

Corporate Governance - An Alternative Model

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On the eve of the second birthday of the Sarbanes-Oxley Act it will be more appropriate for me as head of a body whose raison d'être is creating awareness of best practices in corporate governance, to talk of the successes in corporate governance effort worldwide. The report card, however, does not say so. There is no doubt that there is plenty of good news. Directors have started taking their jobs seriously. Boards are awash with independent directors. Audit committees, nomination committees, remuneration committees are all being taken seriously. Board meetings, once short briefings, now focus on indepth corporate issues, stakeholders dialogue and corporate social responsibility. Certification of financial statements on penalties of prison sentences has put a chill in the spine of Chief Executives and they are taking far deeper interest in organisation's financial reporting.

It is all hunky dory, specially for audit companies whose revenues are increasing sharply. Audit Fees for Fortune 500 companies are expected to climb 88% this year, according to a survey by the Public Accounting Report. Top accounting firms already look healthier. Ernst & Young booked a 17.4% revenue increase in its 2003 fiscal year, to \$5.3 billion. Grant Thornton booked a 21% increase, to \$485 million. Of course, with the bean counters cashing in, stakeholder expenses are going up. The largest U.S. companies will typically spend more than \$4.6 million each to comply with just one section of the law, according to Financial Executive International. In Europe, one major energy firm listed in the U.S. market puts the annual cost of complying with Sarbanes-Oxley at over \$100 million. And large companies complain that the get-tough accounting regimen is draining resources. Paul Schmidt, controller for General Motors, says GM's chairman and CFO are spending more time on accounting and certification issues, "instead of strategy". And it could get harder, if more governments follow suit. "One of the problems two years down the road is the danger that we're going to have a proliferation of several country codes", warns Rod Armitage head of company affairs at the Confederation of British Industry. "For a company with multiple listings, this is very costly."

On the market front things are far from satisfactory. Frauds are continuing to take place with unremitting regularity. The fraud at Ahold, the Dutch Supermarket giant, which revealed that its 2003 accounts were overstated by 500 million dollars caused its shareholders loss of more than 6 million dollars. There is little correlation between

occurrence of a fraud and its detection and reporting. The fact that most of the corporate scandals are reported in the US does not necessarily mean that frauds occur in US alone and other countries are more honest. If at all it should be the other way around. Countries where no corporate frauds are reported should be the ones to be watched and avoided by investors. It is like the third truth. Truth, as we know, has several aspects. Geeta says "Infinite truth has infinite aspects". We deal with three aspects here. The first truth is that we tell ourselves i.e. the reality as we know it. Second truth is what we tell others: not the reality as we see it but the way, we would like others to see it. The third truth is when the reality is so distressing that we fear even acknowledging its existence. Countries which do not report corporate frauds fall into the last category. Here one must acknowledge and commend the power of US institutions to take up the frauds head on. It is always this side of the Atlantic that frauds rarely get reported. Even when they are reported the establishment closes up and soon all is forgotten.

Lot of song and dance was made of insider trading in Marks & Spencer shares. Nothing came out at the end. British do things differently. One could never think of a British icon being incarcerated the way Americans have done to Martha Stewart. These double standards in corporate governance have come into sharp relief in imposing fines on Shell by the two watchdogs. Shell has been fined a total of 151 million dollars (£ 83 million) for wrongly booking 20% of its reserves. The fine imposed by UK's Financial Services Authority is only a fraction - £17 million against £66 million imposed on it by Securities and Exchange Commission. The penalties are a flea bite as far as Shell is concerned which has just reported £2 billion of net profit in the second quarter alone, thanks to the boost in oil prices. Contrast it with over a billion dollars in fines imposed by Eliot Spitzer on three financial services giants: Citibank, Merrill Lynch and CSFB even before the Sarbanes Oxley came into force. As with so many of these fines, the punishment does not seem to be particularly painful and therefore not a sufficient deterrent. By paying these fines Shell has been able to get the investigations against it closed without having to admit wrongdoing. This does not mean that the company is now over the hill. It still faces a regulatory enquiry in the Netherlands, a potential criminal investigation by the US Justice Department and a raft of class action suits. When asked about the weakness of FSA in imposing fine on Shell it was found that FSA did not even require oil and gas to make disclosures about their reserves.

The US had a head start in legislation on corporate governance having passed the Sarbanes- Oxley legislation on 31 July 2002. There was more dithering on this side of the Atlantic. Even though Sir Derek Higgs had submitted his report not very long after Sarbanes, the combined code on corporate governance incorporating his recommendations came into force only on the 1 November last year. According to the research conducted by Manifest, commissioned by the Financial Times

