BOARD EFFECTIVENESS REPORT 2013-14

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FOREWORD

Many directors of listed companies (both executive and non executive directors) and members of professional teams that advise the boards and committees of listed companies are currently searching for up to date insights into corporate governance practices. In addition, the international community is hungry for reliable data on corporate governance practices in India. There have now been three India Board Reports published by Hunt Partners, AZB and Partners and PWC which have been extremely well received amongst the national and international business community that contain information about governance practices that cannot be found anywhere else. I was therefore pleased to learn that the consortium is now supplementing their influential publications with the launch of The Board Effectiveness Report 2013-14.

This Report is being published at an important time since the global financial crisis, the recent economic recession and high profile corporate frauds manifested the need for good corporate governance practices amongst listed companies. In addition, the changes being introduced in The Companies Act, 2013 provide clear evidence of efforts being made to streamline and update the corporate governance system to suit the changing business environment.

I am delighted that this report focuses on the increasingly important role independent directors are playing in upholding the tenets of corporate governance. They are required to make decisions without any personal interest, with appropriate care and attention and to act in the best interest of the company. The roles and responsibilities of independent directors outlined in The Companies Act, 2013 give them the power to play a key role in influencing decisions in the board room. But are they sufficiently influential? Do they have adequate information and resources for the jobs they are performing? How effective are the board processes in allowing them to play this role? How effective are the board committees in supporting the board activities? This report examines best practices for board structure and composition including board diversity and explores the roles and responsibilities of an independent director. It focuses on views and recommendations on board evaluation and effectiveness of eminent and highly experienced board members. In this report panel members and survey respondents have opined that empowering independent directors will improve corporate governance, generate value for the company and thereby enhance board effectiveness leading to heightened investor confidence, so much sought presently.

I am sure that the Report will provide many valuable insights concerning current governance practices in India for each and every reader that spends the necessary time to study and consider the findings contained within the report.

Chris Pierce

CEO, Global Governance Services Ltd, London
Consultant, Board Evaluations Ltd., London

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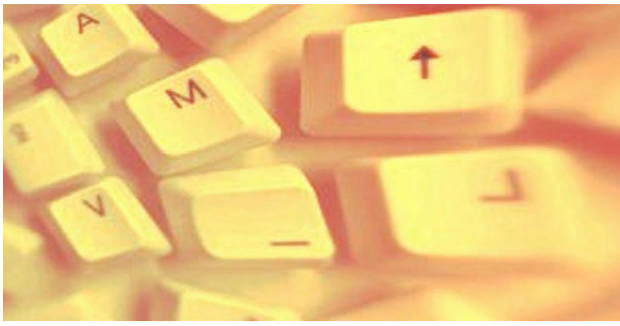
SCOPE AND METHODOLOGY

The report focuses on corporate governance practices, processes and board effectiveness



SCOPE

The Board Effectiveness Report 2013-14 takes a closer look at corporate governance practices and board effectiveness in India and delves deeper into the roles and responsibilities of independent directors.

It addresses important issues of:

- Board composition
- Roles, responsibilities and accountability of independent directors
- Board processes
- Board effectiveness

It highlights areas of improvement by comparing corporate governance standards in India to those across the globe. The report also covers upcoming trends including the use of external advisors and consultants to improve corporate governance in India.

METHODOLOGY

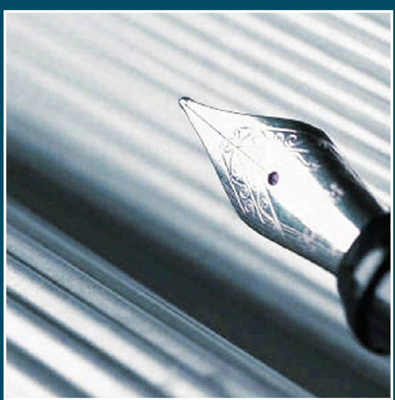
The third edition of India Board Report, published in 2011[1] , considerably one the most venerable sources of credible information on Indian Corporate Boards, consisted of a two part survey. One part focused on leading Indian companies to study statistical data around boards and the other on opinions of eminent independent directors.

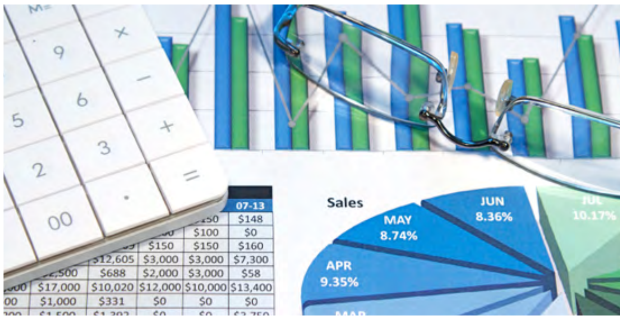
The report was followed by a panel discussion and a survey.

- The discussion saw participation from eminent panelists such as Amal Ganguli, Arun Duggal, Keki Dadiseth, Pradip Kanakia and Zia Mody. It was moderated by Shailesh Haribhakti, where each panelist shared his/her experiences and opinions
- This was followed up with a survey that sought opinions from independent directors on issues highlighted during the panel discussion
- Detailed desk research was conducted to delve deeper into various aspects of corporate governance, current and proposed laws and regulatory framework in India
    a. The Companies Act, 2013 has been accorded greater significance in the report
    b. Regulations and best practices from other countries have been used to draw comparisons
- The report is based on analysis of data from these sources

[1]INDIA BOARD REPORT 2011: http://www.hunt-partners.com/displays/uploaded/File/India Board_Report__2011.pdf

EXECUTIVE SUMMARY





"Going beyond Corporate Governance, a much more evolved way to target enhanced performance for the board, is Board Effectiveness.

