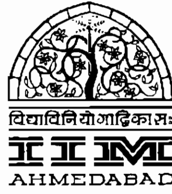

Working Paper

CORPORATE GOVERNANCE FOR SHAREHOLDER VALUE

By

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Abstract

In the last few years there has been serious debate about the generally poor quality of corporate governance in Indian companies and the need to improve the same. This has led to the publication of a recommended code of corporate governance by the Confederation of Indian Industry (CII). More recently, the Securities and Exchange Board of India (SEBI) formed its own committee on corporate governance and its recommendations are sought to be implemented through amendments to the Stock Exchange Listing Agreement.

This paper traces the emergence and spread of the shareholder value and corporate governance movements in other countries and examines the structural reasons that may have contributed to the serious governance problems in Indian companies despite convergence of management dominant equity ownership. It is argued that while CII and SEBI initiatives might be welcome, they seem to address only the form and not the substance in relation to corporate governance. Some suggestions for further improvement of the SEBI guidelines (under the new clause 49 of the Listing Agreement are given. The corporate governance charter issued by Warren Buffet (called the Owners' Manual) to the shareowners of Berkshire Hathaway is discussed by way of illustration to highlight the fact that good corporate governance is essentially a question of managerial attitude and goes often beyond regulatory fiats.

CORPORATE GOVERNANCE FOR SHAREHOLDER VALUE

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One hopes all the recent debates on corporate governance in India do not merely end up as a corporate flavour of the month, now that the concept has been given some kind of official blessing. The Securities and Exchange Board of India (SEBI) has been quick to give some teeth to its own Kumar Mangalam Birla Committee recommendations through prompt amendments to the stock exchange listing agreements whereby listed companies would henceforth have to comply with a set of guidelines for better corporate governance. We have moved far forward from the days of the CII (Confederation of Indian Industry) code of corporate governance, a recommended code of practice. Welcome as these developments are, we must recognise that corporate governance is far more than a set of norms or guidelines, but rather it is inextricably intertwined with the *raison d'etre* of the corporate form of organisation, viz., shareholder value. We argue that corporate governance and shareholder value management are two sides of the same coin; ***effective corporate governance essentially involves establishing and maintaining a robust managerial architecture sharply focused on creating and sustaining wealth for the large body of shareowners***. In other words, in its broadest sense corporate governance is nothing but managing for shareholder value. This extreme view should trigger instant protests. Many would argue that a corporation has several other stakeholders (such as employees, customers and community) and shareholders are but one of them; and good corporate governance should balance the interest of all these stakeholders. As we shall note there is no serious contradiction between these two and it is a question of relative emphasis. Irrespective of the philosophical preferences, there is no gainsaying that a corporation should be governed effectively through sound systems and robust practices. Corporate governance essentially refers to the bundle of rules, procedures, conventions and practices for making decisions on corporate affairs with particular emphasis on protecting the residual claims of equity shareholders

This paper is divided into 5 parts. We begin with a quick review of the concepts of shareholder value and corporate governance in Part 1, followed by brief discussion in Part 2 on the recent trends in the international context. In Part 3 we examine some of the key issues and problems in these areas in the Indian context. We attempt in Part 4 a short critique of the Indian corporate governance initiatives and offer some suggestions for improvements. We conclude in Part 5 with a brief discussion on what we believe to one of the most powerful articulation of corporate governance practised by any company, the so-called ***Owners' Manual*** issued by Warren Buffet of Berkshire Hathaway, Inc.

1 Shareholder value and corporate governance

1.1 Shareholder value: a conceptual review:

Shareholder value, as is known, is typically measured by the changes in the market price of a company's shares and the dividends distributed by the company during the reference period. To put it differently, (shareholder) value creation involves generating consistent returns on shareholders' investments through dividends and more significantly through increases in the market price of the shares of the company concerned. It is widely recognised that the source of shareholder value, i.e., the key determinants of changes in a company's share price over time, is the cash flow generating potential of the company's business and the returns expected by investors consistent with the risk they are called upon to take. To paraphrase Rappaport [1], "the shareholder value approach estimates the economic value of a corporate [action] by discounting forecasted cash flows by the cost of capital. These cash flows in turn serve as the foundation for shareholder returns from dividends and share price appreciation". Cost of capital is nothing but the investors' expected return that in turn is influenced by the risk profile of the cash flows.

Managing for shareholder value (MSV) involves maximising cash flows over time in a manner that would help service the diverse categories of investors through giving them appropriate returns commensurate with the risk they carry. MSV emphasises that cash flows are the most important sources of value and any corporate action involving cash outlay could be justified only if future cash flow, on discounting at an appropriate cost of capital, generates a positive net present value.

