

# Directors Have a Cause to Live For

Madhav Mehra  
President World Council for Corporate Governance

**“The greatest tragedy of corporate governance lies in the manner in which it is being abused by the vested interests to perpetuate their self interest whether it is auditors, CEOs or other powerful lobbies. Time has come for directors to sit back and think how they can use the five pillars of good governance namely transparency, accountability, equity, diversity and social and environmental responsibility to make a difference in running their business so that they not only create sustainable wealth but also improve the lives of communities involved. With triple bottom line as their agenda and almost 4 million people still hungry in this world they would never have a better cause to live for”, says Dr Madhav Mehra**

Never before in human history have the directors' role in national wealth creation and human happiness been so poignant as today. Never before did they have so much capacity to improve the lot of common man.

Business today is not longer simply an economic entity. It is an engine of economic and social transformation. The prolific advance in technology and globalisation has transformed the capacity of businesses to effect human lives. Companies are increasingly realising that wealth creation requires a vision that goes way beyond their bottom line. Companies who simply focus on quarterly profits rarely succeed in the long run.

Such a high profile occupation has a cost attached to it. Naturally public expectations of director's roles and responsibility have also increased sharply. Directors who have been found wanting in the performance of their duties have had to pay a heavy price. Recently, Keneth Lay the former Chairman of Enron was marched off in handcuffs. America's household goddess Martha Stewart was sentenced to 5 months in jail and 5 months of house arrest following her conviction for lying about a stock sale during government investigations.

Recently, 10 former directors of the Worldcom (now MCI ) have agreed to pay \$18 million out of their own pockets as part of a shareholder lawsuit. A few days later, 18 former director of collapsed energy conglomerate Enron agreed to pay \$13 million as part of a settlement in a shareholder lawsuit. Rebecca Mark, who played such a prominent role in the controversial power purchase agreement for the now defunct Enron's Dabhol Power Company plant in India, is among those who will be paying out.

The spectre of directors being marched off in handcuffs and awarded prison sentences is now haunting every director. Time has come therefore for directors to take their responsibility seriously and get to grips with what they are supposed to do. Continual training of directors has been made compulsory in several countries. This also forms a core of Naresh Chandra's Committee report in India and Derek Higgs in the UK.

In the corporate form of business organisation the board of directors occupies unique position. The Cadbury report placed the corporate board at the central stage of governance system. Elected by the equity shareholders of the company, the board of directors oversees the performance of the company through the executive management.

The Cadbury report described the board responsibility to include setting of company's strategic aims providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship.

Shareholder activism on directorial responsibilities has also opened up new opportunities for aspirants of director's positions. It has brought a new breed called 'independent directors'.

Clause 49 of the listing agreement defines the independent director to mean non executive director of the company who

- a. apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its senior management or its holding company, its subsidiaries and associated companies;
- b. is not related to promoters or management at the board level or at one level below the board;
- c. has not been an executive of the company in the immediately preceding three financial years;
- d. is not a partner or an executive of the statutory audit firm or the internal audit firm that is associated with the company, and has not been a partner or an executive of any such firm for the last three years. This will also apply to legal firm(s) and consulting firm(s) that have a material association with the entity.
- e. is not a supplier, service provider or customer of the company. This should include lessor-lessee type relationships also; and
- f. is not a substantial shareholder of the company, i.e. owning two percent or more of the block of voting shares.

Naresh Chandra committee also recommended that at least 50% the directors in the listed companies should be non-executive independent directors. This means that India would need 22,500 independent directors in the very near future.

Independent directors are entitled to sitting fees which have also been enhanced from Rs 5,000 to Rs 20,000. In addition they are entitled to 1 % of the company profits. A number of directors have multiple independent directorships. There are already complaints that pendulum has started moving in the other directions and some independent directors are receiving 12-15 lacs per year as sitting fees and commission and thus can hardly be called independent.

We must know that at the end of the day these costs will have to be paid only by shareholders and investors. It is because of this that there is a huge investor outrage at the cost of compliance of the recently legislated Sarbanes-Oxley Act which came into effect in the US on 31 July 2002.

