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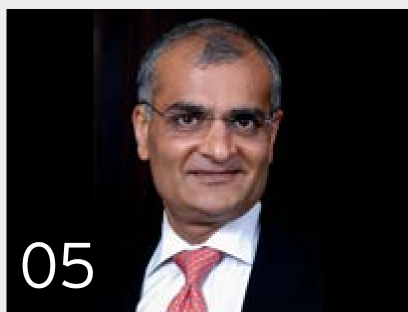
Insights for boards and audit committees

In this issue

This edition of the BoardMatters Quarterly is focused on the Insolvency and Bankruptcy Code (IBC) 2016, a legislation that has spawned an entire ecosystem to resolve the problem of corporate debt. The IBC recognizes corporate failures while remaining focused on early resolution and quick revival of stressed businesses. In keeping with the theme, we also feature a conversation with Rashesh Shah, Chairman and CEO, Edelweiss Group, one of India's leading diversified financial services companies that also runs one of India's largest asset reconstruction companies.

Interview
Rashesh Shah
Chairman and CEO
Edelweiss Group



How should boards evaluate stressed asset acquisitions?

Rashesh Shah elaborates what boards should look out for in areas of risk governance and shareholder management when evaluating stressed acquisitions or investments.

03 Decoding the Insolvency and Bankruptcy Code: What lies ahead?

It has been a year since implementation of the Code in December 2016 and in a short span of time, multiple additional regulations have been issued to strengthen the Code, and insolvency proceedings have been initiated across various benches of the National Company Law Tribunal (NCLT). However, there are inhibitions among stakeholders creating practical challenges for implementation. This article focusses on the provisions of the Code and the key considerations for board members.

07 Forensic audits for bad debt

As the number of cases being filed under National Company Law Tribunal (NCLT) are rapidly increasing, it is imperative for insolvency resolution professionals to identify and review the cases through a 'risk' lens and employ the right skills when it comes to specialist areas such as forensic.

09 The new norm post IBC: Timely intervention and EBITDA expansion program

Stressed or distressed assets require an effective turnaround plan providing sustainability to the organization and preventing any further value erosion. Board members have a critical role to play in utilizing their boardroom presence. This article highlights the early warning signs of decline and the key pillars of a formal EBITDA expansion program.

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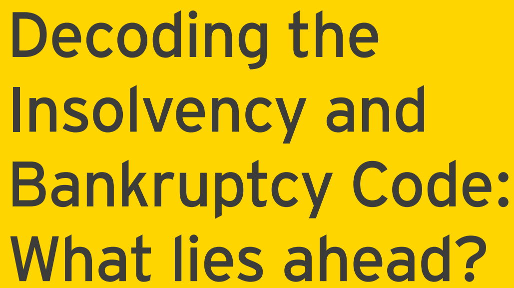

Decoding the Insolvency and Bankruptcy Code: What lies ahead?

Abizer Diwanji
Partner and Head - Restructuring and Turnaround Services, EY India

This year has seen several landmark reforms, with the Insolvency and Bankruptcy Code 2016 (IBC or The Code) being one such reform. The significant efforts of the Ministry of Finance and the Bankruptcy Board of India to implement a Bankruptcy Law (the Law) must be lauded. The Law is quite distinctive when compared to other laws in India, as a section has been included which allows the Law to supersede any existing laws in case of a conflict.

The Law carries the following implications for corporations:

Default including wilful default: Default is the first indication to the possibility of a claim, hence triggering what is popularly referenced to as a Corporate Insolvency Resolution Process (CIRP). This, if declared wilful, would make directors criminally liable for any claims from creditors, including banks. The recent amends to The Law as well as court judgements lay firm emphasis on the liabilities of the company and its management. Directors need to assess such issues well beforehand especially in their review of the financial results and bank covenant compliances.