In as much as the total value of any enterprise at a given time is represented the present value of its future cash flows, the claims of the various security holders have to be satisfied out of this value pool. Equity shareholders, by definition, have the residual claims to this value pool once the (mostly) fixed obligations of other security holders are satisfied. Shareholder value or wealth is nothing but this residual or equity portion of this value pool $\boldsymbol{V_c}$ as shown below.

(1) Company value $(\boldsymbol{V_c})$ = PV of future cash flows = Value of debt $(\boldsymbol{V_d})$ + Value of equity $(\boldsymbol{V_e})$

(2) $$\boldsymbol{V_e = V_c - V_d}$$

Ideally this should be equivalent to and captured by the market capitalisation of the company concerned.

A commonly used, comprehensive model is the free cash flow to the firm **(FCFF)** [1] model summarised up below.

(3) V_c = Sum of discounted annual free cash flows (**Fcf**), with yearly cash flows discounted at a cost of capital (K_c)

(4) K_c = Cost of equity (K_e) + Cost of debt $((K_d)$, both K_e and $(K_d$ duly adjusted for the respective weightage in the target (planned) capital structure of the company.

Since companies have perpetual existence, V_c (the firm valuation), should capture the expected Fcf through the future and Fcf typically represents the net cash flows after providing for incremental investments in fixed and working capital.

And often the significant source of positive cash flows is profits, after accounting all expenses and taxes. Since increasing stream of cash flows is a function of volumes, output prices and cost of and efficiency in input consumption, the entire gamut of growth and operating strategies pursued by a company management is captured in this valuation model. By the same token, since increase in present value can also be influenced, besides increases in cash flows, by lowering the cost of capital, the importance of financing mix through an optimal debt-equity mix is also recognised by the FCFF valuation model. Similarly the dimension of risk is also incorporated both through adjustments in the cash flows and in the cost of capital. To reiterate, any corporate decision, whether it be an expansion project or acquisition could be considered to be shareholder value creating or enhancing only if the project or the acquisition generates positive cash flows in present value terms over its life. See Rappaport (*supra*) for detailed discussion on shareholder value

There is considerable empirical evidence that stock market valuation of a company invariably trends towards its free cash flow valuation [2] and thus the key to shareholder value management is maximising the cash flow generation over time and/or lowering its cost of capital. This underscores that company management should undertake transactions only if they are capable of generating positive present value generating cash flows. A corollary to this rule is that company's management should be open and required to distribute an increasing portion of its cash flow generation by way of dividend to its shareholders rather than reinvesting in negative present value generating investment projects. If the investors reckon that a company management pays for an acquisition a very high price that is unlikely to be recouped by the present value of the post-acquisition *incremental cash flows-i.e.,* the standalone cash flows of the acquired business plus the post-acquisition

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1 There are alternative models like cash flows to equity, adjusted present value etc. in which both cash flows and discount rates are adjusted and would theoretically give the same results.

synergistic and efficiency gains- the deal will end up as shareholder value destroying. And as one would expect, the acquiring company's share price would fall on the announcement reflecting the expected value destruction, a far too common feature in take-over situations. See Venkiteswaran[3] for a discussion on the shareholder value consequences of corporate restructuring.

There has been considerable debate on the appropriateness of a somewhat narrowly-focused shareholder value-oriented approach, referred to as the Anglo-American model. Critics favour the more broader stakeholder-oriented European (particularly German) model which states that "its [a company's] objectives encompass the interests of a wide range of stakeholder groups-investors, employees, suppliers, customers and managers - but cannot be equated with any of them"[4]. In reality a compromise view has emerged that while explicitly recognising the importance of other stakeholders does accord precedence to shareholder value as the *raison d'etre* of a corporate organisation, as for example:

"Generating long-term economic gain to enhance shareholder (or investor) value is necessary to attract equity investment capital, and is, therefore, the corporation's central mission. At the same time, however, corporations must function in the larger society........Full transparency of economic and non-economic objectives...... will be necessary in the global competition for capital".[5]

1.2 Corporate governance

Corporate governance has been variously defined as "the system by which companies are directed and controlled"[6] or "as providing a structure within which stockholders, directors and managers can pursue most effectively the objectives of the corporation"[7]. To quote OECD, "[corporate governance) involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company's are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interest of the company and its ***shareholders***......, thereby encouraging firms to use resources more efficiently.[8] (Emphasis supplied).

From the earlier discussions it is evident that managing for shareholder value at the broadest level would involve the following.

- Increasing the size of the "value pie" through sound management of the key value-drivers, i.e., appropriate investment, efficiency-enhancing and risk minimisation strategies.
- Managing the claims of other security holders such as bond-holders in such a way that value transfers to them are not excessive.