of UK, only a slim majority of leading companies are on track to meet corporate governance standards as outlined by Sir Derek. Smaller companies have actually scaled down the number of non Executives on the key board room committees taking advantage of the exemption given by Sir Derek. The data shows that while 86% of small CAP companies boasted at least 3 non executives at the audit committee in July 2003, 12 months later the figure dropped to just 70%. Sir Derek came down heavily against the combined role of chief executives and chairmen. There is a good news here. While last year 20 of the biggest 350 companies had chairmen and chief executives rolled into one the figure has now gone down to 13. Also the number of FTSE 100 companies that had designated a senior independent director has increased from 73% to 83%. The biggest rub however is only on remunerations paid to the non executives. These have risen sharply. HSBC pays its non-executives £35,000 a year with plans to increase that to £55,000. Audit committee members get an extra £15,000 while the chairman pockets £40,000 more. By contrast, the chairman of the bank's remuneration committee received an extra £20,000. At Diageo, the drinks company, non-executives receive a base £50,000, an increase of £15,000 on 2002. Its audit committee chairman gets an extra £20,000, double the amount of the year before. At Reuters, non-executives get a base £50,000, an increase of £15,000 on the year before; the audit committee chairman is paid an extra amount equivalent to triple that of his counterpart on the nominations committee.

Payment of such remuneration to independent directors defeats the very object of the exercise. Their remunerations have soared so much that they rate alongside the executive directors raising the same issue of conflict of interest. An analysis of 2004 compensation data shows average remuneration for so-called "non-employee" directors of the top 200 US companies rose 13.4 per cent to \$177,000 (£97,000). Fees paid for attending committee meetings jumped by more than a third. The most important issue facing the companies today is of transparency. Edward Archer, managing director of Pearl Meyer & Partners, the New York compensation consultant that carried out the analysis, said: "It is like hazardous duty pay. They are worried about the risk to their reputations as well as legal liability from the fact that they have to put their name on the dotted line." Pearl Meyer says most companies now choose to issue shares to directors plus fixed annual retainers because of criticism of past reliance on variable attendance fees, share options and other perks such as pensions. For some companies, share awards now make up the bulk of director compensation. At Goldman Sachs, for example, new arrangements mean directors are offered restricted stock worth \$280,000 a year plus a retainer of up to \$100,000.

One of the issues that came into the forefront in Philip Green's takeover battle with Marks & Spencer is the degree of opacity still maintained even by star companies in their financial statements. Philip

Green merely wanted to carry out a programme of due diligence on Marks & Spencer before buying it. How his attempt was foiled is now history. The story is instructive to the extent it brings into fore the difficulties experienced by a typical private equity investor. The World Council for Corporate Governance has always believed that the focus of corporate governance should not be simply compliance to regulation but making boards more competitive. Competitiveness can improve only if companies are open about sharing information. Philip Green had to sweat and bleed even to get information on Marks & Spencer pension funds. Investors who wish to hold significant stakes in businesses want those companies to be more competitive and naturally want a lot more information than is currently available as per statutory requirements.

According to Charles Cary-Elwes who set up RREV, the corporate governance joint-venture between the National Association of Pension Funds and the Institution of Shareholder Services, "the debacle such as at Sainsbury - where Sir Peter Davis, the chairman, was awarded a substantial bonus despite poor performance would not have happened had private equity investors been serving on the board. The big difference is that when pension funds and other institutional shareholders talk of engaging with companies, they usually mean Corporate Governance; whereas, when private equity investors talk of engagement, they tend to mean something different, namely "Enterprise" Governance." We believe that corporate governance without "enterprise" governance is an almond without a kernel.

Today's business faces multitude of challenges, increasing business pressure on all fronts, globalization, shorter product life cycles, internet, over capacity, complex regulations, currency volatility, value migration etc. Meeting these challenges will bring about economic discontinuities that are unprecedented in rate and scope, and would require highly innovative approaches. We have to leapfrog over existing technologies rather than incrementally improve them. Using Nicholas Negroponte's expression for the times that we are living "incrementalism is our worst enemy". But innovation will bring tremendous resistance from vested interest. One only has to refer to Jim Utterback's (An MIT Professor) case studies of pressures on electric companies brought by gas lighting companies in the 1880s, recorded in his book "Mastering the Dynamics of Innovation", to understand how hard it is to resist change. This is the Board's number one job in today's economy which is driven by innovation.

The fact is that even two years after Sarbanes Oxley & similar acts elsewhere there is no let up in the frequency and magnitude of corporate frauds. These frauds have only added to the burden of shareholders and costs to the customers. The glorification of greed continues with the rape of corporations for the personal enrichment of the senior executives and the creation of ventures whose business plans do not extend beyond the initial public offering. The real question

is how do we handle greed before it destroys capitalism. Greed is the biggest blame of the market economy and may well become the death knell of the capitalism. So, the biggest challenge before us is how to handle this greed. How can human behaviour be rewarded other than through the money. One, therefore, has to look for fundamental purpose of the corporation. It is relevant to draw attention to Enron again in this context. In their book on Enron's demise "What Went Wrong At Enron", Peter Fusaro and Ross Miller record that when at Harvard Business School, Mr Skilling was asked what he would do if his company was producing what might cause harm – or even death - to people who used it, he is said to have replied: "I'd keep making and selling the product. My job as a businessman is to be a profit centre and to maximise return to the shareholders. It's the government's job to step in if a product is dangerous".