Suspension of the board: The Law requires the board to remain in suspension during the 180/270 day CIRP process. It is important to note that the board is not disbanded but only held in suspension. Accordingly, the directors will be held liable for past actions. Further, actions taken during CIRP may not cure past issues as all the IRP does is to maintain a status quo during the CIRP.

Post CIRP: Post the 180/270 days period, there is a strong possibility of the entity undergoing a change. However, should the entity remain the same and the board members continue, the legacy liabilities too would continue as earlier, and the CIRP process would not absolve the directors of the liabilities.

Disqualification: Post the 180/270 days, in all probability the entity management would change. However, should the entity management remain the same and the board members continue, the legacy liabilities too would continue as earlier.

Progress of the code

The code this far has seen significant progress with approximately 70 companies in CIRP, more than 1500 registered insolvency professionals and 11 operational benches of the National Company Law Tribunal (NCLT) which are handling in excess of 250 cases. This is despite skepticism about the Law and the availability of requisite infrastructure to deal with a USD200 billion issue. The Code has several areas of concern and has to deal with some apprehensions as below:

Promoters: Decision-making by promoters has largely been anti-dilutive on shareholding or done out of emotion. This is caused by the fact that this far their decisions were rarely accountable to anyone. Under the CIRP, promoters have no operating leverage on the decision-making and hence seek ways to counter every decision taken by the IRP. They are also likely to make the process difficult through non-cooperation, limited disclosures and other such actions to impact the smooth functioning of the IRP. There have been instances of legal challenges to the CIRP in the courts of law on grounds of validity.

Banks: In joint lender forums, banks have to mature from playing their part as lenders concerned with their individual exposures to being members of the committee of creditors (COC), who are now custodians of the enterprise and for all practical purposes, the board. They are skeptical as repeated attempts to lend to a company have not resulted in a sustainable turnaround. They are also unsure of the IP playing their role, let alone offering the much needed interim financing.

Consumers or operating creditors: This class has borne the most collateral damage over the years when an enterprise moved from prosperous to vulnerable and stressed to distress. They tend to flare up with every change in control and their arguments are likely to be more moral than rational. This could be a reason why they are not part of the CoC where the financial creditors come together.

Practioners: IPs are mitigating the above apprehensions and are generally unable to deliver to the best of their abilities as they lack interim finance, manage a push-back from the promoters, engage irate creditors and consumers, and above all face the risk of litigation. Hence, all their moves are cautious and risk averse, resulting in sub-optimal decision-making and exposing them to blame. Having said this, IPs would need to behave like entrepreneurs and this change is happening with each passing day.

The above apprehensions have resulted in considerably delayed decision-making, excessive use of lawyers, legal cases (sometimes to gain legal sanctity but most times as a delaying tactic) and many more transactions by promoters to safeguard their personal interests.

Key considerations for directors

Directors, given their position will be faced with several issues for their consideration before any CIRP or whilst buying a company in CIRP. As the risks are completely different, it may be pertinent to discuss these separately.

Issues when a company is headed towards CIRP

There are several issues that directors need to consider before a company heads towards CIRP mainly with relation to past transactions. Generally, the company management (read promoters) get wind of impending crises and build safeguards to protect their capital and other benefits. This invariably leads to what the act calls preferential transactions (section 43 of the Law), undervalued transactions (section 45 of the Law), extortionate credit transactions (section 50 of the Law) and fraudulent transactions (section 66 of the Law). Whilst the Law mainly targets management, the consequent implications on directors for such transactions cannot be ruled out. It may be prudent that directors keep an eye on related party transactions, which is defined widely under the Companies Act, 2013. In fact, Section 66 of the Law requires adequate due diligence from directors.

In all of the above instances, the Law requires a look back period of two years for related party transactions and one year for non-related party transactions. If any instances are found, it could open up transactions for an unlimited period of time. The Insolvency and Bankruptcy Board of India (IBBI) in its notification dated 07 November 2017 has mandated the IP to highlight such transactions so that those can be dealt with appropriately in any resolution plan. With the subsequent ordinance to restrict promoters from rebidding for their businesses, the recourse available to new buyers to enforce compensation of the categories of transactions may result in continued liability on the directors.

