

Critical Issues Faced by a Board of Directors

By Lilani Perera



The-Panel-from-Left,-Mr.-Samantha-Ranathunge,-Ms.-Marise-Decker,-Mr.-Mahen-Dayananda,-Ms.-Dilani-Alagaratnam-&-Mr.-Suren-Rajakarier

“The Sri Lanka Institute of Directors has embarked on an initiative to address a variety of issues intimately concerned with the overall standards of corporate governance with specific reference to Sri Lanka” perceived Mahen Dayananda launching in to the panel discussion on the continuing programme on ‘Contemporary Views on Corporate Stewardship and Board Room Governance’ held at the Cinnamon Grand recently.



Mr.-Mahen-Dayananda-during-his-address

Dayananda, the President of the Sri Lanka Institute of Directors who is also the former Chairman of the Ceylon Chamber of Commerce, Chairman of Total Tea Concepts and the Chairman of the Advisory Council to the Monetary Board of Sri Lanka was well supported by his panellists, Dilani Alagaratnam, President Group HR, Legal and Secretarial John Keells Holdings PLC; Marise Decker, Managing Director Astron Ltd; Suren Rajakarier, Partner Audit Services, KPMG and Samantha Ranatunga CEO/Managing Director CIC PLC. They together ably decimated the topic ‘Critical Issues for the Board of Directors’ to a packed audience that evening.

Dayananda commenced proceedings in his meticulous style giving his personal definition of the main functions of a Board of Directors, which was, to operate an organization being mindful of the interests, rights and expectations of the shareholders, members of staff and other stakeholders of the business, within the overall framework of corporate responsibility.

“It should be the initiative of a team rather than that of individuals” he asserted. “The Board of Directors must ensure the organisation is not only profitable and sustainable but also that it behaves ethically and is committed to acceptable standards of social responsibility. He emphasised ‘ethical conduct’ as one of the more critical issues of concern to the Board of Directors. There is also the matter of compliance to statutory requirements. The Board of Directors must therefore direct their minds to a plethora of issues over and above their primary responsibility of ensuring the profitability and long term sustainability of the business. The success or failure of a business is largely dependent on the strategies which are followed by the business. Hence increasing attention must be paid to this aspect of management and a decent return to shareholders which was not only their expectations but also their right.”

“Strategy” he continued “is a very important component not only with regard to management but also in sports or studies or whatever.” As per the Oxford Dictionary he defined ‘strategy’ as “the art of planning and directing larger movements and operations of a campaign or war, but more importantly skill in business operations, politics etc“

Marise Decker expanding on strategic planning based on her current experience at Pfizer confirmed that Directors should be involved in strategic planning, but it does not have to be done by the Board of Directors. It starts at the management level with the Directors contributing to the process. Finally the Board formulates the strategy of the company.

“This is an ongoing process, with about one months notice given to Divisional Heads, Directors and Executive Directors of a forthcoming strategy session. Bearing in mind the current environment, they are requested to brainstorm ideas for strategy. A further meeting and presentations are made, documented and circulated. Eventually the Non Executive Directors will participate in the process. Although it is the management who knows a lot about it, ultimately it is the Board which assumes responsibility for the success of the company.”



Marise-Decker

Decker added “Our planning horizons are between 2 to 3 years. At times they may be for a period of 2 years because some investments may have a life of 10 years or more. In the event of developing new products in-house, the planning period may be around 2-3 years. Planning would have to take all of that in to account.”

There needs to be a monitoring process through which the progress of the plan can be assessed. Where there appears to be under performance, it can be reviewed and recommendations made to improve. In addition to considering the operating environment, it is necessary to consider the strengths and weaknesses of the Company. The weaknesses need to be overcome and the strengths need to be built upon to achieve the plans.

Executive Directors need to monitor the plans on an ongoing monthly basis but the Board doing so once in 3 months against what has been achieved, would be quite sufficient. The Directors need to ensure that there is a vision, mission and an objective and take responsibility to achieve the plans.

The Board must ensure that the planning and implementing process adds value to the business and all its stakeholders such as shareholders, employees, customers, and any other interested parties. Implementing the plans is most important and it is necessary for the Directors to be involved in the implementation. However, it is not necessary for Non-Executive Directors to do so. The main objective of the Company would thus be achieved via the strategic plan and its implementation.

