Clause 49: Are We There Yet?

The most far reaching legislation on corporate law in the history of the corporate world probably has been the Sarbanes-Oxley Act of 2002. The Act itself was passed by an unprecedented majority, quite unheard of convergence of political differences to fix errant and evil corporate directors. The impact of this Act, in its tsunami like behaviour was felt across the world – from Dublin to Delhi. Countries brought about swift changes, inspired by SOX, building safeguards and accountability in their systems.

Sarbanes is a reactive piece of legislation. It was passed as a reaction to the plethora of scandals that rocked the bedrock of American economy – it obliterated the wealth of the common man, reduced their life's savings and pensions to nothing – all of this at the hands of unscrupulous corporate leaders and managers. The American CEO in 1984 was earning about 40 times that of an average worker. In 2004, it was about 400 times. The celebrity status and the frenzy of the financial markets till early 2000, told stories of unprecedented greed and arrogance that brought down some of the largest companies and ruined millions of individuals.

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The History

The CEO of Enron, when asked in court whether he was aware of the misstatements in Enron's financial statements – which had fraudulently reported a large profit instead of a loss, said that he was unaware of such an act as he had not signed the financial statements. Under the US laws then, there was no requirement for the CEO to sign the company's financial statements. SOX brought in such changes, making the CEO and CFO responsible not only for the efficacy and robustness of the financial statements but also for having an effective internal control over financial reporting. In India, the responsibilities of the financial statements have been clearly stated in the Companies Act of 1956 and they lie with the Board of Directors.

The Board is also responsible for maintaining proper books of account which would give a true and fair view of the financial statements and comply with the Accounting Standards. The principles of 'truth and fairness' of the books of account embody the robustness of internal controls – the responsibility of which lie with the Board. The auditors under the Indian laws, since 1975 – nearly 30 years before SOX were issuing an opinion on the internal controls over critical processes of a company.

On 1st January 2006, the amended clause 49 will be effective. In the absence of legislation similar to Companies Act in India & the UK, a law like SOX was made in the USA Unfortunately; we seem to replicate significant parts of SOX in one form or the other, even where our laws have remedies for such misgivings.

The Effort Outlay

Since the amendment goes effective on 1January 2006, this means for the quarter ended 31 March 2006, a company would have to comply with the requirements of establishing risk management processes, internal controls, have appropriate number of independent directors, establish a code of conduct etc., and issue a compliance report by 15 April 2006.

Internal controls are those systems that act as checks and balances over the operation of an enterprise to preserve the sanctity of transactions the company has with others and itself. They are all pervasive and spread across the entire fabric of an organization. The controls need to be in operation for the entire year to be able to deliver robust year end financial statements. In order to have internal controls in place which are effective and not materially deficient, they need to be in operation for the entire year or substantially thereof. It would be very unusual for a company to establish such controls over a period of 90 days from 1January and also test them for efficacy.

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In many ways, the 'D' day of 1 January is inappropriate for compliance with establishing adequate internal controls as companies should have had them in place and operating for nearly the whole year. This is where we need to draw the line.

According to AMR Research of Boston, U.S. companies in compliance with their own internal control reporting will spend in 2005 about USD 6.1 billion to comply with SOX rules, a figure that includes everything from consultants' fees to technology. Blythe J. McGarvie, a director of a number of Fortune 500 companies gives the example of Pepsi Bottling spending over 34,000 hours in assessing the internal controls and their auditors spending 12,000 hours.

So, what have companies in the USA learned over the past few years? Dow Chemical Co. offers some clues. Dow makes more than 3,500 products, ranging from Styrofoam to farm fungicides, which meant surveying about 30,000 different

internal systems. The targets were as large as company computer networks -- and as small as making sure sales contracts for customers in Mexico City were properly authorised.

Last year, the company spent about 100,000 man-hours getting its controls in order -- a job that cost more than $12 million and frequently put Dow's compliance officers at odds with auditors.

This is the magnitude of the outlay of efforts.

The buzz and overall work that compelled U.S. companies to comply with SOX took the entire financial world by surprise. The motto was 'zero tolerance' and billions were spent. Corporate governance specialists – a new breed of professionals were created and audit firms had their best year ever. The year 2004 to financial accounting was what year 2000 was to the software industry. In contrast, a few days before the deadline, we hear little buzz in India - faint rumours laced with expectations that Clause 49 deadline will be deferred. Little has been done by companies to comply in letter and spirit. We legislate rules of governance but rarely comply with a conscience.

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Independent Directors

The mythical angels called independent directors now have the sole responsibility of keeping corporate India in check. CII and Prime Database have set up a large database of individuals who could work as independent directors. Needless to say that in India, such a database gets populated very quickly by all retired, retiring, out of work and aged professionals who rarely managed to get to the board position of the companies they worked for. We seem to forget that a director holds a fiduciary responsibility and needs to be carefully chosen. You would not go through the yellow pages to look for your favourite neuro-surgeon. You do not go through a public database to find a director for a listed company.