It may be prudent for directors to make sure that these transactions are assessed for all companies where there are covenant breaches or where cash flows may suggest an imminent default which could trigger the Bankruptcy Law.

Issues when a company is bidding for another company under CIRP

The biggest issue for bidders of distressed companies in India has been the information asymmetry and the lack of any representations and warranties which are inherent in normal mergers and acquisitions. Further, since companies are stressed there may be more issues than are seen in normal transactions. There would be large contingent liabilites (especially related to statutory dues and taxes) that need to be addressed. A cash crunch results in excessive working capital cycles that impact value. Unlike the Sick Industrial Companies Act (SICA), the Bankruptcy Law does not provide for any immunity of past liabilities. Other jurisdictions world over too do not offer such immunities, but the government dependencies there are lesser than in India.

Furthermore, there are issues around cross guarantees and related party dependencies that are critical. Sometimes, promoters have put in poison pills like cross guarantees of their other businesses or business dependencies like supply of raw material, logistics support or even asset holdings in related entities. These would have to be assessed as well since Corporate Group insolvency related laws are yet to be decided. Finally, there are erstwhile guarantees by promoters or their holding companies for the loans outstanding. These will have to be assessed and ring-fenced appropriately to make sure the incumbent resolution applicant is not impacted by the same.

In conclusion, given that the Bankruptcy Law is an openly run legal process, the accountability of directors goes up significantly and transactions are no longer internal to the company nor are acquisition negotiations bilateral. Directors need to look out for 'red flags' before CIRP and be alerted by the 'red flags' while acquiring companies. Increased accountability will bring in better empowerment and responsibility, and could change the face of board governance in the future.

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How should boards evaluate stressed asset acquisitions?

Interview

Rashesh Shah

Rashesh Shah is Chairman and CEO of the Edelweiss Group, one of India's leading diversified financial services company that also runs one of India's largest asset reconstruction companies (ARC). He has experience of over 28 years in financial services and serves on the boards of various companies and public institutions. Rashesh is a member of the High Level Task Force on Public Credit Registry for India as well as the Insolvency Law Committee.

Acquiring distressed assets

Step 1 Strategy formulation

Step 2 Conducting due diligence

Step 3 Portfolio segmentation

Step 4 Portfolio valuation

Step 5 Transaction structuring

Q. How must boards view IBC companies that they want to invest in or give priority funding/debt? How must they choose these companies?

Each category of investor will need to take a different perspective when considering investing in distressed companies. For a strategic investor, it is important to consider the long-term impact of investing in a company on the parent – for example, a substantial investment in a distressed company can impact the parent balance sheet. Hence, the board must keep the long-term stability and sustainability of the acquirer company in mind as long as it has the ability to subsume the short-term impact such an acquisition might create.

For a financial investor, a pure debt funding is part of the normal course of business for an Asset Reconstruction Company (ARC). In such cases, it is expected that the organization is well-equipped to handle the financial aspects of any such transaction. In such a scenario, the board must focus more on the corporate governance aspects of the investee company. Additionally, in some cases, ARCs consider equity stake in businesses where the reputational risk is a major factor to look out for.

Q. What kind of assets are you focusing on in the distressed space?

We are primarily focused on assets which might be financially broken and the balance sheet has been stretched due to downturn or other issues. The companies are operating and have a viable business model which is generating cash flows, though not enough to service all debt obligations. In some instances, we also consider projects which are 80-90% complete but have become Non Performing Assets (NPAs) due to late approvals or permissions, etc. These are the assets which can be revived with last mile funding. It is important that this be viewed as a resolution business and not a recovery business as is the case with several ARCs. Resolution business is more of aggregating debt, infusing fresh capital, identifying non-core assets, and bringing in a strategic partner. It requires a good mix of financing background, investment banking capabilities and also an understanding of the equity market.