Organizations are increasingly becoming receptive to newer thoughts including Board evaluation, training for Independent Directors and Lead Independent Director among several other global best practices to improve corporate governance. Shifting the focus to core business issues and not just compliance is what the organizations are coming around to."

- Suresh Raina,
Senior Partner, Co-Lead Board Practice, Hunt Partners

KEY FINDINGS:

Board Composition and Structure:

A balanced board is categorized by an appropriate number of directors, the right mix of executive and independent directors, low familiarity quotient and diversity in skills, experience, and gender among other things.

- 86% of the survey respondents said that the position of lead independent director would contribute to improved corporate governance
- 79% of the survey respondents said mandatory nomination and governance committees would lead to better corporate governance
- 36% of the survey respondents said that there is greater diversity in board composition, reduction in familiarity quotient, and less cronyism

Roles, Accountability and Processes:

Several of the impediments to good governance in recent years have been on account of boardrooms that have either been complacent or rendered ineffective due to lack of adequate power. This issue brought the roles, accountability of independent directors and board processes under government scrutiny.

- Around 2/3rd of the directors who participated in the survey are of the opinion that cronyism exists on corporate boards and a formal selection process needs to be established
- 56% of the survey respondents stated that though independent directors are 'Independent' from a legal perspective, the definition is not adequately covered in the current company laws
- 86% of the respondents agreed that governance is not just about compliance and means much more, including performance and risk management

Board Effectiveness

An effective board is a prerequisite to good corporate governance. Initiatives that will drive board effectiveness include evaluation, training, succession planning among others. Each one of them plays a distinct role to enhance board effectiveness.

- The survey revealed that 46% of the respondents agreed on the emergence of activist proxy advisory firms as a means to improve the scope of corporate governance
- 86% of the survey respondents recommended performance evaluation of board of directors, committees and individual directors to improve corporate governance in India
- 79% of the respondents suggested the formation of the Nomination and Governance committee to improve board effectiveness

The Companies Act, 2013 is a step in the right direction and includes various provisions and core governing principles of corporate governance for protection of the rights of minority shareholders, adequate disclosure and increased accountability.

CORPORATE GOVERNANCE: AN UPDATE

Corporate governance regulations are undergoing changes across countries to meet challenges posed by the current business scenario

CHANGES IN CORPORATE GOVERNANCE REGULATIONS GLOBALLY

New York Stock Exchange (NYSE) Proposed Amendments (USA, 2012)

The suggested amendments to NYSE Corporate Governance Listing Standards focus on ensuring independence:

- Independence of Compensation Committee: Listed companies to consider if a director on the compensation committee has any material conflict of interest that is likely to impair their ability to make independent judgments about executive compensation
- Independent advisor: Compensation Committee can hire services of compensation consultants, independent legal consultants and other advisors who are determined to be independent and they can be given a reasonable compensation

Nasdaq Stock Market Proposed Amendments (USA, 2012)

The proposed amendments focus on:

- Independence of Compensation Committee: Listed companies to have an independent compensation committee with at least two members and a written charter enlisting committee authority and responsibilities
- Independent Advisor: Compensation Committee can hire compensation consultants and other advisors determined to be independent
- Remuneration to Compensation Committee: Compensation committee cannot accept any fee, other than for board service, from the listed company or any of its subsidiaries

Amendments to the UK Corporate Governance Code
(formerly the Combined Code) (United Kingdom, 2012)

The changes to the Code will increase accountability of boards and improve engagement with investors. The Code retains the principle of "comply or explain". Key changes include:

- Audit Tendering: FTSE 350 companies to put their external audit out to tender at least once in 10 years to ensure quality and effectiveness of the audit process
- Diversity disclosure: Companies are to outline the progress with policies on boardroom diversity
- Compliance disclosure: Detailed clarifications to shareholders as to why the Company chooses not to follow a provision of the Code

Amendments to the UK Stewardship Code (United Kingdom, 2012

First published in 2010, the Code sets out good practice on monitoring and engagement between institutional investors and companies. It requires authorized asset managers to report on compliance:

- Investors to give detailed explanation on management of conflicts of interest, circumstances in which they will take part in collective engagement and use of proxy voting agencies
- To provide greater assurance to their clients, asset managers are encouraged to have the processes that support their stewardship activities independently verified

Other regulatory changes across the globe

- A new corporate governance law passed in **the Netherlands** aims to strengthen corporate governance practices in companies by curbing shareholder activism and promoting engagement between shareholders and the management. The threshold for the right of shareholders to place items on the agenda of the general is proposed to be increased to those who have a holding of 3% or more
- A revised Code of Corporate Governance released by the Monetary Authority of **Singapore** focuses on the areas of director independence, board composition, director training, remuneration practices and disclosures, risk management, as well as shareholder rights and role
- Recent changes to the Norwegian Code of Practice for Corporate Governance prescribe that the board of directors should provide an account of the company's internal control and risk management systems in the annual report

CORPORATE GOVERNANCE IN INDIA

The Companies Act, 2013:

The Companies Act, 2013 focuses on stricter corporate governance norms. For the protection of the rights of minority shareholders, adequate disclosure, accountability and better governance of listed companies, various provisions and core governing principles of corporate governance have been included in the Act. Some of these new provisions address the following:

- Definition, appointment and tenure of independent directors
- Duties of directors
- Code of Conduct for independent directors
- Appointment of at least one woman director in prescribed class of companies
- Constitution of Remuneration and Nomination committee and Stakeholders Grievances Committee
- Rotation of Auditors and restriction on Auditor providing non-audit services
- Constitution of National Financial Reporting Authority, an independent body to take action against the Auditors in case of professional misconduct

Other provisions include training, development and evaluation of independent directors, declaration of independence of independent directors, mandatory expenditure on CSR activities, voting through electronic means, among others.