As a natural corollary from the above it emerges that:

- Shareholders do have full information at all times to understand the value creation performance as well as to make their own assessment of the future value creation potential under a management, and
- Shareholders do have say in transactions that might lead to significant value transfers to other security holders.

And also in view of the fact substantial resources are increasingly being vested with company management that is typically divorced from ownership there is widespread concern about the agency problems in modern corporations; i.e., the possibility that managers may not always act in the best interest of the shareholders. Serious managerial misdemeanours as in the case of the Maxwell group in UK in the early 1990s have only heightened the concerns. Consequently introducing checks and balances on operating management has emerged as a key aspect of corporate governance. These include:

- Expanding the role of the outside directors in key areas
- Strengthening the audit function through processes such as the constitution of audit committee of the Board of Directors.

The principal elements of the corporate governance initiative in most countries seek to address these issues.

2 Why corporate governance?- international experience

A variety of global economic developments and country specific factors account for the corporate governance movement gaining importance in the eighties and nineties. At the heart of the movement is the increased deregulation and globalisation of capital markets. While this has improved the access to a wider pool of capital and also enhanced financing flexibility and options to companies, "greater competition for capital {also] results in greater pressure corporate economic performance and significant pressures on long-standing relationships with employees"[9]

Closely linked to this has been the steady rise of institutional holdings in the ownership structure of companies in the US and UK (to about 60%), and the more activist role they were beginning to play. Particularly in the US and the UK, institutional investors like the pension funds and the mutual funds began taking more proactive stance in trying to the fix the problems in underperforming companies rather than selling out their holdings in them. Funds like CalPERS, the California Public Employees Retirement System, began targeting poorly performing companies in its portfolio for intense monitoring. CalPERS put the management of such companies on notice on the need to take urgent corrective steps to improve governance (which in their view was synonymous with shareholder value) or face the power of their enormous voting power. In the words of CalPERS "corporate governance has become a powerful force in American business in a short span of the past two decades.

The movement may best be described as the prudent exercise of **ownership rights, toward the goal of increased share value"** (Emphasis supplied). Similarly a UK institutional investor, Hermes Investment Management Limited, stated in 1997: " the role of corporate governance is to ensure that companies are run in the long term interest of shareholders. [....] a company run in the long term interest of shareholders will need to manage effectively relationships with its employees, suppliers, customers and with regard to the common weal". With the integration of global capital markets such institutional investors began investing in Europe and Asia as well, slowly but unmistakably sensitising companies in these regions also to the (Anglo-American) concept of corporate governance and shareholder value management.

The emergence of an extremely active market for corporate control or take-over market in the US and UK since the eighties gave a major fillip to a greater shareholder value-oriented corporate governance system in these countries. Financial engineering driven bust--up specialists and LBO investors such as Hanson, Carl Ichan and KKR came to scene with a sharp eye for value and capacity for value unbundling and capture and began acquiring under-performing companies with a view to clean them up. Faced with the real threat of hostile acquisitions, errant and slack company boards quickly fell in line with renewed emphasis on shareholder value-based governance system. In the well known case of RJR Nabsico which was subjected to a bid from the company's own chief executive, the special committee consisting of outside directors did a remarkable job of extracting maximum value to the shareholders before selling out to the rival bidder, KKR.

In the UK a series of corporate failures and scandals in the early nineties such as the collapse of Polly Peck and Maxwell Group saw some new initiatives to improve the standards of corporate governance to avoid recurrence of such events. The Cadbury (1992) and Greenbury (1995) Committees were set up in this context. Subsequently, another Committee was set up under Sir Ronald Hampel on the sponsorship of a number of agencies including the London Stock Exchange. The Hampel report issued in early 1998 recommends specific practices covering the following areas.

- Directors: The role and duties of the board of directors, board appointments, composition and balance, directors' remuneration etc.
- Shareholders: Emphasis on the important role of institutional investors to make considered use of their votes.
- Accountability and audit:: Financial reporting, internal controls and the audit function.
- Reporting on the compliance with the above recommendations.

In April 1999, the Organisation for Economic Co-operation and Development (OECD) released the OECD Principles of Corporate Governance that emphasise the following.[10]

- Protection of the rights of shareholders, including the right to secure methods of ownership registration, right to participate and sufficiently informed on, decisions concerning fundamental corporate changes etc. It is

also reiterated that "the markets for corporate control should be allowed to function in an efficient and transparent manner" and "anti-take-over devices should not be used to shield management from accountability"
- Equitable treatment of all shareholders.
- Recognising the rights of stakeholders.
- Disclosure and transparency. Disclosure should include, besides the financial and operating results, major share ownership and voting rights, foreseeable risk factors and governance structure and policies.
- The responsibilities of the board. These include the strategic guidance of the company, management selection and compensation, the effective monitoring of management and the board's accountability to the company and its shareholders.

