shall take this opportunity to share with you my views on effective corporate governance. Along the way, I shall highlight how we try and incorporate the best practices of corporate governance at the 106-years-young Godrej Group.

There is no universal definition of corporate governance. In the narrowest sense, Noble laureate Milton Friedman defined corporate governance as "the conduct of business in accordance with shareholders' desires, which generally is to make as much money as possible, while conforming to the basic rules of the society embodied in law and local customs". In a broader sense, James Wolfensohn, President of the World Bank, recently defined corporate governance as the "promotion of corporate fairness, transparency, and accountability". In my opinion, corporate governance should be defined as efficient supervision which encourages 'doing everything better' and protects the interest of the Company while conforming to all established laws and ethics.

Very often, especially in the wake of the recent discoveries of corporate malfeasance in the U.S., corporate governance tends to be confused as 'the protection of the interests of minority shareholders'. The misconstrued notion couldn't be further from the truth. Corporate governance should promote the long-term good of the Company and not necessarily the majority or minority shareholders. It is well understood that neglecting or bypassing the interests of stakeholders like shareholders, employees, vendors, customers, consumers, the Government, or the society at large is likely to adversely affect the long term interests of the company.

At the Godrej Group, we believe that the constant effort to improve operational performance, guided by our values, forms the basis for good corporate governance. Corporate governance is strongly driven by our values such as quality, customer orientation, commitment, discipline, integrity, learning, transparency, respect, teamwork, and trust. These values are important to us and this value framework is an unwritten constitution of corporate governance and shows us the path we must follow for continued success. Overall, corporate governance in any organization needs to be principle-based - Simple, Moral, Accountable, Responsive and Transparent.

It is important that corporate governance be principle-based rather than rule-based. This is essential since *principles* are harder to 'get around' compared to rules. In trying times the temptation to seek loopholes in the rules remains large. However, with principle-based corporate governance the quality of governance is as robust as the principles.

Corporate governance principles need to be simple to be easily and widely understood. In the ideal scenario, every employee - from the Chairman to the shop-floor-worker - becomes a custodian of the Company's interests. Simple principles are both easy to implement and enforce. Further, simple and moral principles are important to ensure that governance is an aid and not a barrier to business development.

Good governance means high levels of accountability and responsiveness. The need of the hour is not more rules, laws, and bye-laws but effective enforcement. Our Government and market regulators need to enforce the existing legislations rather than create more legislation. Legislation alone is no panacea, and un-enforced legislation is worse than no legislation!

Effective corporate governance programs provide for corporate ombudsmen and encourage whistleblowers to dissent when the interests of the Company are potentially in jeopardy. Many believe that corporate governance is limited to the highest levels of the company - perhaps the Chairman or the Board of Directors alone. Again, nothing could be further from the truth. Good corporate governance is the responsibility and privilege of each and every stakeholder. The benefits of having top-notch corporate governance are plenty:

- Firstly, good governance provides a competitive advantage in the global marketplace.
- Secondly, governed companies raise capital widely, easily, and cheaply.
- Thirdly, governance leads to improved employee morale and higher productivity.
- Fourthly, well governed companies last longer.

Lastly, it is important to remember that 'the market' is the definitive compliance officer. The increasing power of the capital markets to discipline errant management and the dominant shareholder by denying them access to the capital market is a strong reason to take corporate governance seriously. The newly unleashed forces of deregulation, disintermediation, institutionalization, globalization, and tax reforms are making the minority shareholder more powerful and are forcing companies to adopt healthier governance practices. Effective corporate governance is closely linked with corporate performance, human resources management, and the Board.

Corporate Governance And Corporate Performance: Good corporate governance *must* include the framework of a strong performance orientation. Conformation with good governance is a hygiene factor - performance is important. Good governance needs to incorporate leadership and management imperatives that can lead to strong financial and strategic performance. Corporate governance and performance are not mutually exclusive - on the contrary, the companies with sustained sterling performances are usually the paragons of governance too.

I would like to describe some of the initiatives and tools we use to promote the performance culture.

- Economic Value Added - EVA, in short - is the residual profits after the cost of capital used has been deducted. EVA is used as the principal financial metric in our Group. A large number of our employees are on a performance-linked variable remuneration system which is linked to EVA improvement in the business. Variable remuneration forms a large part of their total remuneration package. There is no limit to the upside and downside of the variable remuneration. To promote a long term viewpoint, not all the variable remuneration is paid out in the year it is earned: some of it is held in a reserve. The next year, the bonus earned is added to the reserve and a portion of that sum is paid out, and so on. The variable remuneration is modified by applying an individual performance factor based on the individual performance, gauged through a balanced scorecard approach.