Revision of Clause 49 of the Listing Agreement:

The dynamic business scenario mandates a review of the Clause 49 to make the existing framework for corporate governance more effective.

Proposed amendments include seventeen guiding principles of corporate governance prescribed by the Adi Godrej committee constituted by the Indian Ministry of Corporate Affairs (MCA), six principles by the Organization for Economic Co-operation and Development (OECD) and comparison of existing best practices.

- An independent director should not have any material pecuniary relationship with key managerial personnel, should not be a material supplier, service provider or customer of the company and should be minimum 21 years of age
- Independent directors should meet the criteria of independence provided in listing agreement and mention the same in a declaration of independence
- Companies and independent directors need to abide by the Code for independent directors as prescribed in Schedule IV of The Companies Act, 2013
- Payment of stock options to independent directors as remuneration is prohibited
- Non-mandatory requirement to impart training to independent directors
- Performance evaluation of the independent directors may be made mandatory in line with The Companies Act, 2013
- Listed companies are to issue a statement indicating risk management policy and elucidating elements of risk

Other changes include term of independent directors, number of directorships that an individual can hold, requirements, roles and functions of Audit, Nomination and Remuneration and Stakeholders Relationship Committees, whistle-blowing provisions, among others.

BOARD COMPOSITION AND STRUCTURE

Two-third survey respondents believe that cronyism exists on corporate boards


BOARD COMPOSITION

36% of the survey respondents said that there is an increasing trend toward greater diversity in board composition and reduction in familiarity quotient

A competent and effective board of directors is an inherent pre-requisite to good corporate governance. A board that is cognizant of its roles and responsibilities, asks pertinent questions, demands corrective actions, is knowledgeable and affronts any wrongdoing. Erstwhile Satyam Computer Services Limited suffered because clearly some board members baulked and did not raise a flag; while in Coal India Limited, board members contested the decision to sell coal at subsidized rates to certain sectors. They did not agree and made it known.

Putting together a balanced board that will take decisions is a challenge and mandates a multi-pronged approach with intensive thinking and planning. An appropriate number of directors, the right mix of executive and independent directors, low familiarity quotient and diversity in skills, experience, and gender among other things categorize a balanced board. A board thus formed will inevitably add momentum to growth plans and ensure higher corporate governance standards. To illustrate, the listing agreement requires 50% of the board independent with the promoter also functioning as chair of the board. Nestle India Limited has 50% independent directors, 37% foreign and 12% women directors indicating a good balance. In contrast, clearly flouting rules was the Kingfisher Airlines board, which in September 2011 consisted of one independent director, two non-executive non-independent directors, one executive director and the promoter functioning as chairman of the board.

The boards of Indian companies need some improvement before they can meet international standards. The percentage of independent directors on S&P 500 boards was at an impressive 84%, Indian companies lag with only 54% independent directors (IBR 2011). The average tenure of non-executive directors in India is seven years as compared to the three years in Europe. This increases the risk of over familiarity. According to a report published by a global consulting firm on India, many large companies such as Cipla Limited, HCL Technologies Limited, Hindustan Unilever Limited, do not have any women or foreign board directors.

To improve board composition, The Companies Act, 2013 has included many suggestions:

- Increase the maximum number of board directors from 12 to 15
- The term of an independent director to be five consecutive years
- Only one five year extension to be allowed, which will require special resolution by the company and disclosure in the Board report

The Act acknowledges the challenges that companies face with finding quality board members and suggests:

- A provision to select independent directors from a data bank, to be built by central government notified institutions
- Increase in the number of directorships that a person can hold from 15 to 20, of which only 10 can be public companies

Companies in India have another option that they can use for board member selection – third party executive search firms. Their core competence can add immense value in identifying and appointing the appropriate people. The benefits that accrue from such firms will make them indispensible in selection of board members. In the UK, after the Lord Davies Report 2011, 20 leading executive search firms drafted a Voluntary Search Code to address lack of gender diversity on boards. In addition, 73% of FTSE 100 firms reported that they employed executive search firms to appoint board directors.

As per IBR 2011, the average board size of the top 100 companies in India was **11.8**, which is close to **12.1** (average of top 400 companies) in Europe.

"Companies are spending more time in selecting independent directors that the market feels will protect the interest of minority shareholders."

- Santosh Senapati

DIVERSITY IS AN INTEGRAL PART OF EFFECTIVE BOARD COMPOSITION

79% of the survey respondents said that corporate governance will be enhanced with gender diversity in the boards

"Gender diversity will lead to more effective boards and better corporate decisions. Therefore it is in the companies' self interest to have women directors voluntarily rather than it being imposed by regulations"

- Arun Duggal

Indian boards continue to draw flak for low representation of women. According to IBR 2011, the women representation in surveyed companies was at 4.6%. This is far less than the estimated S&P 500 average of 17% or the European average of 12% women board members. According to a study 'Board diversity in India', by the Hyderabad-based Institute of Public Enterprise (IPE) almost 50% of companies had 'all male' boards. To mitigate the skewed ratios, The Companies Act, 2013 proposes 'at least one woman director in the prescribed class or classes of companies'.