The East Asian crisis of the late nineties brought into sharp focus the weak corporate governance structures and practices in these countries, as banks and governments struggled to unravel the mysteries of the complex web of cross-holdings and subsidiaries of some of the largest companies in the world. For example it has taken several man-years of special investigative study just to get a ballpark estimate of the liability of the leading South Korean *keiretsu*, Daewoo to banks and institutions. Not surprisingly in many of these countries a key area targeted for urgent reforms in the post-crisis period has been corporate governance.

It may be reassuring in a discussion on corporate governance to note that as per a recent McKinsey research study[11], companies with high corporate governance standards were worth significantly more to investors than with low governing standards.

3 Governance-related issues and problems in the Indian context

One comes across a variety of problems in the governance of Indian companies from a shareholder value point of view-many of them unintended consequences of the economic and the regulatory policies pursued over the years.

a) One striking feature of the Indian corporate sector in general is the fact that substantial shareholders also wield significant managerial power. The concept of "promoters" theoretically should address the agency problems typical in the other countries. The managers, also being the major shareholders, could be easily expected to act in the interest of *all* the shareholders. Unfortunately Indian experience appears to have been otherwise. Since management control does offer substantial "control rents" that need not be shared with all the shareholders, management control has come to be viewed as an end in itself. Ownership of substantial shareholding has come to be viewed as the "price" to pay for securing management control to capture the "rent", rather than as a direct indicator of the wealth-creation outcome. We believe that financial

institutions' insistence on a minimum promoters' contribution for every project they finance has contributed to the moral hazard problem; setting up large projects probably had come to be accepted as a goal per se irrespective of the shareholder value consequences thereof for the shareholders at large.

b) It flows from the foregoing that wealth creation/distribution in Indian companies takes place not so much in proportion to ones shareholding as on the basis of whether one is a management shareholder or otherwise. This "we" vs. "they" distinction of shareholders and the resulting unequal treatment of shareholders have been one of the most serious deficiencies of corporate governance in India.

c) Corporate actions involving serious conflicts of interests and self-dealing are so common that they hardly ever raise any eyebrows. Thus companies routinely route purchase/sales/export transactions through "sister" companies or invest in other "group" companies for purely family or filial reasons. Companies including multinational subsidiaries spend large sums on advertisements and promotions on brands that they do not own, but merely licensed to them by their promoter/parent companies for limited periods. Setting up of multiple units in the same industry or setting up 100% subsidiaries by MNCs in India in competition with their own listed subsidiaries are, *prima facie*, against the interest of minority shareholders of the concerned companies.

d) The single-minded focus on management position has often led to internecine quarrels amongst the members of the promoter family for control. Outside directors including institutional nominees and major institutional shareholders have been unable to prevent consequent drift and massive erosion in shareholder value. Similarly when companies are split or divided amongst warring family factions, there has been very little regard for shareholder value consequences thereof.

e) The overly pre-occupation with management control has often meant that a company management, more often than not, does not act in the larger interest of *all* the shareholders. For example, a leading company (say, company "X") already reeling under severe import-led competition let a value-creating merger opportunity with its key customer slip-off, as the management did not want to cede control. The latter company (say, company "Y") accounting for about 40% of the output of "X" itself decided to integrate backwards by setting up new manufacturing facilities. The serious adverse implications for "X" and its shareholders could very well be imagined.

f) Working in a tightly regulated environment for decades in which strategic lead often meant obtaining a bunch of licenses (and pre-empting others) and core competencies were often touted as "managing the environment", most Indian companies were found wanting in strategic thinking and competitive response in a fast-deregulating environment. In

a sense Indian management had inadequate appreciation of the key value drivers and their impact on shareholder value in the changing scenario. The theory floated by several well-known CEOs that issuing shares at a high price was "cheap equity" in the aftermath of issue price deregulation is but an example of this. Similarly any type of diversification may have been fine in a licensing regime, but not any more. A shareholder-valued focused company management should always remember that investors can always diversify directly through rebalancing their portfolio in the market and the company should be able to create unique value, not available otherwise, in its diversification efforts.

g) Indian companies have been traditionally pursuing growth through the inter-corporate investment/lending route and routing investments through a web of investment companies. We believe that the institutional requirements of promoters' contribution in an era of high tax rates, extremely restrictive licensing and the so-called anti-monopoly regimes and filial reasons had probably contributed to this pattern. This route of growth has been accepted as conventional wisdom in India. However any inter-corporate investment is *prima facie* shareholder value destroying for the investing company and its non-promoter shareholders, a recognition that is gaining acceptance only belatedly.