As regards investment, although the Directors should get involved, it would not be necessary to get in to the minor details of it as the Executive Director and the Managing Director would be responsible for doing so. Ideally it should be delegated to the

management. Since the overall responsibility rests with the Board, it must review and evaluate investment proposals.

Dilani Alagaratnam covering the enforcement of ethical behaviour, statutory compliance, fiduciary, legal, and regulatory responsibilities, declared that Compliance law which was close to her heart was a basic hygiene factor for everyone. The Board is responsible for a sustainable business and this means compliance with the law. How does a Company achieve this? It is not often that companies have lawyers on their Boards, nor is it expected that Directors are directly responsible for compliance with the law by ensuring they check in detail. Compliance is achieved by instituting processes and systems which ensures compliance at the management level. The Board is responsible for ensuring such checks and balances in the system are in place.



Dilani-Alagaratnam

“Let me share with you what we do at John Keells,” continued Alagaratnam. “We do have the luxury of an in-house legal team, which not only keeps abreast of what the current laws are but also monitors changes and forthcoming legislation by proactively checking the Parliamentary web site.”

“The legal department periodically conducts legal audits of every business in the group and examines how it works on a daily basis. For instance in the case of a hotel they will look at the guest registration form and examine if it complies with the law, or would it lend itself to possible disputes in the future? They will also advise on how a complaint should be handled. The Legal Department will have sessions with Management to apprise

them of the legal environment under which they must work. These processes, then assures the Board, that compliance requirements are met, and the likelihood of things going wrong are remote.”

“The Finance people and the COOs assure that they have complied with all laws, paid the relevant taxes etc. Periodically the Board has to give us certificates which are given to the Audit Committees. The Internal Audit also assure us that processes and systems are functioning effectively, which then assures the Board that the Company is in compliance with its legal and statutory obligations. As such the Board does not have to check on every thing but ensure that the processes and systems which will stand the reasonableness test are in place.”

“In recent times the concept of ‘ethical conduct’ has acquired much importance. Now a whole plethora of groups in addition to shareholders, employees, government and tax collectors are looking at the Company and its conduct, and it has become a topic of increasing concern to the Board. Many of us acquire our ethics from our families, schools and religious institutions. Similarly, in a 140 year old Company it has developed over the years and these are passed down to new employees as part of the corporate culture. However, with the increasing size of the Company it is necessary to codify these so that it is uniformly applied throughout the Group. In early 2000 a written code of conduct was introduced to all the JK Group Directors who received a copy on their appointment. Thereafter it was extended to all the Executive cadres. In 2009 it was issued to all employees and made available in all three languages, and on the Company intranet. The Company has introduced several mechanisms to ensure compliance measures are implemented. Employees are rated on their performance, their competencies and adherence to company values. We also conduct a 360° survey amongst our senior staff to look at how they exhibit their values, which goes towards the performance management system. All of the recognition schemes are based on exhibition of values and how one has set an example to others.”

On another aspect of transgression, we encourage people to put their hands up to say something is wrong in the workplace. Five years ago we created a secure, confidential, email address ‘Chairman Direct’ which employees could use to tell the Chairman that something was going wrong. As that was inadequate we now employ an Ombudsman, a person who is totally independent of the group to whom employees could take their complaints to with respect to transgression of values. An inquiry followed by a recommendation to the Chairman could be made in confidence. In this manner we inculcate as well as enforce the code of conduct.

Getting on to the fiduciary and legal duties and obligations of Directors, (as opposed to that of the Board), are set out in the new Companies Act and imposed on the Directors personally. Essentially it is to act in good faith in the interest of the Company, to disclose any interests, not to use confidential information for personal gain and to refrain from divulging proprietary information. Directors should not act negligently or recklessly, and should exercise a standard of care commensurate with their state of knowledge, especially technical or professional knowledge. For example, a Chartered Accountant will be expected to have a higher level of understanding and skill with respect to accounting and finance than a non-professional. A Director may rely on an expert, but he must exercise due care when choosing an expert. For instance, he must not consult an expert who has given poor advice in the past. The courts will not look at that too favourably.

On the legal liability of Directors related to labour, legislation on EPF, ETF, Gratuity, Industrial Disputes Act, places obligations of compliance on Directors. A Director may plead ignorance of commission or omission provided due diligence was exercised by him.