These efforts follow the trends set by leading European countries, even though their standards are much stiffer:

- Norway mandates 40% women directors on boards
- French listed companies to reserve 40% of the board seats for women by 2017
- FTSE 100 companies in the UK to have 25% women board members by 2015

Currently, in the UK, 15% of all board members in the top 150 companies are women as compared to 12.3% last year. The 5% increase in number of women on boards in the country in the last five years underlines the impact of such regulations.

Skeptics may argue that mandating women representation may result in compromises. However, experts opine that qualified women board members proffer unique perspectives and augment diversity. The altering workforce demographics have also set the tone for gender diversity in board composition.

In discussions on diversity, the aspect of gender garners maximum attention. The other two very crucial aspects are diversification in skill sets and nationalities. In the absence of related regulations, company strategies and focus on global growth drive these decisions.

According to a report on European countries by a leading consulting firm, boards in Belgium, France, the Netherlands, Switzerland and the UK; have an average of four to five foreign nationals, with The Netherlands pegged at an impressive 47% in international representation.

This will improve decision-making and risk management. Diversification reduces familiarity and gives further impetus to directors' independence.

Executive search firms can take the lead, with a company specified description of board member roles and responsibilities, and help find suitable candidates. The experience of executive research firms will accord more credibility in identifying the best-aligned profiles as well as ensuring diversity quotient. Goodyear, Brookfield, Atos, Tata Consultancy Services, Monsanto and Avantha are just some examples of companies that have benefited from services provided by executive search firms in identifying directors.

In IBR 2011,

72% independent directors rated lack of diversity as a concern area

As per IBR 2011, merely

6% of the surveyed companies had foreign directors on their boards in 2009-10

LEAD INDEPENDENT DIRECTORS CAN ENHANCE BOARD PERFORMANCE

86% of the survey respondents said that the position of lead independent director would contribute to improved corporate governance

"It was through the Sarbanes Oxley requirement for independent director to meet separately that the lead director concept took shape and became the bridge between the non-independents and the independents."

- Zia Mody

In India, the concept of lead independent director is in its nascent stages. The Companies Act, 2013 has stopped short of taking any concrete steps in this direction. According to panel members, this is an important position that liaisons between the executive and non-executive directors and between the Board and the shareholders.

According to the UK Corporate Governance Code, the lead or senior independent director is one of the independent directors appointed by the board to co-ordinate activities and voice the opinion of other independent directors.

Under the U.S. Securities and Exchange Commission (SEC) rules, companies must reveal reasons for combining or separating the roles of the Chairman and CEO. The guideline further extends the ambit and states that if the two roles are combined, a lead independent director has to be appointed.

Similarly, a clear articulation of the reason for appointment and definition of the role is required. Leading consulting companies have reported the following:

- 92% of S&P 500 boards have a lead or presiding independent director
- One-third of European chairmen are independent; in the UK and the Netherlands the percentages are highest at 73% and 72% respectively

According to the National Association of Corporate Directors, US data published in 2011, 88% of the boards that appointed a lead independent director claimed enhanced board effectiveness.

Lead directors can influence and forge stronger relationship between the CEO and the board, enhance board performance and lead in a crisis.

"Anytime suggestions have come in, I as a lead independent director passed it to the Chairman, where each and every suggestion was accepted. This shows that Independent Directors do not just discuss at the board meeting. They independently discuss issues not covered in the meetings and convey their views to the chairman who accepts."

- Audience, Panel discussion

79% of the survey respondents believe that appointing an independent director as a chair can help achieve the goal of independent leadership

"The lead independent director, along with the other independent directors evaluates the performance of the chairman in his absence. He is responsible to get the perspective of principal shareholders and interact with them on important issues such as risk management, governance, remuneration of the board of directors, etc.."

- Pradip Kanakia

COMMITTEES ON BOARD WILL ENHANCE CORPORATE GOVERNANCE

79% of the survey respondents said mandatory nomination and governance committees would lead to better corporate governance

"Just having such committees and having them as paper tigers is utterly useless. There will be many companies that have a nominations committee but they are rarely actively involved in selecting the people on the board."

– Keki Dadiseth

Regulatory focus on Committees accentuates their role in ensuring good corporate governance. Those deemed important include Audit, CSR, Governance, Nomination, Risk, Remuneration, Strategy and Stakeholders relationship.

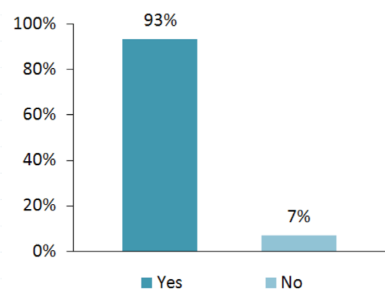
The following numbers indicate the significance that incumbents attach to these committees:

- All participant companies in IBR 2011 had audit committees; over 80% had remuneration committees, and 18% possessed nomination committees
- Research by a global consulting firm reveals that 98% of the boards in Europe have audit committees, 91% have remuneration committees and over 71% have nomination committees

These numbers also tell another story - that India has some catching up to do.

This was evident in the panel discussion as participants expressed concern regarding undue promoter interference and influence stifling the committees. The panel members also stated that for effective performance of committees, empowerment and periodic rotation are crucial.