h) In a milieu of socialist philosophy, the government and government controlled financial institutions were at best ambivalent and at worst negative to shareholder capitalism. Issues like dividend distribution were actively discouraged. High wealth tax meant that companies did not work for maximising shareholder wealth! And a formula-driven issue pricing by the former office of the Controller of Capital Issues meant little incentive for value creation. Also recall the days when the government proposed, in a sudden fit of environmental concern, that companies need to send only abridged annual reports to their shareholders. Financial institutions continue to be a confused lot, unable to reconcile their differing roles as development agencies, lenders and shareholders. The chairman of a leading development bank was quoted as stating not long ago that the institutions would be averse to funding corporate take-overs, as take-overs create no new assets, even as the same institution was saddled with a large portfolio of non-performing assets from under performing units.

i) The boards of directors of companies in India-whether they be promoter or MNC controlled-have been typically dominated by insiders. Often the only outside directors have been the nominees of the financial institutions who were typically their own executives or retired bureaucrats. It is again accepted as conventional wisdom in India that managerial succession *has to be* from the promoter's family, irrespective of merit or proven competence. It is hardly ever surprising that such governance structure had very little shareholder orientation.

j) The financial institutions by virtue of the stringent covenants in loan

agreements were in an ideal position to improve governance of Indian companies. Large shareholdings in companies, nominee directorship, convertibility clause and host of restrictive covenants meant that they could force good governance on companies. Unfortunately this not materialise due to a combination of slack monitoring, failure to intervene and act decisively and more importantly inability or unwillingness to sell out in favour of new investor-managers.

k) It is widely believed that company managements in India routinely indulged in insider trading; given their dual positions as large holders of corporate equity and top management positions, it would have been only surprising had it been otherwise. Managements are believed to indulge in "pump and dump" operations. Financial and investment institutions by virtue of the nominee directorship and special reporting and approval requirements have also been privy to information not available to the public investors.

l) The virtual absence of a market for corporate control meant that there was no institutional mechanism to either correct errand management or for that matter recapture value embedded in poorly performing companies. Unhelpful legal/tax provisions and tardy institutional approach in decisively dealing with problem cases have certainly contributed to the twin syndromes.

m) Investor communication and disclosure practices, another important dimension of good governance, were woefully inadequate. In the context of the slow emergence of rigorous accounting and reporting standards in India, there was considerable room for creating accounting. Directors' reports continue to exhibit their concern to control the stationary costs! They offer very little insights either in terms of past performance or future potential.

Thus traditionally Indian companies have had very little to show in terms of a shareholder value focus or a robust corporate governance system. As we have seen the regulatory and institutional structures enacted under the politico-economic philosophies of the time were largely responsible for this. However it is heartening to note that the situation is changing for the better, though not as rapidly as one would like to have.

4 Improving corporate governance practices in India

4.1 Emerging trends

We believe that the entry of foreign institutional investors (FIIs) into the Indian market has brought about salutary changes in the realms of shareholder value orientation and corporate governance amongst Indian companies. Another contributory factor has been the instances of Indian companies accessing overseas capital markets and the consequent need to

comply with the stringent overseas (typically US) regulatory requirements and investor expectations. With the sharp growth in domestic mutual funds industry and the increased investor participation in the capital of public sector financial institutions themselves, domestic institutions have also begun to emerge as activist investors. More recently the emergence of knowledge-based companies in what has come to be known as the convergence sector (Information Technology, Communication and Entertainment) run typically by first generation entrepreneurs with very little legacy assets or managerial hangovers has also helped to set new governance standards. No doubt the major reforms in the capital market concurrently carried out by SEBI and a more responsive tax regime have also reinforced the momentum. Underlying to all this has been the change in the economic philosophy of the political leadership. While shareholder value orientation has probably spread rapidly, we believe that changes in the corporate governance philosophy and practices have been somewhat slow to catch on. See the following trends.

a) In the aftermath of a variety of institutional and regulatory reforms particularly in the latter half of the nineties, there is believed to be greater maturity and sophistication in the process of price discovery and formation in the Indian stock market. The Indian market has been quick to punish the managerial "excesses" of the post-reform period including reckless investments in mega-projects. Value creation is giving place to size and growth as the key measure of corporate performance by the market, leading to re-orientation in corporate thinking.

b) Institutional investors, particularly FIIs, have been quick to respond to questionable managerial practices and shareholder-unfriendly decisions by selling out in the market, forcing company managements to review their decisions. Anxiety to attract institutional investments into their companies has also prompted managements to be genuinely shareholder-friendly and introduce better corporate governance practices. Corporate initiatives include large scale restructuring, elimination of cross-holdings and inter-corporate investments, broad-basing of boards, better investor communication etc. Growth of the security analyst profession and a more enabling regulatory environment have also helped.

c) There has been a sea change in the quality and frequency of information made available to the shareholders at large. Introduction of quarterly earnings releases, publication of detailed supplementary information including US GAPP financial statements by several leading companies are but some examples. Moreover leading companies are being actively "followed" by the security analysts; as result major corporate decisions are quickly analysed and reported on for their shareholder value consequences.

d) At least two leading Indian groups have taken initiatives to separate active management from ownership. The promoters have withdrawn from active management positions and seek to perform the monitoring role as investors through a supervisory board and/or the regular corporate board.