Q. Should boards wait for certain specific companies or they look at whichever companies come their way and turn that into gold? What is the right approach?

The first filter should be on whether the company satisfies the broad criteria– in our instance, being an operating company generating cash flows. This filters out a large chunk of companies. Other filters around size, aggregation potential, etc. can be applied to further narrow down the list. Once all of these filters have been applied, it is important to also filter out companies in the negative list, if any. Ideally, all the companies remaining should be then analyzed from a pricing and expected yield perspective to arrive at potential investment opportunities. Typically, these operational nuances are handled at the business level and thereafter put up to the board for approval.

Q. What are the questions that IDs must ask the management after an investment in stressed assets?

There are two lenses to look at a post-investment scenario:

- From an overall group level, the independent directors must remain vigilant about the concentration towards certain sectors, group exposure limits, etc.
- They must also try and evaluate the business perspective of a certain set of cases which cover a large chunk of the total portfolio. This could be in the form of resolution plans, return perspectives, recovery outlook, recent developments, etc.

Q. What is the role of the board in deal rationale and deal execution?

The board should focus on testing the strength and validity of the risk framework and the assumptions made. For instance, there should not be any deals which are too large in relation to the acquiring company and that threaten the long-term stability of the acquirer. Similarly, compliance processes must ensure that deals are entirely compliant to the extant regulations as well as take into account the possibility of any future compliance challenges from the acquisition.

Q. What should be the key considerations for independent directors in the areas of risks, governance and stakeholder management when evaluating stressed acquisitions or investments?

Risk management should primarily focus on ensuring that the encompassing frameworks and policies suffice for robust risk management. The clearance hierarchy should be clearly defined with the biggest deals potentially going to the board for approval, depending on their size vis-à-vis the acquiring company. Governance is a key metric to evaluate any potential portfolio company. Especially in case of equity stake acquisitions, any governance failure can adversely affect the reputation of the acquirer and must be taken into consideration when evaluating any stressed acquisition.

Stakeholder management is another important aspect to be considered during the acquisition of stressed assets. While it is business as usual for ARCs to invest in distressed assets, non-ARCs might find it difficult to justify a stressed asset acquisition. In such cases, the independent directors, if they are convinced of the rationale of the acquisition, play an important role in settling the deal across multiple stakeholders, be it clients, investors and even the acquirer's own employees.

Forensic audits for bad debt

Arpinder Singh
Partner and Head – India and Emerging Markets, Fraud Investigation & Dispute Services, EY

The Insolvency and Bankruptcy Code 2016 (IBC or the Code) was rolled out a little over a year ago to accelerate insolvency proceedings, deal decisively with the increasing non-performing assets (NPAs) and boost the overall confidence in investments in India. Since the enactment of the IBC, there have been significant deliberations on its impact and effectiveness, need for amendments and charting out a roadmap for the future. The recent amendment to impose restrictions on wilful defaulters is most likely a consequence of this contemplation.

The IBC has been formulated to revive the business environment by reorganization and/or aid in the recovery process for lenders in a time-bound manner. The other important aspect of the Code is the classification of all classes of existing creditors as financial and operational, without any sub-classes.

Insolvency and frauds: The need for a forensic review

One of the key imperatives for the successful implementation of the IBC is stakeholders understanding it in spirit and not just in form. The lenders (financial creditors) can proceed with insolvency proceedings in the event of a default after considering factors such as the nature of the delinquency (short or long term), process of addressing it through restructuring or reorganization methodologies and exercising resolution only through insolvency proceedings. Each of these would need to be strategized by the lenders closely as they carry different sets of implications.