Figure 1 - **Need for Nomination and Remuneration Committee**



The Companies Act, 2013 mandates that listed companies in India have audit, nomination and remuneration committees with a majority of independent directors. While this Act defines certain roles and responsibilities, it stops short of framing specific regulations. For instance, the United States SEC mandates that nomination and compensation committees have only independent directors. Similarly, splitting of nomination and remuneration committees is prevalent in Europe, conforming to separation of roles to augment effectiveness.

The emerging best practices of nomination committees in Europe include profiling of the board to aid achievement of company's long-term plans, induction programs for new directors and increased involvement in succession planning for the CEO. Adoption of international best practices can help companies in India move beyond compliance and focus on enhancing effectiveness. Executive search firms can help companies in achieving the optimum level of skill required for committees.

Committees with distinctive roles and obligations will guarantee competent decisions, eventually leading to comprehensive improvement in corporate governance and enhancing board performance.

"If we have a nomination committee, then the boards functioning will improve. Monitoring of board performance should be carried out by this committee."

- Amal Ganguli

ROLES, ACCOUNTABILITY AND PROCESSES

50% of the respondents believe that independent directors are unable to dispense their responsibilities as the roles are not adequately defined and understood

INDEPENDENT DIRECTORS
THE COMPANIES ACT TO ENHANCE ROLE & ACCOUNTABILITY

Independent directors can influence - expedite or stall - corporate decisions. Many high profile corporate frauds in recent years have been on account of boardrooms that have either been complacent or rendered ineffective due to lack of adequate power. The ambiguity surrounding perceptions and beliefs regarding the term 'independence' further compounds the problem. These issues brought the roles, responsibilities and accountability of independent directors under government scrutiny.

The overwhelming need for clarity is obvious as almost 57% of the respondents replied in negative when asked, "Do you feel the role of the Independent Director is adequately defined and at the same time clearly understood by the individuals sitting on a Company Board in India?"

The Companies Act, 2013 is a step in the right direction and starts by defining clearly an 'independent director'. It prescribes their responsibilities and accountability, in committees and otherwise.

36% of the survey respondents stated that though independent directors are 'Independent' from a legal perspective, the definition is not adequately covered in the current company laws

50% of the survey respondents believe that independent directors are unable to dispense their responsibilities in the current scenario

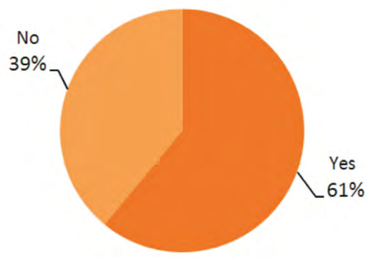
The Companies Act, 2013 focuses on issues related to the association that an individual should have / not have with a company. The definition of individual was extended to include family members while that of company was extended to include holdings, subsidiaries, etc. The following points indicate the level of detail that the Act adopts.

- A person of integrity and with relevant expertise and experience
- No pecuniary relationship with company, its holding, subsidiary or associate company, promoters, or directors, during current and two immediately preceding financial years
- No association, in any of the three financial years immediately preceding the financial year in which he/she is proposed to be appointed, with—

  - (A) a firm of auditors or company secretaries in practice or cost auditors of the company or its holding, subsidiary or associate company; or

  - (B) Any legal or a consulting firm that has or had any transaction with the company, its holding, subsidiary or associate company amounting to ten per cent or more of the gross turnover of such firm.

Figure 2 - **The Companies Act, 2013 Redefines Independence and will Help Enhance Corporate Governace**



In the current scenario, directives in The Companies Act, 2013 will bring many companies under review as boards and committees have representatives from advisory firms and audit companies that are already working closely with the company.

The efficacy of steps taken by The Companies Act, 2013 is apparent when independent directors express belief that the new guidelines enhance the role of independent directors.

INDEPENDENT DIRECTORS
ROLES AND RESPONSIBILITIES

The Companies Act, 2013 Schedule IV is an attempt to articulate the responsibilities of independent directors. The directives will steer the efforts and help meet squarely the challenges posed by promoter influence, over familiarity, lengthy tenure, lack of timely information, irregular meetings and lack of expertise among others.

Enumerated below are some of the inclusions in the Act outlining roles and responsibilities of independent directors:

- If independent directors lose independence, they must immediately inform the Board
- Bring an independent judgment to Board's deliberations on issues of strategy, performance, risk management, resources, key appointments and standards of conduct
- Satisfy themselves on the integrity of financial information
- Safeguard minority shareholders' interests
- Determine appropriate levels of remuneration of key and senior management personnel
- Appoint and where necessary recommend removal of key and senior management personnel
- Undertake induction and regularly update and refresh their skills, knowledge and familiarity with the company and external environment
- Seek appropriate clarification or information and professional advice and opinion of outside experts.

"An independent director has to be bold enough to express his view even if it is contrary to what the Chairman or the management desires/proposes."

- Mansingh L. Bhakta

The Companies Act, 2013 states, *"Every independent director shall at the first meeting of the Board, in which he participates as a director and thereafter at the first meeting of the Board in every financial year or whenever there is any change in the circumstances which may affect his status as an independent director, give a declaration that he meets the criteria of independence as provided in sub-section."*

This is a clear indication that individuals appointed as independent directors share the onus and should at all times be cognizant of their status and responsibilities.

Committee Roles and Responsibilities:

The Companies Act, 2013 attempts at regulating committees, especially Audit & Nomination and Remuneration Committees.

For an audit committee, the Act has listed monitoring use of funds, evaluation of internal finances, risk management, valuation of undertaking, as some of the responsibilities.

