CHALLENGES IN CORPORATE GOVERNANCE – A FAMILY BUSINESS PERSPECTIVE

In the last few years, there has been a buzz around the concept of Corporate Governance. To my mind, it is a transparent, ethical, moral and value based framework for managing the affairs of companies. It involves defining a set of transparent systems, processes and principles by which a corporate is run in order to sustainably create wealth for its 'stakeholders'. In other words it should aim at increasing "shareholder value keeping in view the interests of other stakeholders".

By stakeholders, we mean – employees, customers, suppliers, debtors and civil society at large.

But apart from the lengthy systems and processes that one puts in place, it is really the spirit of practice that defines the essence of the concept.

To give a historical perspective:

It was the collapse of some of the prominent companies in the early 90s in the UK that triggered the thinking behind corporate governance. There was a lot of anxiety in the British public, not so much because the companies had collapsed, but because none of their Annual Reports, before the crash gave any indication of the poor financial status of these businesses. Asked to show better growth and profitability many companies were exploiting the weaknesses in accounting standards to report a much better picture than what was really the case. In many of them the Boards had shrunk and the roles of the Chairman and Chief Executive were combined so that one individual effectively ran the company. However brilliant the person, there was a growing realisation that no one individual could be 'right' all the time and needed guidance from independent Board members.

Britain had always enjoyed the reputation of being a dependable financial centre and the London Stock Exchange was concerned that if some steps were not taken this reputation, built up over the years, would get eroded. A Committee set up in 1991 under the chairmanship of Sir Adrian Cadbury published a report on the Code of Best Practices. What is interesting is that this was not a mandatory Code for all public companies and the Code had no legal binding – nor was it prescriptive. However from July 1993 all listed companies were obliged to state in their Annual Reports how far they had complied with the Code and to give reasons for areas of non-compliance. It laid down broad guidelines, which every Board, in its own self-interest, should follow, because when adhered to, the credit-worthiness of the Company would increase in the eyes of the shareholders. We are at the beginning of the new Millennium and yet in advanced, mature economies like the UK, Code of Conduct is not compulsory. What is obligatory is the compliance statement in their Annual Report.

It is worthwhile to remember the rationale given by Sir Cadbury. He said, "the important reason why I believe it is vital for enterprises to set and maintain high ethical standards is that good companies attract good people".

In India, SEBI has introduced the Listing Agreement, wherein Board composition, Audit Committee responsibility, subsidiary companies dealings, risk management, CEO/CFO certification of financials and internal controls, legal compliance and other disclosures have become mandatory.

Corporate Governance 'processes', when followed in spirit, can lead to value creation, as studied by McKinsey. It has been argued that apart from the ethical aspect of being accountable to shareholders and stakeholders, there is a business imperative too, as transparency has a major competitive advantage - winning investor's trust and confidence. According to the McKinsey report, investors in emerging markets including the Middle East are willing to pay as much as 30 percent more for shares in companies with good corporate governance. Companies incorporating even a single element of governance can expect a 10 to 12 per cent boost to their market valuation. However, I would like to believe that we follow corporate governance not merely because it gives you a business advantage but because it makes good business sense – something that we owe to our stakeholders.

Apart from Corporate Governance processes, CRISIL has come out with a correlation between strength of stakeholder relationships and management capability with sustainable wealth creation of shareholders. They study organizations and interview the shareholders, debt holders, employees, customers, suppliers and society at large and come out with a 'Governance and Value Creation' (GVC) Rating. Governance practices like formation and composition of the Board, equitable treatment of all shareholders (whether minority or not), transparency and disclosures amongst others are evaluated and rated.

Coming to family businesses, I feel there is nothing like a family business versus non family business when it comes to corporate governance and sustainable wealth creation. I see no difference at all. Across the world, there are popular names of businesses that have fueled entrepreneurship and enterprise – Tatas, Godrej, Dabur, Ford, Bechtel, Heinz, Johnson and Johnson, Wal-Mart or Ikea. These are brands as big as they can get which are family owned.