The success of this experiment will be keenly watched.

e) The corporate governance initiatives of CII and now SEBI are certainly welcome steps in the right direction. Now that the stock exchange listing agreements have been amended to include the SEBI guidelines, listed companies have certainly greater accountability in this regard. However we believe that far more needs to be done to strengthening the governance practices in India. In this context a brief analysis of the SEBI guidelines on corporate governance (being implemented under a new clause 49 to listing agreement) is given below.

Area	Requirements	Comments
Board of directors	Induction of "independent" directors- up to one-third to one half of the Board's strength"	Definition of "independent" too generous. Relatives of directors, other members of promoter family can come under "independent" directors.
Audit committee	The majority membership of audit committee to consist of "independent" directors. Role and powers of the audit committee defined	
Remuneration of directors	Board to decide remuneration of non-executive directors.	Need to include annual review of CEO's performance. No requirement regarding managerial succession planning.
Board procedure	Conduct of at least four Board meetings a year. Information to be placed before the Board to include annual budgets, quarterly results including segment reports, capital budgets/updates minutes of audit committee, regulatory updates and compliance, information on recruitment and remuneration to senior executives etc.	
Management	Directors' report to shareholders to include detailed Management Discussion and Analysis *within the limit set by the company's competitive position.* (italics given)	Very welcome development. It is possible that companies use the escape route to withhold material information
Shareholders	Disclosure of brief resume of persons being nominated to the Board Placement of quarterly results and Analysts' presentation on the company's website.	Very welcome suggestions. Provide for also continuing disclosure in annual reports on other directorship and date of first election to the board. Website disclosure should also cover presentations made to financial institutions that are shareholders.

4.2Some suggestions

While the aforesaid provisions are in deed welcome as a beginning, we believe they have not gone far enough to address more serious deficiencies in

governance of Indian companies. Some suggestions for further toning up are given below.

a) The concept of promoter-managers should be steadily de-emphasised in favour of a system of managerial succession based on merit-based considerations rather than mere birth. The supervisory board model experimentation by some Indian companies referred to earlier is certainly worth-emulating. In the meanwhile at the first sign of internecine quarrels, outside directors should take charge and ensure orderly managerial transition. Institutional shareholders, with their large voting power, have to play a far more pro-active role in this regard.

b) Whenever there are transactions that involve potential conflict of interest (e.g. acquisition/merger of a group company), the same should be overseen by a committee of outside directors only.

c) It is to be recognised that an active market for corporate control is *sine qua non* disciplining force in any healthy corporate governance system. SEBI's current Take-over Regulations seeks to perpetrate the system of promoters, are heavily biased in favour of outgoing and incoming management, thereby compromising the position of minority shareholders. Examples include the high cut-off of 15% to trigger public offer, the annual 5% creeping acquisition exemption limit, and even in the event of public offer limiting public offer requirement to mere 20%. As one has witnessed in recent times, not surprisingly promoters have exited comfortably, shutting the exit route for shareholders. The take-over rules have to drastically revamped to make them more shareholder-friendly, like for example, insisting on full-scale bid or 100% acquisitions. Similarly the incumbent board of directors of a company subject to a bid must have a very clear role vis-à-vis its shareholders. The board should take a view on the bid and the bidder, the offer price and post-acquisition strategy of the bidder etc. and formally communicate the same with their recommendation to shareholders.

d) While the quality of information dissemination requirements vis-à-vis shareholders, in general, has improved a great deal in recent times, the same cannot be said in respect of corporate restructuring transactions. Sections 391-394 of the Companies Act that deal with various types of arrangements (including mergers, de-mergers etc.) has not kept pace with the times[12]. As a result the information sent to shareholders under section 393 continues to be remain sketchy; consequently lately there have been any number of controversies surrounding such transactions. Without waiting for amendments to the Companies Act, SEBI could step in to improve the disclosure norms, perhaps by amending the listing agreement. The relevant information should include the following.

   - Brief background of the companies/parties involved in the merger/de-merger transactions and the strategic context surrounding the proposal.