Similarly, the Act envisages a greater role for the nomination and remuneration committees to check instances of concessions. It lists determining selection criteria, identification of suitable candidates, recommendations on remunerations for key personnel among the duties of these committees.

As per the SEC regulations in the United States, the nomination committee must have a written charter that addresses:

- The committee's purpose and responsibilities – identify qualified individuals as per approved criteria and to select, or to recommend that the board select, the director nominees; develop and recommend to the board a set of corporate governance principles; and oversee board and management evaluation
- An annual performance evaluation of the committee

A clear definition of the responsibilities of the committees enhances their contribution to deliberations and decisions related to strategy, performance, risk, resources, appointments, financial information, and shareholder interest among many others.

COMPROMISING THE INDEPENDENCE OF DIRECTORS

Selection Process:

A formal and transparent selection and appointment process is crucial in ensuring independence of the directors. As per IBR 2011, 46% of survey participants cited personal networks of other directors on board as the preferred medium for selection and appointment of independent directors. As mentioned earlier in the report, companies must designate independent nomination committees to scrutinize the candidates for the position of independent directors on their board to avoid undue promoter influence and cronyism.

Around

2/3rd of the directors who participated in the survey are of the opinion that cronyism exists on corporate boards and a formal selection process needs to be established

Compensation:

Currently five of the BSE top 30 companies such as ITC, Dr Reddy's, HDFC have granted stock options to their independent directors. The Companies Act, 2013 proposes to put an end to this practice in a bid to eliminate any conflict of interest.

Some other directives in Clause 197 (12):

- Every listed company shall disclose in the Board's report the ratio of remuneration of each director to the median employees remuneration
- Independent directors not entitled to any remuneration, other than a fee provided except under prescribed situations

Among the companies surveyed in IBR 2011, the average compensation paid to non-executive directors went up from INR 0.82 million in 2008-09 to INR 1 million in 2009-10, an increase of around 20%. There was also a wide gap in the compensation paid to non-executive directors, with INR 15,000 the minimum, whereas INR 5.4 million was the maximum paid for 2009-10.

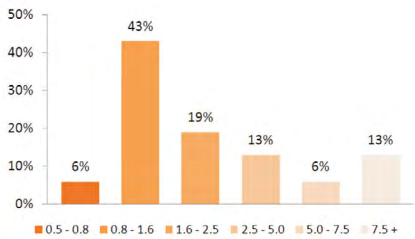
"True independence will happen only when the director is not selected, interviewed and decided solely by the executive chairman and/or managing director."

- Ranga Iyer

"Compensation impacts people differently based on how much capital they already have. For example, INR 1.6 million for a retired civil servant, who was paid pittance by the government, may compromise independence, but for a senior PE professional even INR 7.5 million may not."

- Luis Miranda

Figure 3 - **Ideal Compensation Range for an Independent Director (in INR million)**



Almost half the survey respondents indicated that an annual compensation range of INR 0.8 – 1.6 million is ideal for independent directors.

Tenure:

Apart from a formal selection and remuneration process, length of the tenure of independent directors can lead to increased familiarity on the Board. In a study conducted by a leading proxy advisory firm in 2012, 88 independent directors from 31 top Indian companies have served on the boards for more than 10 years, which include prominent names such as HDFC Ltd., Tata Steel Ltd. and Apollo Hospitals Enterprise Ltd.

The Companies Act, 2013 states:

- The term of an independent director to be five consecutive years
- Only one five year extension to be allowed, which will require special resolution by the company and disclosure in the Board report

Experts believe that long association with a company would result in a high familiarity quotient and impact the independence of their decisions. In a bid to 'check boxes' for compliance, companies retain independent directors for decades together, completely deriding some of the basic mandates. While precision in definitions and many other similar criteria are expected to induce changes in existing board structures, commitment from companies and individuals to improve governance will be critical.

RISK MANAGEMENT

Another critical area under the purview of board members is management of risk. This includes risks posed by fraudulent activities (execution) and potential investments (strategic). Other risks include nonconformance to regulatory, reputational and environmental requirements. Risk management has acquired the status of, according to experts on the panel, being one of the most important aspects that require board involvement.

Director opinion on this in IBR 2011 was however, disparate with 70% of survey respondents stating that risk management is not a critical component.

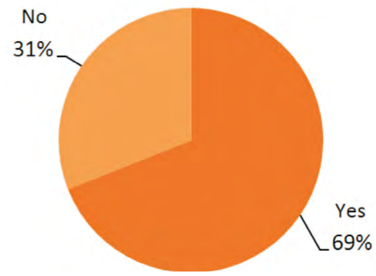
The financial crisis a couple of years ago has put risk management systems under spotlight. The Companies Act, 2013 states that independent directors must bring an impartial opinion on board deliberations, scrutinize management performance and integrity of company financial statements. They should be satisfied with the integrity of information and strength of risk management systems.

Risk management has a direct impact on minority shareholders' interests and experts on the panel opined that independent directors need an unbiased opinion on board policies and functioning. They also supported the option of companies opting for periodic reviews of risk management policies by the board.

Speculation on the effectiveness of pegging compensation to performance and risk management is rife. However, there are voices of dissent that say board compensation cannot be performance based.

86% of the respondents agreed and said recognition is increasing that governance is not just about compliance and means much more, including Performance & Risk

Figure 4 - **Director Compensation should be liked to Risk and Performance**



"To provide an independent view on accurate reporting and interpretation of the business result and to be able to caution shareholders in case of any risk that is not represented."