An independent director is an oxy-moron in a country where owning or promoting families have substantial ownership and control. Under the Companies Act, all directors need to be appointed and remunerated through resolutions approved by the shareholders. The family usually owns a majority stake or has a substantial stake and overwhelming influence over such enterprises. No independent director would be appointed or remunerated unless the family gives an approving nod. Where would his interest lie? Rarely have we seen independent directors taking a vastly different view than the promoters. If they do, they usually end up voting with their feet. The recent Escorts case is an example when some of the independent directors stood up for what they believed was just and equitable and

resigned, which reinforces the ‘fait accompli’ faced by independent directors – either you are with us or against us. Our insurance against mismanagement would not lie in definitions and rules of appointing independent directors but in the ethical calling and reputational risks some of these directors will have to protect themselves from.

Rules Vs Principles

The fundamental difference we have with SOX is on the sheer definition and the breadth of responsibilities under 302 and 404 of SOX. The certification process by the CEO and the CFO on internal control is on those controls over financial reporting. In the UK and Europe, the guidance is issuing an operation and financial review statement by the Board on all the aspects of risks and internal controls.

In contrast, care needs to be taken when comparing the relative merits of Section 404 of SOX and the Turnbull guidance of the UK, (the UK governance rules) as there are significant differences in scope and approach. Both are parts of a broader regulatory framework, and both are products of those frameworks. The US approach is usually characterised as being rules-based, while the UK approach is principles-and market-based (as epitomized by ‘comply or explain’). Importantly, Section 404 is concerned only with internal controls over financial reporting, while the Turnbull guidance covers all controls. *Clause 49 requires certification on all internal controls.*

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The Review Group (of UK governance rules in 2005) received little encouragement from investors to recommend Section 404 style disclosures.

There appears to be a general acceptance that the initial implementation costs of Section 404 have been considerably higher than anticipated and, in the view of some commentators, disproportionate to the benefits. It is not clear to what extent the costs incurred by companies during the first year of implementation will prove to be one-off or recurring costs. In May 2005, the SEC and PCAOB both issued further guidance intended to address some of the difficulties that had been experienced in implementing Section 404 in the first year. Nearly 14% of all the large US companies failed the 404 test of having satisfactory controls in the first year. This is after all the effort.

A certification process necessarily is a compliance of a set of rules to deliver an opinion and in such a process one covers his risks by distributing responsibilities. Typically, this leads to a number of back to back certification with every individual

in the chain signing off pieces of paper, whether or not the control processes would enable them to logically certify such processes.

The Indian CEO and CFO under Clause 49 will need to certify on the efficacy of all aspects of internal controls – from manufacturing processes, sales processes, legal compliance, human resources to financial, making this the most onerous certification process in the world. Pity the CFO, who would now need to build all the expertise to understand manufacturing processes in complex industries for such certification. It is quite incomprehensible that in today's world of specialisation like a finance function, the CFO has to take all risks and liabilities of all control or would rather take comfort in a myriad of back to back certificates. This defeats our basic foundation of being principles based.

The Way Forward

Paul Atkins, the SEC Chief in 2004 made a statement saying "*we have seen an unprecedented number of rules since the enactment of the Sarbanes-Oxley Act". It's safe to say that never before has the SEC promulgated so many new rules in such a short time. So at some point there has to be a reassessment of some of the things we've done. We need to perform a cost benefit analysis to determine what does work in terms of advancing information for shareholders and what is only causing superfluous expenditures".* ……

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The vastness of the efforts has already made SEC defer the implementation of SOX certification for small cap US companies and overseas companies listed in the USA. SEBI should stagger the implementation of Clause 49 as the small cap companies are not in a position to comply with most requirements of Clause 49. They clearly need more time and guidance.

In the UK, the review group will come out with final guidance in early 2006. "One size fits all" approach is detrimental to the corporates in India as this will result in a rush to comply with these requirements only on paper. Clearly, larger companies, especially those already listed in the USA, like Infosys and Satyam are way ahead in this path. The small companies with their meager resources and budgets will find the going tough.

It is beyond the call of duty of the CEO/CFO to take responsibility of all controls. This should clearly be reviewed as being too onerous.

SEBI has not been forthcoming in releasing guidance on the implementation and clarity on the rules of the Clause. It is left to individuals to interpret in the way deem fit. In today's capital markets, 'comparability of information' is a key and SEBI needs to do more to drive the unanimity and comparability of the approach. It is easy to draft rules that are drawn from SOX and SEC but then one needs to be as proactive like the SEC in helping implementation of the rules. A need for clear guidance is the call for the day. **Independent Directors**

The cure for all corporate evil seem to lie with the independent directors. In a culture like ours where obedience, respect for age and authority, feudalism in varying colours play a huge role, raising dissent in a board and being heard is no mean task. This is not an issue only in an Indian context. In Asia, from Japan to China to Dubai, the Anglo-Saxon model of governance is likely to fail.

An Asian governance model would need to evolve from our deep rooted family businesses, our bonds to families, our cultural strengths, which is unique to our world. This will take time but surely be an integral part of our corporate lives in the near future.

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