While deciding on the strategy related to insolvency, a key consideration for the lenders is recovery. The recovery mechanism under the IBC sometimes requires financial creditors to sell at a higher discounted value — the issue becomes exponential in case of unscrupulous borrowers who may have diverted or siphoned loan proceeds, leaving behind the limited residual value of the assets. The recent non-performing asset (NPA) crisis has led to forensic audits on corporate borrowers, revealing diversion and siphoning of funds in majority of the cases. In such cases, it may merit considering the liquidation process directly rather than following the course of action under the Code.

Given the increase in the number of cases of wilful default, the IBC has a specific clause that requires a "lookback" review of transactions for a period of two years pertaining to related parties, and one year in case of unrelated parties. The Code has further bifurcated such transactions into the following: preferential transactions (Section 43), undervalued transactions (Section 45), transactions defrauding creditors (Section 49) and extortionate credit transactions (Section 50). These classifications were not available under the prior applicable acts and the "lookback" period was also limited to 6-12 months.

The lenders, along with the insolvency resolution professional (IRP), are required to focus on these provisions of the law to identify transactions of the above nature and the value impact of such transactions. More often than not, these would not be straightforward to identify and necessarily warrant a professional business review by forensic specialists. As the number of cases being filed under the National Company Law Tribunal (NCLT) is rapidly increasing, it is imperative for IRPs to identify and review the cases through a "risk" lens and employ the right skills when it comes to specialist areas such as forensic. Examples of "red flags" that may require further probe and

analysis are concentration of sales and purchases, related party transactions, movement of stock and current assets that are not in line with business and industry benchmarks, revaluation of assets close to period end, sudden change in auditors, circular movement of funds in bank accounts, accounts held out of consortium and large order book with new customers, etc.

The new amendment: Ordinance

The Ordinance aims at further strengthening the insolvency resolution process and has considered it necessary to prohibit the submission of a resolution plan by certain persons (as specified in Section 29A) who, on account of their antecedents, may adversely impact the credibility of the processes under the Code.

Section 30 (4) of the Code has been amended to cast responsibility on the Committee of Creditors (CoC) to consider the feasibility and viability of the resolution plan. Further, the CoC shall not approve a resolution plan if such resolution plan has been submitted by a resolution applicant who is ineligible pursuant to Section 29A of the Code and with the approval of 75% of the voting share of the financial creditors.

The amendment would imply the need for extensive due diligence on resolution applicants, more so in case the borrower is looking to buy back the company from the bank through indirect means. This requirement of the Code would again require the CoC and resolution professionals to review bids submitted by the prospect to check the capability and credibility of the borrower to fund the buyout. They may also need to conduct source analysis of the funds proposed (to be used for the buyback) along with extensive background verification to identify any incapacities attracted as defined under the Code.

The third amendment to the Code specifically expects IRPs to check the identity of the resolution applicant. They need to check for any convictions in the past five years, any pending criminal proceedings, a disqualification under the Companies Act 2013 to act as a director, have been identified as a wilful defaulter under the RBI guidelines, or debarment from trading in the securities market by SEBI and have transactions with the corporate debtor in the past two years from the perspective of Sections 43, 45, 49, and 50 of the IBC. IRPs should also perform these checks on any individuals connected to the resolution applicant.

An effective due diligence would additionally benefit potential companies (not linked to promoters) that are looking to acquire distressed assets or to invest in them, in the valuation process.

Key considerations for the board members and independent directors

Under the Code, a single default could potentially result in the board losing control of the company and exposure to extensive scrutiny, including being held liable for transactions ultra vires the Code (Sections 43, 45, 49 and 50). No exemption of sorts might be available to independent directors as well.

Boards will have to exercise effective vigilance and identify inadequacies, if any, at an early stage and have close communication and transparency on those inadequacies with the lenders. Aggressive business practices and over-diversification into other business channels or geographies are other considerations to be monitored by the board and independent directors. A periodic "health check" on key business partners and internal processes to identify leakages would prove to be prudent. It would be further imperative to work proactively and decisively towards an internal resolution mechanism, given the new restrictions where company promoters may not even be allowed to bid under the resolution plan.