According to a new survey the big four accounting firms have doubled their audit fees because of the work mandated by the Sarbanes Oxley act. The act was originally drafted to protect investors by curtailing the powers of these very firms who were found to be at the heart of each corporate scandal. In the bargain investors feel having been ripped off.

The survey quoted above was conducted by Corporate Executive Board, a consulting firm and involved 43 companies that have had to comply with section 404 during 2004. The average increase in audit fees at 134% was highest in the case PwC followed by 109% for KPMG, 96% for E&Y and 78% by Deloitte. The survey found that the companies spent on average \$5m to \$8m dollars to comply with Sarbanes Oxley legislation.

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. Even US companies feel that the new regime is draining their 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".

Coupled with this is the remuneration of independent directors. An analysis of 2004 compensation data showed independent directors of top 200 companies are being paid £97000 for barely 7 days work in a year. Would you expect such directors to give "independent" and "unbiased advice"?

As cost of compliance of regulations such as Sarbanes Oxley is increasing astronomically the question most frequently asked is whether the onerous and unnecessary expenditure on compliance is worthwhile and is it really in the interest of investors who eventually have to foot the bill?

This has resulted in corporate opposition to compliance and demand from European companies to delist from US Stock Exchanges. A delegation of European business leaders, including top officials from leading companies such as BASF, SIEMENS & UK's CBI has met William Donaldson, SEC Chairman, to relax rules that compel companies to comply with US reporting requirements if they have more than 300 US investors. A growing number of European companies are considering delisting.

According to a US quoted German company half the DAX 30 companies with US listings want to withdraw from US market. Sir Christopher Bland, Chairman of BT Group said it would delist if it had the option.

This is one of the issues which is going to be debated in the forthcoming 6<sup>th</sup> International Conference on Corporate Governance being held in London on 12-13 may 2005. The theme of the conference is "making corporate governance decisions that work".

Sarbanes Oxley Act has split the corporate community. Companies, specially the ones based outside the US, feel that they can do without the excessive cost of compliance of SOX. There is another view that this is an investment that offers significant opportunities of competitive advantage in an environment where each stakeholder is looking for greater transparency and disclosure. A survey by PwC involving 1300 chief executives indicated that those who think that compliance of SOX is an investment, outnumbers the "cost" group by almost 2:1.

Most CEOs understand that improving corporate governance by strengthening board expertise, board oversight and exercise of better internal controls to manage risks, would improve managerial effectiveness and add significant benefits and savings. The compliance can result in enhanced reputation, increased operational effectiveness, higher employee moral, improved customer loyalty and more transparent engagement with civil society. Transparency is the heart of corporate governance. With the increasing demands on disclosures, companies cannot survive without putting in place internal control architecture that will enable timely disclosures without risking reputation.

The globalisation today offers huge opportunities for proactive businesses. Today's business is dealing with only a fraction of the infinite field of available options. There are enormous opportunities for innovation and creativity. But innovation does require investment. Transparency can work wonders in improving company's credibility and access to global capital.

The real management challenge for global companies lies in creating systems for global governance that comply with stakeholder expectations right across their global operations and help them to build new markets and increase profitability. One of the nagging worries of the businesses after Enron and WorldCom directors accepted to compensate company losses from personal funds is to attract quality independent directors. Companies that have developed robust compliance programme and transparent structures would make them ideal choices for qualified directors.

William Donaldson is currently reviewing the effectiveness of Section 404 of SOX. The question that he should be addressing himself is why the cost of compliance should be so prohibitive and how he can reduce the wages of sin for these auditing companies, minimise their hegemony so that he can achieve the goal of creating value for investors.

The greatest tragedy of corporate governance lies in the manner in which it is being abused by the vested interests to perpetuate their self interest whether it is auditors, CEOs or other powerful lobbies. Time has come for directors to sit back and think how they can use the five pillars of good governance namely transparency, accountability, equity, diversity and social and environmental responsibility to make a difference in running their business so that they not only create sustainable wealth but also improve the lives of communities involved. With triple bottom line as their agenda and almost 4 billion people still hungry in this world they would never have a better cause to live for.

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