It is the implementation and the 'will' to implement governance in a family business, that is the real challenge !

What are some of the issues that crop up in a Family Business?

1. Board :

There are two aspects:

- Structure of the Board
- Role of each Board member

We want a Board that takes independent/unbiased decisions; they are the 'trustees' of the shareholders, especially the minority – entrusted in providing transparent data, taking decisions in the best interest of the 'shareholder'.

In a family business, very often, the Board consists of mostly family members – often those who are there by name, but don't understand or aren't made to understand their duties, or what the business is all about. Sometimes outside members are selected by the owner/entrepreneur as 'rubber stamps' – people who rarely disagree or question the owners thought process or decisions.

It will not be appropriate for me to speak on behalf of all family owned companies with their immense diversity of practices. But I am happy to speak from our own experience at Thermax.

Years before the Cadbury Committee was formed, even when we were a private limited company, our founders, Mr. A S Bhathena and Mr. Rohinton Aga were convinced that we cannot misplace the trust which people have bestowed on us. I remember a friend of my father telling him when we were about to go public: 'now that you are going public, you must be feeling very relieved and your stress level would come down!' My father's prompt response was that in fact his stress level would go up because he had greater responsibility, since he was now dealing not only with his own money, but that of many others who had placed their trust in him.

Until 1999-2000, we ourselves had a Board consisting of four Independent Directors; however, we also had nine executive directors including the three family members who really overpowered the Board. Also, wearing two hats – one of a passionate executive and the other of an impartial/dispassionate Board member – was increasingly difficult. Roles were muddled, decisions were at times biased and voices and advice were internally focused – we were hearing (perhaps not even listening to) a lot of our own voices without having much of an 'outside-in' perspective. This together with our poor performance led to some dramatic changes –just for the sake of survival.

It was in 2000, with help from the Boston Consulting Group that my mother and the family took some very tough decisions, some of which were a complete revamp of the Board and separating ownership from management.

Today as a public listed company, we have five non-executive independent directors, three non executive promoter directors and our managing director. The operations of the company are managed by the Managing Director (a non family member) and an Executive Council. Earlier, the office of the Chairperson in our company had been made non executive paving the way for a real separation of ownership from management. Our Independent Directors have distinguished themselves as professionals who bring us rich experience and expertise. They have been carefully chosen to bring diversity and add a dimension to the business wherein the sum of the parts is greater than each alone. We hold regular Board Meetings 6-8 times a year and a detailed agenda along with necessary data is circulated to all the Board members before the meeting so that each one can make a meaningful contribution. We spend 1 ½ days a year at a retreat (away from Pune) wherein major strategies are discussed and planned.

We have set down a Code of Conduct to be followed by directors and senior management employees as defined in Clause 49 of the Listing Agreement.

We also have five Board Committees – an Audit Committee, Share Transfer and Shareholders' Grievance Committee, Strategic Business Development Committee, Human Resource Committee, Borrowing and Investment Committee and Overseas Investment Committee, which are chaired by various Board members, depending on their expertise. Just to share with you, although some of the Committees are mandatory today, these were set up prior to the introduction of Clause 49. I feel that these Board approved Committees have given us good insights into the pulse of the company without actually running the day to day operations.

We still have a long way to go, but the spirit behind it is what is heartening – we genuinely want to do what is in the best interest of the institution that has been carefully built. It is NOT to serve the promoters' interests or any individuals' interests – it is to serve our vision and create sustainable value for all.

2. Separating ownership from management:

In selecting the CEO of a company, one would want the organisation to be run by the 'most competent' person.

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Having no family owner, it has to be the 'best' professional chosen	Very often, the owner thinks he/she is most capable – there are many who are and that's fine.

However, what happens if he/she is not?

