Reappointment of Directors and Auditors

Why investors need to step up and vote

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As a voting advisory firm, we ask shareholders to vote against merging unlisted companies belonging to the 'promoter family' with a listed company, with the sole object of increasing the families' control. As a voting advisory we ask shareholders to vote against resolutions where the family wants the 23 years old princeling not just on the board, but as a working director. We also ask shareholders to vote against the increase in royalty payments being hoovered by the global owners. But if you look at the data in the Table below, for the most part we have advised shareholders to vote against the reappointment of auditors and against the reappointment of independent directors.

Table: IiAS Voting recommendations 2012-13

	For	Against	IiAS Analysis/ Seek Information	Not for Approval/ Noted/Split	Total
Approve Accounts	-	-	216 [1]	1 [2]	217
Declaration of Dividend	191	0	0	1 [2]	192
Appointment of Auditors	79	129	1	6 [3]	215
Appointment of Directors	509	205	2	15 [4]	731
Remuneration of Directors	196	36	3	5 [5]	240
Alteration of MOA & AOA	28	3	1	1 [6]	33
Disposal of undertakings	26	1	0	0	27
Issue of Securities	78	5	0	0	83
Scheme of Arrangement	8	8	0	0	16
Intercorporate Loans	14	3	1	0	18
Donations	0	3	0	0	3
Debt	18	0	0	0	18
Alteration in capital structure	27	0	0	0	27
Authorise/Modification/Ratification of ESOS	42	3	0	0	45
Others [7]	8	2	0	0	10

Source: IiAS

1. IiAS does not provide recommendations on adoption of accounts, but an analysis
2. Not for approval
3. Split, as its for appointment of joint auditor
4. 13-noted, /2-split
5. 1 noted, 4 split
6. 1 split
7. Includes items like shift in registered office, keeping documents outside registered office etc.

As is seen above, related party mergers, appointment of successors, royalty increases happen only on the odd occasion for each individual company. But each year companies propose reappointing auditors and each year they propose appointing new and reappointing existing directors. It's the frequency of such resolutions which accounts for our statistics; it's this same routineness that ensures these resolutions are taken least seriously. So you find directors who have remained independent for 26 years, directors in all four listed group companies being called independent, accountants who started a practice only to audit a firm and in one instance one who has audited the books for over 50 years.

Why do companies carry on with existing auditors? Companies argue that the replacement costs for auditors will become significantly high and far outweigh any transparency benefits that may result from the change. They maintain that businesses nowadays are far more complex and the audit process requires a fair degree of familiarity with the internal processes, systems and key risk areas of the company. Periodic rotation therefore will not achieve the intended results and conversely, may end up reducing the audit quality. But if audit integrity is desirable, so should the need to change auditors. Vintage auditors tend to develop a certain level of comfort with the company management, thereby compromising the integrity of the audit process. Mandatory rotation will not only bring a fresh perspective on the financials, it keeps the existing auditors on their toes as they will be aware that a new auditor may detect any irregularities in the accounting process.

In a survey regarding governance, investors indicated that quality of financial reporting is the most important parameter while deciding whether to invest in a company. Hence, any doubts regarding the integrity of the audit process creates a negative perception in the minds of investors. Breaking this existing relationship between companies and their auditors will be a critical step towards raising the corporate governance standards in India.

No one questions the need for non-partisan directors. Yet while reappointing independent directors, companies prefer to remain within their comfort zone. But this rationalization rests on fragile foundations – there are no quality people to join the board? Further given the ownership overhang, investors choose to go with what the controlling shareholder largely because the see a strategic alignment of interest between the controlling and public shareholders. But as the interest of the controlling shareholder may at times diverge from the other investors in the company, the board needs to safeguard minority investors. And this precisely is why the independence of the board is crucial. At the risk of generalizing it's safe to assume that the length on the board is inversely proportionate to a directors' independence.

The good thing is both - lengthy occupancy of the board and extended audit tenure, are set to change. The new Companies Bill has defined independence and said that directors who have served for more than ten years on a board, can no longer be considered independent. If companies nonetheless value their advice, they can continue with them on the board, but must not classify these directors as independent. To maintain the statutory mix of independence and non-independence, boards will need to infuse fresh blood. Regarding long serving auditors the Bill advocates rotation after five years with the flexibility to extend it to ten, after which there is a mandatory cooling off for five years.

Before we conclude change is here stay, it's worth remembering that the Companies Bill is yet not law. And then there is the matter of small print. For reappointment, the Bill is silent on the existing tenure. So an independent director on the board for 12 years can end up with serving on the board for another ten more as an independent director. As regards the auditors, the Bill does not recognize 'network audit firms'. Example Price Waterhouse & Co., Lovelock & Lewes, RSM & Co, Dalal & Shah are all under the Price Waterhouse Coopers audit network, but are treated as independent. So auditors and board appointments can continue happening within the owners comfort zone. And this is why investors need to step up and vote.

IIAS is an advisory firm dedicated to providing participants in the Indian financial markets with voting recommendations on shareholder resolutions, independent opinions, research and data on corporate governance issues.