- We have a strong performance management system in place. We force-rank all our managers, We reward top-performers disproportionately and put the laggards under the scanner. The best talent in the group is identified through a structured process and monitored carefully. Rewards and recognition are used to spur both individual and team performance. There is a very strong emphasis on performance which needs to be attained within the framework of our cherished values.
- Corporate Governance regulation is here to stay. Regulations do have a major role to play. It is, however, dangerous to have statutes in the area of process. We need to be careful not to go overboard in terms of over regulation that affects entrepreneurship and performance to the extent that they become, as a friend of mine recently said, 'weapons of mass distraction'.

Corporate Governance and Human Resources Management: The best custodians of the long-term interests of a company are its employees - provided they are armed with appropriate opportunities to do so. No one cares more about the future of a company than an employee who has been with - and plans to be with - the company for a considerable period. At the Godrej Group, we have built our HR processes - both formal and informal - around this principle.

- ✦ In each of our business we periodically form two teams of young managers who spend three to four months interacting with a lot of people both inside and outside the organization. They collect data, study developments, and then work out a strategic plan for their business for the next three years. The two teams, we call them the Red Team and the Blue Team, present their strategies to the senior management of the business. The senior management, together with the two teams then forms a larger team called the Plum Team, to finalize a strategic plan for the business using the best ideas from each team. This excercise gives us an excellent opportunity to engage in bottom-up strategic planning.

- ✦ We have constituted a Young Executive Board (YEB) of ten young managers from across functions and businesses in the Group. They are in their late-twenties or early-thirties. They have access to all the information that senior boards do. They look at issues such as strategy, corporate governance, and human resource development that senior boards look at and report their findings once a quarter to the Group Management Committee comprising the CEOs of each business. Membership of the YEB is rotated every two years. This again provides for useful, bottom-up, and independent feedback. Both, the Young Executive Board and the Red and Blue team strategic planning concept, provide for a powerful development tool for our young managers.

- We have a Think Tank whose seven members are senior managers across companies and functions. The Think Tank explores developments in fields such as science, technology, I.T., management, demography, economics, and geo-politics that could be significant threats to or opportunities for the Group. The membership of the Think Tank too is for a period of two years and is subject to rotation.
- As the Chairman, I regularly meet groups of about ten managers over tea for a couple of hours. At the Chairman's tea, we have freewheeling discussions on the Group's progress, on improvement areas, and on what we need to do differently. These sessions provide me with very useful and wide-ranging feedback. The CEOs of our various companies have similar sessions with managers and officers in their respective business which, too, have been found to be very useful.

Corporate Governance and The Board: The third important dimension of corporate governance is the Board of Directors. An alert and well governing Board inhibits conflict of interest of accountants, lawyers, analysts, investment bankers, and consultants; ensures the presence of strong internal controls and a commitment to compliance; and provides third-party verification.

A great board comprises of strong directors. The hallmark of a strong director is courage. He or she must have the courage to protect the interests of the Company, even if it means standing firm and opposing popular opinion. Good directors ought to ask themselves the following questions:

(i) Do I have a conflict of interest?

(ii) Do I have all the facts I need?

(iii) Is communication to shareholders transparent?

(iv) Is it socially responsible?

(v) Is it in the best interest of the company?

(vi) Am I a good steward of assets?

(vii) Would the board be embarrassed?

The Godrej Group is mainly a private group, so I will indicate what we do for corporate governance from the Board point of view in our flagship publicly listed company, Godrej Consumer Products Ltd. GCPL has a strong Board. Half the Board members are independent directors, who are professionals of distinction in their respective fields.

These independent directors are well compensated by Indian Standards and are expected to spend quality time with the company. Our Board meetings last at least half a day. We have a two day offsite Board meeting devoted to strategic issues once a year. The Board inspires and ensures strong corporate governance, strategic posture and performance orientation in the company.

Godrej Consumer Products was the first company in the country to be rated on both corporate governance and stakeholder value creation. The rating firm ICRA has assigned a "CGR2" rating to the corporate governance practices and a "SVG2" rating to the stakeholder value and governance practices, signifying a high level of assurance.

I would like to conclude by emphasizing that corporate governance is not just another management or social fad. *It is the ultimate management tool.* Good corporate governance is a journey and not a destination. It's a very rewarding journey for those who choose the right path. Above all, corporate governance is both, about doing things right and doing the right thing.

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

-- Eugene Black

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The Forum of Free Enterprise is a non-political and non-partisan organisation started in 1956, to educate public opinion in India on free enterprise and its close relationship with the democratic way of life. The Forum seeks to stimulate public thinking on vital economic problems of the day through booklets and leaflets, meetings, essay competition and other means as befit a democratic society.

Membership is open to all who agree with the Manifesto of the Forum. Annual Membership fee is Rs. 100 (entrance fee Rs. 100) and Associate Membership fee Rs. 60 (entrance fee Rs. 40). Students (Graduate and Master's degree courses, full-time Management students, students pursuing Chartered Accountancy, Company Secretaries, Cost and Works Accountants and Banking courses) may enrol as Student Associates on payment of Rs. 10 per year (no entrance fee).

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