- Summarised operating and financial performance data for the previous five years and for the current year to the latest quarter.
- Risk factors, so that investors can assess the impact on the overall risk profile consequent to the transaction in question.
- Proforma/restated financial statements *after* giving effect to the proposed merger/de-merger.
- Tax consequences of the transaction.
- Effect, if any, of the proposed arrangement on the claims of various security-holders.
- Effect of the proposed arrangement on shareholding/ownership structure including promoter and other principal shareholdings (i.e. before and after the transaction)
- The number of shares/other securities to be issued consequent to the transaction under various possible scenarios.
- Valuation report and fairness opinion justifying the proposed exchange ratio.
- Explicit reporting as to whether the companies concerned planned to make any make fresh issue before the completion of the merger, and if so, the method of adjusting the previously announced exchange ratio consequent to the above.
- Intention about the possible purchase of the shares of one or more companies involved in transaction by the other company or companies, the maximum number of shares to be purchased and the maximum amount to be utilised for the purpose and the treatment of the consequent shareholding in the merger.
- In the case of demerger, the specific plans envisaged for the resultant (demerged) companies including promoters' continued commitment or exit plans, indicative time schedule for stock exchange listing etc.

e) Conduct of annual general meeting:
There has been a tendency amongst companies to shift their registered offices to a factory location, where very few shareholders reside. In the interest of good corporate governance, it is suggested that shareholder meetings are held only in locations where a large number of shareholders reside, so that these meetings serve the intended objective.

The above is only an illustrative list the spirit of which could be extended to other corporate governance situations.

5 Corporate governance: a question of trust

The bottom line in any debate of corporate governance boils down to a question of trust. Company managements that seek to attract investors' savings all the time must conduct to reassure them that their savings are in safe hands and that it would be their endeavour to maximise returns through value creating investments. Shareholders trust is reinforced through transparency and communication so that investors face no surprises and they have at all times meaningful information for a buy/hold/sell decision. However much one may

wish, the whole gamut of corporate governance ideals might not be legislated upon. Ultimately it's a question of management attitude. Good corporate governance often goes far beyond legislative fiats. In this context, we believe that the corporate governance code enshrined in the *Owners' Manual* issued by the legendary Warren Buffet, the Chairman of Berkshire Hathaway, Inc., to the company's shareholders is the most reassuring document. The thirteen governance principles of Buffet are quoted below.[13]

1) *Although our form is corporate, our attitude is partnership. Charlie Munger and I think of our shareholders as owner-partners, and of ourselves as managing partners. (Because of the size of our shareholdings we are also, for better or worse, controlling partners.) We do not view the company itself as the ultimate owner of our business assets but instead view the company as a conduit through which our shareholders own the assets.*

2) *In line with Berkshire's owner-orientation, most of our directors have a major portion of their net worth invested in the company. We eat our own cooking. Charlie and I cannot promise you results. But we can guarantee that your financial position will move in lockstep with ours for whatever period of time you elect to be our partner. We have no interest in large salaries or options or other means of gaining an edge over you. We want to make money only when our partners do and in exactly the same proportion. Moreover, when I do something dumb, I want you to derive some solace from the fact that my financial suffering is proportional to yours.*

3) *Our long-term economic goal (subject to some qualifications mentioned later) is to maximise Berkshire's average annual rate of gain in intrinsic business value on a per-share basis. We do not measure the economic significance or performance of Berkshire by its size; we measure by per-share progress. We are certain that the rate of per-share progress will diminish in the future - a greatly enlarged capital base will see to that. But we will be disappointed if our rate does not exceed that of the average large American corporation.*

4) *Our preference would be to reach our goal by directly owning a diversified group of businesses that generate cash and consistently earn above-average returns on capital. Our second choice is to own parts of similar businesses, attained primarily through purchases of marketable common stocks by our insurance subsidiaries. The price and availability of businesses and the need for insurance capital determine any given year's capital allocation.*

5) *Because of our two-pronged approach to business ownership and because of the limitations of conventional accounting, consolidated reported earnings may reveal relatively little about our true economic performance. Charlie and I, both as owners and managers, virtually ignore such consolidated numbers. However, we will also report to you the earnings of each major business we control, numbers we consider of great importance. These figures, along with other information we will supply about the individual businesses, should generally aid you in making judgements about them.*

6) Accounting consequences do not influence our operating or capital-allocation decisions. When acquisition costs are similar, we much prefer to purchase $2 of earnings that is not reportable by us under standard accounting principles than to purchase $1 of earnings that is reportable. This is precisely the choice that often faces us since entire businesses (whose earnings will be fully reportable) frequently sell for double the pro-rata price of small portions (whose earnings will be largely unreportable). In aggregate and over time, we expect the unreported earnings will be fully reflected in our intrinsic business value through capital gains.