- Sunil Lulla,
CEO and MD, Times Now

BOARD EFFECTIVENESS

Over three – fourth of the directors are of the opinion that board evaluation should be made mandatory

As stated earlier an effective board is a prerequisite to good corporate governance. This segment of the report covers initiatives that will drive board effectiveness. These include evaluation, training, succession planning among others. Each one of them plays a distinct role to enhance board effectiveness.

BOARD EVALUATION

Results from IBR 2011 indicated that board evaluations are not taken seriously by Indian companies:

- More than 50% of the directors surveyed said that board evaluations were rare
- Almost 68% of boards undergo only informal assessment
- Only 5% of boards are evaluated by the Nomination Committee

The general opinion is that Indian companies are still a few years away from acceptance of board evaluation. The panel members expressed that while board evaluations in Indian companies are more an exception than the norm, they were able to share anecdotes, indicating the change.

Similarly, the concept of evaluation of the chair or the CEO by the board remains a distant goal.

86% of the respondents recommended performance evaluation of board of directors, committees and individual directors to improve corporate governance in India

"On one of the boards that I sit, I get a personal appraisal from the chairman, which can last up to two hours and they just don't talk in the air. They give specific examples. This is usually done through a 3rd party, which talks to each of the board members to get his opinion on every other board member. I have found this valuable."

– Keki Dadiseth

While

77% of the respondents were in favor of making board evaluation mandatory, only

43% felt that this concept is gaining acceptance with companies

"Evaluations can only be done if expectations are set at the beginning of the evaluation period; by setting a board charter."

– Nawshir H. Mirza

The Companies Act, 2013 has taken concrete steps to encourage the practice of board evaluation. It mandates that public companies include a statement of formal evaluation of the Board, its committees and individuals.

The entire board should undertake the task of performance evaluation. The result of evaluation will ideally form the basis for intervention to improve board effectiveness. Evaluation is one of the responsibilities of nomination and remuneration committees.

The importance of board evaluation is perceptible with many countries making it mandatory. The UK Corporate Governance Code, in addition to "formal and rigorous" annual evaluation of the Board, requires the non-executive directors, headed by the lead independent director to evaluate the performance of the chairman, taking into account the views of other executive directors. The Code also prescribes that evaluation of FTSE 350 boards be externally facilitated at least once in every three years.

Evaluation goes beyond measuring the performance of independent directors. Instead, it looks at the effectiveness of the board as a whole and thereby measures the performance and enhances effectiveness.

- Helps with clarification on duties, responsibilities and expectations from directors
- Identifies areas of improvement, promotes active participation, and enhances trust between board members

As discussed, a few companies are now conducting evaluations as part of corporate governance best practices and board effectiveness enhancement. Listed companies such as Infosys Technologies Limited and Dr. Reddy's Laboratories Limited conduct board member performance evaluation and disclose details in their annual board reports. State-run companies are taking similar steps. For instance, Oil and Natural Gas Corporation (ONGC), has taken the initiative to evaluate the performance of independent directors.

Evaluation of boards by third parties is a step further to add more objectivity. These companies can formalize the entire process and use industry best practices. A structured and formal approach will ensure an unbiased evaluation.

A study conducted by a global consulting firm in 2011 reports that

98%

of UK boards undertook performance evaluation between 2008 and 2010, of which approximately

1/3rd

were conducted by a third party firm.

"I think, there are very few companies that I am aware of that actually evaluate their board. When I have made suggestions to have an evaluation by a third party outsider, nobody says no, but it has rarely progressed – it is not in the Indian DNA."

– Keki Dadiseth

DEALING WITH LIMITED TALENT POOL

DATABASE

93% of the respondents said that appropriate training would help improve effectiveness of independent directors

Identifying independent directors who can contribute to good corporate governance is challenging.

The effort by regulators to tackle the issue is evident as The Companies Act, 2013 includes a provision for selection of independent directors from a data bank. Institutions with the necessary expertise, as notified by the central government will create this data bank. The responsibility of due diligence will lie with the company appointing the director.

Panelists warned against the possibility of compromising the database to serve vested interests. The panel also recommended training and a formal induction process for newly appointed directors to acclimatize to the environment to help discharge their duties more effectively.

Survey respondents supported formal training programs, seminars and workshops to help the directors, especially those with limited board experience, in understanding the business scenario.

Executive research firms will be able to aid companies in reaching out to a wider base of possible candidates.

DEALING WITH LIMITED TALENT POOL
TRAINING

The UK Corporate Governance Code lays the responsibility of ensuring formal training for independent directors on the Chairman. The training should enable them to take informed decisions in the constantly changing business scenario.

The Companies Act, 2013 assigns the responsibility of training to the independent directors. Induction to understand the company and regular updates to enhance skills and knowledge can be demanded by the directors. Information about the company and the business environment are important for decision makers. The companies also acknowledge the importance and are making efforts to invest in independent directors' awareness.

- Directors in HDFC Bank Limited attend workshops and seminars to understand the economic and regulatory changes in the business environment
- Infosys Technologies Limited provides orientation to all newly inducted non-executive directors about the company, structure, risk management strategy, etc. Each director is entitled to a training fee worth $5,000 per annum. Independent directors are allowed to attend board/corporate governance educational programmes
- Hindustan Unilever Limited has a more elaborate training structure, with a formal induction program for each newly appointed director. This includes a detailed briefing by the Company Secretary and CEO on their roles and responsibilities. Non-executive independent directors are also provided with a comprehensive 'Director's Induction Manual' which includes company background, codes, policies, risk management systems, among others.