Under the IBC, independent directors on interim board positions should consider a detailed feedback from the IRP on the need for a forensic review, the approach being followed and the outcome of the review. There could be specific situations where the "look-back period" of two years may further be extended to arrive at a conclusion especially in cases where the NPA reporting for the company may have been beyond two years of the filing under the IBC.

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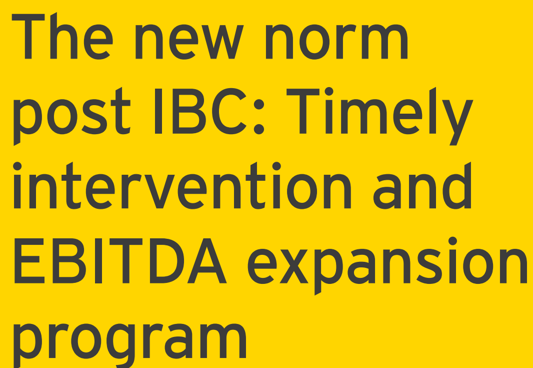

The new norm post IBC: Timely intervention and EBITDA expansion program

Akhil Puri
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The Insolvency and Bankruptcy Code, 2016 (IBC) became effective in December 2016 and the various stakeholders are coming to terms with the new norm in the distressed and turnaround space. It envisages a "creditor in control" regime with financial creditors exercising control through Insolvency Professionals (IP) in the event of a single default in repayment of any loan on interest. As a result, stressed or distressed corporates need to implement an accurate cash flow forecasting mechanism to identify mismatches on inflows with commitments on a timely basis. If there is a possibility of a potential default that can trigger IBC, an effective turnaround plan should be devised and communicated to all stakeholders in advance– including financial and operational creditors, employees, etc. Such a plan should include aspects of financial restructuring, operational improvement and possible sale of assets which can be monetized.[1]

All of these have implications to boards and specifically the independent board members. Independent director have roles that are a balance of those of a coach and a referee. They are expected to guide the company on best practices from their past experience, connect the management with best-in-class subject matter experts or advisors, ask the right set of questions to guide strategic thinking and very importantly help in the understanding and managing of risks without getting involved in day-to-day operations. A company in a distressed situation may have landed there due to external factors (beyond the management's direct control like geo-political issues) or internal factors (in direct control of the management). Many in the industry believe that ultimately the reasons for decline are largely internal, though management may blame external forces, similar to a ship's captain who did not react appropriately to the weather forecast. Boards can play a significant role here.

Early warning signs

Regardless of the cause or nature of a distressed company's challenges and reasons for decline, there is usually an 'early warning' phase. A few examples of typical symptoms include:

- **Stagnation or slight decline in revenues:** Instead of detailed analysis or risk assessment, most write it off as seasonality or cyclical blips
- **Loss of market share:** While the company remains profitable, a loss in market share is usually attributed to pricing or promotion strategies
- **Change in consumer patterns:** Evolution in demographics and target customer preferences
- **Missed adoption of technological evolution:** This can include digital, artificial intelligence, blockchain, etc.
- **Heroic expansion plans:** Blind pursuit of growth without proper risk related checks, what-if scenarios and a resultant stretch in credit

Crisis symptoms

In most cases, the board and management ends up reacting when faced with a crisis. Some of the symptoms of the crisis could be:

- **Cash crunch and inability to service debt:** Declined interest coverage and rising debt-to-EBITDA ratios and ever-increasing revolver loan balance

1 From "The Insolvency and Bankruptcy Code, 2016 - An Overview", July 2016, published by EY

- **Rapid rise in obsolete inventory:** Mismatched capex and production vis-à-vis growth expectations leading to write-offs and value erosion
- **Impending covenant breaches:** Typical covenants that risk being tripped are fixed charge coverage ratio (FCCR), funded debt / EBITDA, current ratio etc.