The fines and restitution amount of \$1.4 billion imposed on the big US banks were expected to end the multimillion dollar pay packets some analysts enjoyed in the bill market, which were justified by the amount of investment banking business they brought in. But such is the bizarre world of corporate finance that soon after CSFB had offered an equity analyst at JP Morgan Chase a package that could earn him up to \$4 million in the first year. Where will this money come from if not from an unholy alliance between the analysts and underwriters?

A revealing statistic was presented to Congress during the hearings leading up to the Sarbanes-Oxley Act: the ratio of buy to sell recommendation by securities analysts employed by brokerage firms rose from 6 to 1 in 1991 to a high of 100 to 1 in 2000. During the 1990s, analysts appear to have moved from being neutral umpires to becoming cheerleaders for their firms' underwriting clients.

In a recent article Prof Jensen, with Joseph Fuller of The Monitor Group, argued: "As the historic bankruptcy case of Enron suggests, when companies encourage excessive expectations or scramble too hard to meet unrealistic forecasts by analysts, they often take risky value-destroying bets. In addition, smoothing financial results to satisfy analysts' demands for quarter-to-quarter predictability frequently requires sacrificing the long-term future of the company."

The problems in corporate governance are the problems of execution. There is too much rhetoric and too little conviction. There are many among business still not convinced about the moral angle of business. There is still an argument as to whether more money is destroyed by frauds or strategy. Corporate governance is not just an issue of legal compliance. It is an issue of hearts of pride in doing the right thing. Our biggest challenge lies in replacing greed for running the corporation to a zest for making a difference to the community and turning corporate governance as an instrument of economic and social transformation. Corporate governance, therefore, is an issue of the heart and not simply statutory compliance. To have the institution managed in the

interest of real owners has been a challenge at all times. The question is will we be able to meet it effectively even in the 21st Century?

The simplistic view that prevailed in 1990s that business leaders need to focus exclusively on shareholder value as determined by the share price and that financial analysts are the best judge of business strategy simply has now become entirely overlooked. Companies have to find innovative ways to contribute to broader needs of society and at the same time improve the revenue and cut operating costs. The corporations need to find new models of constructive engagement involving all stakeholders to bring about change in the society. The business must look for innovative formats that stimulate systemic thinking and dialogue rather than posturing. The question is no longer whether the business has a role in social change but how it should play this role and corporate governance has to be a catalytic for that change. Corporate governance has to be based on equity and fairness. The issue is not simply growth but that the growth is shared. Company's goal should not be the prosperity of a few but many. Inequality will be the greatest threat for the security of corporations in 21st Century. People can live in poverty but not injustice. This is why corporations are increasingly realising that the social good has become the greatest competitive differentiator.

The good news is that the role of business today is far more encompassing than ever before. Its constituency has extended to become global. So, its mindset should not be stuck into parochial grooves. It must recognise that its success will come from involving everyone and that it is only by valuing diversity, dissent, difference and dialogue that it can spark the clash of ideas that will create innovations to sustain the corporations of the future. Corporations have to recognise value today comes not from deference but difference. It is created not by conformity but dissent.

Today it is the economy that drives politics. It is the business that drives governments. The terror, turmoil & turbulence all around us is proof enough that the political system has failed to address the human problems of inequity, poverty and security. Business can offer a hope, if run on true principles of transparency, equity, accountability and integrity and responsibility business can make a difference. It is the knowledge that you can make a difference that can be a powerhouse and pride for execution and a true incentive for driving the corporations.

For making corporate governance work we have to go through a profound metamorphosis from inside out. We have to change our metaphors of success from "winner takes all" and "success at all costs" and develop an inner value system which prides on ethics, morality, equity, legitimacy, transparency, diversity and most of all courage to own genuine failures.

The real problem lies in our education system, which does not prepare us to handle failures. Instead by focussing on short term success. It only helps us add further layers of translucence and traps us in the self-conceit of success. We need to change the model. We must change the culture of living from quarter to quarter where CEOs are more interested in managing the stock rather than creating strategic value for business. We must change our horizons and focus on long-term goals.

This requires a 180 degrees shift and can not come without a deep commitment for training. Practice of Corporate Governance, therefore, cannot be ingrained in boardrooms without a sharp focus on the training of directors. The norm to appoint independent directors shall be a good opportunity to ensure all new appointees are trained in the new role of directors as wealth creation for all stakeholders. Training can work wonders as can be illustrated from the example of Mahatma Gandhi. There cannot be a more powerful illustration of the transforming power inherent in training. He describes his first encounter in a small cause court where he was required to cross-examine a witness of the plaintiff. The Mahatma writes, "I stood up but my heart sank into my boots. I could think of no question to ask. My head was reeling and I thought the whole court was doing like wise. The judge must have laughed and the lawyers no doubt enjoyed the spectacle. But I was past seeing anything. I told the agent "I could not conduct the case". Same Gandhi writes further "But I persevered and I persevered. I can now give a certificate to myself that a thoughtless word has neither entered my tongue nor escaped my pen". I have no doubt that it is only through perseverance that our boards will be able to transform organisations to become engines of economic and social transformation.