50% of the directors surveyed opined that given the continuously changing and complex business environment in Corporate India, Independent Directors are unable to truly dispense their responsibilities

"Training is a requirement for people with limited board experience"

- Luis Miranda

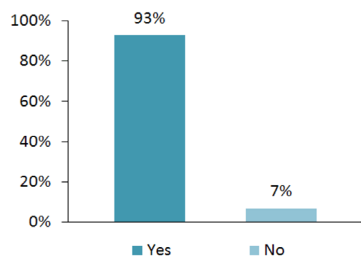
85% of the respondents admitted to inadequate procedures for inducting newly appointed directors to their organization.

- A report on corporate governance in listed companies in India, 2010-11

The panel recommended training and a formal induction process to acclimatize newly appointed directors to the environment to help discharge their duties more effectively. Survey respondents also supported formal training programs, seminars and workshops to help the directors, especially those with limited board experience, in understanding the business scenario. The support among independent directors for periodic training and development clearly indicates that it will improve board effectiveness. With background knowledge, independent directors can facilitate better decisions.

In addition to training provided by the company, more structured and formal training can be sourced from professional development programs. Companies are now engaging third parties that provide these services, to bring more objectivity to their 'onboarding' processes and improve effectiveness of the board. These programs have core and optional modules which adopt international best practices. They encompass training on roles and responsibilities of directors including audit committee, board assessment, processes, financial essentials to name a few. Recognized Training programs are now being offered globally by Harvard & Insead and in India by Hunt Partners Directors' Club.

Figure 5 - **Appropriate training to help improve effectiveness of independent directors**



During the panel discussion, members strongly encouraged the involvement of executive search firms to tide over various challenges of talent shortage, achieving diversity, training and development. Their unbiased approach would help in improving board effectiveness.

DEALING WITH LIMITED TALENT POOL

SUCCESSION PLANNING

Succession planning is not mandatory but experts consider it to be a part of risk management. The Companies Act, 2013 does not touch upon the topic of succession planning, the Adi Godrej Committee recommends that the Board of a listed company should ensure succession plans for appointments to the board and senior management.

Even the UK Corporate Governance Code only recommends that the board should have a succession plan in place for senior management and board appointments to maintain an appropriate balance of skills and experience within the company.

Succession planning best practices abound, which include defining requisite skills, detailed timeline, analysis of strengths and weaknesses of a potential successor, among others. The board should identify and execute practices, which are most suited for their company and establish a formal succession plan.

92% of the survey respondents recommended succession planning for the CEO as well as for the Independent Directors to enhance corporate governance among Indian companies.

Seeking external and objective advice from executive research firms which focus on the skills, experience and have an unbiased approach can make this seemingly difficult task more manageable and ensure accomplishment of long term goals.

As per IBR 2011, Leadership development and succession planning features at the bottom at the board priority list, with only

56% rating it as critical.

"...it is not as if succession planning is absent, it is just that it is not practiced deeply enough or widely enough... it should be a nominating committee, that brings out new directors, that there is independence and a process behind the refreshment of the board."

- Shailesh Haribhakti

As per a study conducted on S&P 500 Boards by a global consulting firm in 2011,

71% of the respondent companies have both short and long term succession plans

ROLE OF PRIVATE EQUITY/INSTITUTIONAL INVESTORS IN BOARD EFFECTIVENESS

86% of the respondents said that private and institutional investors will play a major role in enhancing corporate governance

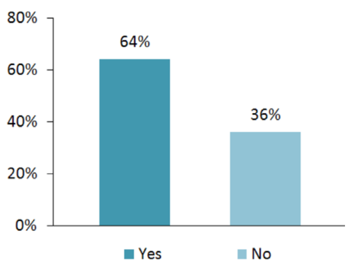
"Good corporate governance does deliver economic benefit to the shareholders. That is the basis on which we need to pursue it.""

- Arun Duggal

Panelists as well as survey respondents agreed that greater involvement of private equity and other institutional investors will improve corporate governance in Indian companies.

The Adi Godrej Committee recommendations to amend the Clause 49 of Listing Agreement propose mandatory provisions to increase intervention of institutional investors in their portfolio companies. The effort is to enable an increase in monitoring and ability to dissent against potential wrongdoings. Companies will be required to improve transparency, disclose meeting notices, communicate effectively with investors and adopt an inclusive approach.

Figure 6 - **Investors are willing to pay a premium for good corporate governance standards**



Services of Proxy Advisory firms will further help to create awareness about issues faced in the current business environment.

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Mr. Pradip Kanakia

Mr. Ranga Iyer

Mr. Santosh Senapati

Mr. S. C. Bhargava

Mr. Shailesh V. Haribhakti

Mr. Subramani Ramachandran

Mr. Sunil Lulla

Ms. Zia Mody

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- 'Best Domestic Law Firm of the Year – India' award by the InterContinental Finance Magazine Global Awards, 2012.
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AZB & Partners
23rd Floor, Express Towers,
Nariman Point,
Mumbai - 400 021,
India
Tel: +91 22 6639 6880
Fax: +91 226639 6888

Hunt Partners
412 B, Trade World,
Kamala Mill,
Mumbai - 400 013,
India
Tel: +91 22 4340 1100
Fax: +91 22 4340 1199

PricewaterhouseCoopers Pvt Ltd
252, Veer Savarkar Marg,
Shivaji Park, Dadar
Mumbai 400 028
India
Tel: +91 22 6669 1000
Fax: +91 22 6654 7800/7801/7802