It is usually too late before the management starts reacting appropriately. There is a risk of significant value erosion if the asset enters the IBC space. Here, restructuring and turnaround specialists are well positioned to support boards with an early assessment and timely intervention on an EBITDA expansion program to prevent and, if the case so warrants, reverse the performance slide.

Early risk assessment:

As a best practice, to mitigate risk, the independent director could request an external review on:

- SWOT analysis for the company
- Z-Score analytics (early warning indicator of a possible distress)
- 13 weeks cash-flow forecast analysis
- Trends in key ratios and market share
- Product benchmarking

Based on the above, if significant challenges are identified, the board may engage an external service provider to support the management in developing, and if required, helping deliver an EBITDA expansion program. If the approach is the latter, to create aligned incentives, a portion of the service providers' fees may be structured to be outcome-based.

Formal EBITDA expansion program:

A robust EBITDA expansion program that lays the foundation for an effective turnaround and provides sustainability to an organization is built on these five pillars – strategic planning, operational growth, financial restructuring, human capital management and process efficiency. The specific levers under each of the five pillars are listed in ***Annexure 1***. While the list is not exhaustive, it provides a view on significant opportunities that exist to not only prevent value erosion, but also create value with timely intervention. Here the independent directors have a role to play utilizing their board presence.

IBC: Post-resolution phase

The Code provides for a framework via which post 180/270 days of moratorium, a resolution plan if approved by 75% or more of the creditors, can be implemented. With increased scrutiny on erstwhile promoters from bidding on these assets, there appears to be a significant opportunity for financial investors to invest in stressed or distressed situations. In most of the cases, due to a speedy due-diligence process and information asymmetry between erstwhile promoter and financial institutions, the latter may require an external service provider to help achieve the underlying growth and EBITDA built into their valuation thesis.

The IBC 2016 is a landmark achievement. While the code and its implementation mechanics will evolve, one thing is sure that an early intervention on EBITDA expansion will help preserve value for stakeholders. In the same breath, for cases admitted within IBC process, a post-resolution EBITDA expansion program will also be very value accretive. This appears to be the new normal for times to come.

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Annexure 1

The five pillars for a formal EBITDA expansion program:

1 Strategic

- Identifying core and non-core businesses, assets and products
- Divestment or monetization of non-core assets
- Acquisition for product line, geographic or market access related expansion

2 Operational

- Revenue growth
  - Enhanced go-to-market strategies
  - Key account management best practices
  - Improving win ratio
  - Pricing optimization
  - Product extensions and new product development funnels
  - Increased market share with current customers
  - New customer acquisitions
  - Geographical expansion
- Cost optimization
  - Focused procurement effort
    - Strategic sourcing
    - Low cost country sourcing
    - Reverse auctions
    - Direct vs indirect spend analytics
  - Increased throughput from plant
    - Focus on efficiencies: manpower, utilities, raw material
    - Overall equipment effectiveness tracking and improvement
  - Optimized general and administrative costs effort
  - Supply chain optimization
  - Make or buy decisions
  - Evaluating effectiveness of marketing and promotion spends
  - Value analysis/ value engineering concepts to reduce costs
  - Headcount optimization
- Working capital and cash management
  - Focus on reducing acounts receivable Optimize accounts payable
  - Focus on days sales outstanding
  - Defer non-essential expenses and capex

3 Financial

- Strengthen balance sheet
- Optimize loan terms or refinance, if possible
- Optimize dividend
- Monetize non-productive lines
- Review hedging policy or forex exposures

4 Human capital

- Effective change management process: Beyond slogans
- Engaging employees in the process
- Align management incentives with performance
- Establish and review specific KPIs: Create a culture of performance
- Optimize Layers
- Where applicable, succession plan for critical posts

5 Process

- Streamlined processes for sustainability
- Robust capex review process
- Clear delegation of authorities with checks and balances
- Weekly and monthly dashboards with "one-source-of-truth"
- Effective governance templates and schedule

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