7) We use debt sparingly and, when we do borrow, we attempt to structure our loans on a long-term fixed-rate basis. We will reject interesting opportunities rather than over-leverage our balance sheet. This conservatism has penalised our results but it is the only behaviour that leaves us comfortable, considering our fiduciary obligations to policyholders, lenders and the many equity holders who have committed unusually large portions of their networth to our care. (As one of the Indianapolis "500" winners said: "To finish first, you must first finish.")

8) A managerial "wish list" will not be filled at shareholder expense. We will not diversify by purchasing entire businesses at control prices that ignore long-term economic consequences to our shareholders. We will only do with your money what we would do with our own, weighing fully the values you can obtain by diversifying your own portfolios through direct purchases in the stock market.

9) We feel noble intentions should be checked periodically against results. We test the wisdom of retaining earnings by assessing whether retention, over time, delivers shareholders at least $1 of market value for each $1 retained. To date, this test has been met. We will continue to apply it on a five-year rolling basis. As our net worth grows, it is more difficult to use retained earnings wisely.

10) We will issue common stock only when we receive as much in business value as we give. The rule applies to all forms of issuance - not only mergers or public stock offerings, but stock-for-swaps, stock options, and convertible securities as well. We will not sell small portions of your company - and that is what the issuance of shares amounts to - on a basis inconsistent with the value of the entire enterprise.

11) You should be fully aware of one attitude Charlie and I share that hurts our financial performance: Regardless of price, we have no interest at all in selling any good businesses that Berkshire owns. We are also very reluctant to sell sub-par businesses as long as we expect then to generate at least some cash and as long as we feel good about their managers and labour relations. We hope not to repeat the capital-allocation mistakes that led us into such sub-par businesses.

And we react with great caution to suggestions that our poor businesses can

be restored to satisfactory profitability by major capital expenditures. (The projections will be dazzling and the advocates sincere, but, in the end, major additional investment in a terrible industry is usually about as rewarding as struggling in quicksand.) Nevertheless, gin rummy managerial behaviour (discard your least promising business at each turn) is not our style. We would rather have our overall results penalised a bit than engage in that kind of behaviour.

12) *We will be candid in our reporting to you, emphasising the pluses and minuses important in appraising business value. Our guideline is to tell you the business facts that we would want to know if our positions were reversed. We owe you no less. Moreover, as a company with a major communications business, it would be inexcusable for us to apply lesser standards of accuracy, balance and incisiveness when reporting on ourselves than we would expect our news people to apply when reporting on others. We also believe candour benefits us as managers: The CEO who misleads others in public may eventually mislead himself in private.*

13) *Despite our policy of candour, we will discuss our activities in marketable securities only to the extent legally required. Good investment ideas are rare, valuable and subject to competitive appropriation just as good product or business acquisition ideas are. Therefore we normally will not talk about our investment ideas. This ban extends even to securities we have sold (because we may purchase them again) and to stocks we are incorrectly rumoured to be buying. If we deny those reports but say "no comments" on other occasions, the no-comments become confirmation.*

To the extent possible, we would like each Berkshire shareholder to record a gain or loss in market value during his period of ownership that is proportional to the gain or loss in per-share intrinsic value recorded by the holding company during that period. For this to come about, the relationship between the intrinsic value and the market value of a Berkshire share would need to remain constant, and by our preference at 1-to-1. Obviously Charlie and I can't control Berkshire price. But by our policies and communications, we can encourage informed rational behaviour by owners, that in turn, will tend to produce a stock price that is also rational.

Our it's-as-bad-to-be-overvalued-as-to-be-undervalued approach may disappoint some shareholders. We believe, however, that it affords Berkshire the best prospect of attracting long-term investors who seek to profit from the progress of the company than from the investment mistakes of their partners.

[Intrinsic value: Discounted value of the cash that can be taken out of a business during its remaining life]

There is no better way to end a paper on corporate governance than reflecting on these mantra. And it may not be a comforting thought to investors at large that there are not many Buffets in the world presiding over companies.

1. Rappaport, Alfred (1986), Creating Shareholder Value: The New Standard for Business Performar New York, The Free Press, pp 12.

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3 N. Venkiteswaran, Corporate Restructuring for Shareholder value, Management Accounting and Research, ICAI, 1997 Vol. 1-1.

4 John Kay, The Business of Economics, 1996

5 Corporate Governance: Improving Competitiveness and Access to Capital in Global Capital Markets, OECD, 1998.

6 Cadbury Report on Financial Aspects of Corporate Governance, 1992.

7 Statement on Corporate Governance, The Business Roundtable, 1997.

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11 Putting a value on corporate governance, McKinsey Quarterly, 1996 No.4,

12 Corporate restructuring: Need for better disclosure, *The Hindu Business Line*, June 11, 2000

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