The CEO has accountability and responsibility to the organisation and its shareholders. He or she should be able to be questioned by an 'independent' authority called the Board or Chairperson of the company. In a worst case situation if found unsuitable, he/she is asked to relinquish the position. Practically, it is when the CEO is a family member, this becomes quite difficult and awkward. This is when there is a compromise to the shareholder.

Secondly, if the CEO and Chairperson is one and the same, we get into the same turmoil, since he is the authority within the organisation and on the Board. To avoid such compromises, it is recommended that the two roles be handled by separate individuals. In a Family Business, very often, it is the entrepreneur who is the CMD – all in one; giving up a position, even to hand it over to the next generation is a tough one to crack and therefore complications set in.

In our own company, during my father's time, he was the CMD as well as the principal shareholder. When my mother, Mrs. Aga took over in 1996, she too was

appointed Executive Chairperson by the Board. This over time did create a lot of ambiguity in roles and responsibility between our Managing Director and her – both within and externally. It was then that Mrs. Aga stepped down as Executive Chairperson and handed over the day to day operations to our Managing Director. Initially, this happened only with respect to 'title' but as the organisation learnt and internalized the change, each of us became clear of our roles and responsibilities.

Although it was very painful to relinquish authority, responsibility and accountability to professionals, I think it is one of the best decisions we as a family made.

I am sure you are all aware, 80% of businesses the world over are family owned as is about 40% of Fortune 500 companies. Many of them owe their success to the care they invest in selecting and grooming their leaders.

Which brings me to the third important aspect, especially when it comes to governance in Family Business - 'Succession'.

3.Succession

A change of guard or succession is a complex and stressful event for any business and in the case of family businesses it gets further complicated. In India, irrespective of whether the inheritor is competent or not, there is a tendency to expect family members to run the show. This attitude prevails in the political field too, as can be seen in the case of many of our parties. The situation can get worse when all the siblings aspire for the top slot, and can even be disastrous when the siblings remaining within a single fold pull in different directions. On family business, there is a saying – "the first generation creates, the second inherits and the third destroys!"

"Succession Planning" : the two words seem so simple and easy to follow and yet it is so difficult because it means coming to terms with the fact that you are not indispensable. However great a leader may be, he/she has to realize that the organisation is larger than the individual, that it has an ongoing life of its own, irrespective of who heads it. To my mind, a leader has not been successful if the organisation cannot manage without her and fairs poorly after her exit.

Since there is room for only one person to head the organisation, how do you deal with the aspiration of two or more contenders for this position? There are no easy solutions but we need to have a process for selection as well as being candid and transparent to the person as to why he/she was chosen and dealing with the disappointments of others to ease the situation. We have just gone through this process in selecting our next CEO, who will be taking over in July this year; and of course at the Chairperson level, we went through a planned succession when I took over from my mother in 2004.

The best legacy an outgoing family leader can bestow on the next generation is to ground them in the values cherished by the family, and that are valued as the hallmark of that organisation. For example, values like passion for quality, customer-focus, professional integrity or giving back to Society. Smooth succession can be an important value that can save many family businesses; and is certainly a very important aspect of governance.

I'd like to end with some insightful thoughts summarized by my father, late R.D.Aga way back in the early 90's:

He talked about ownership:

1. Our views on "ownership" stem from a belief that one can own a company without owning it. This is articulated by a statement I often share with the group that my vision is not to build a dynasty but to build an institution.

2. Public ownership devolves on us an accountability for other people's money. This is best addressed by a conviction that the promoter's role is akin to a trustee so far as the outside investor is concerned.

We often talk of People as being our most valuable resource. But we have to translate that statement into action. I believe that this is going to be the greatest challenge in the changing environment.

He talked of Corporate Governance as "organizing and running a company – to generate a profit." And he maintained – "Profits must remain the ultimate measure of performance. But I would like to believe that profits in the final analysis is not just a set of figures, but of values. And that is what Corporate Governance is all about".