There are statutes relating to tax matters. In the event of Company winding up situations the directors are deemed to be jointly and severally liable. However, as in the labour laws, you are deemed to be guilty unless proved that it was done without your knowledge or that you took reasonable care to ensure that it will not happen but that it happened.

Under the Companies Act failure to submit annual returns, hold an AGM, preparation of Financial Statements, etc are offences. In the event of insolvency of a Company, Directors may be liable for losses incurred by shareholders, due to carrying on the business when it was clearly insolvent. Failure to call an EGM when the Company is facing a serious loss of capital is also deemed an offence. This is why it is important for the board to ensure that they get the relevant advice from the legal authorities on these matters.

“The conflict of interest and related party transactions are closely related” stated Suren Rajakarier who had been assigned to handle these two aspects of the topic. A conflict of interests arises when the personal interest and the professional interest of a Board Member is at variance with each other. “Financial conflicts of interests occur on every Board. When disclosure of related party transactions are taken up it becomes a huge issue as board members do not wish to disclose conflicts of interest.”



Suren-Rajakarier

Conflicts of interest could arise in most situations. If a board member performs professional services for a company or proposes that the company recruits one of his relatives, is there a conflict? Generally, if we follow the normal procedure there will not be a conflict. It quite often is a point of view. Some may think that there could be a conflict. So in any activity that a company does there could be a conflict of interest. Going back to the duties of a director, he has to act in good faith and in the best interest of the company as an entity before the interests of any other party including shareholders. There is a slight difference here as most directors think that they have to act in the best

interest of the shareholders. As such a simple activity like recommending a dividend becomes a conflict.

A Director should avoid conflict between personal and Company interest, and further, he should not make any personal gain out of opportunities that arise by virtue of his position. If no personal gain, there is no conflict of interest. This is important, as any decision that a Board makes can be challenged, as one can always find some conflict which wasn't there at the time when the decision was made.

Loss of public confidence and damaged reputations are possible negative consequences arising from decisions made which may have been subject to a conflict of interest. Some companies are adopting policies on conflict of interest prohibiting or limiting Board Members transacting business with the Company as well as requiring them to disclose potential conflicts of interest they may have vis a vis the Company. Directors' interests are better disclosed at the beginning of the year rather than to start looking for these figures at the end of the year in order to disclose them in the annual report.

Conflicts of interests must be disclosed as they occur so that other Board members voting on a decision are aware of the interest of another member. It is required that a member withdraws from a decision that presents a potential conflict. The member can withdraw from a decision, but was the member present at that meeting? Those are two different things. Lot of Companies has a policy that the interested party stays away from the meeting at the time of voting. However, this may be insufficient. The interested party should stay away from meetings where this matter is taken up for discussion. A further measure could be to establish procedures for competitive bids to ensure that the company is receiving fair value in the transaction.

Many related party transactions take place in the normal course of business between a holding company and its subsidiary, associate company or with joint ventures etc. There may not be any higher financial risk than similar transactions with unrelated parties, because it is your group of companies. One will ensure that the interests of all these companies are looked after. But because of the nature of related party transactions one can complicate things and it can result in higher risks than transactions with unrelated parties. As such, there are rules for disclosing these in the financial statements. Even if the transaction is done at arms length there can be someone who is aggrieved by this. The best way out would be transparency in disclosing these.

The disclosures that need to be shown in the financial statement are; the amounts of the transaction, the amount of the outstanding balances, and their terms and conditions, amounts receivable from a director's company and the terms and conditions related to it, allowances made for doubtful debts, the write offs on such transactions, expense etc. It would then be clear that a transaction with a Company owned by a Director will be shown and thus exposed to the full glare of public scrutiny, thus enabling transparency.

Remuneration of key management personnel must also be disclosed. If it is a publicly held entity disclosure is a must, as in the case of India where every single top management personnel's salary is disclosed in the annual report by name. If it is not a public listed entity these requirements do not apply. One can do whatever one wants with one's money. No conflict of interest, no related party transactions, subject to borrowing from the bank. Banks would be interested in related party transactions to know whether one is transferring profits. Having borrowed from one entity that entity goes bust because profits have been transferred to the holding company and the bank is left carrying the can.

This could be because the bank lent on cash flows rather than on properties. When the bank gets affected, it has a direct impact on the public as depositors.

The Board of Directors necessarily delegates authority to Management. This does not mean it abdicates all responsibility nor does it mean the Board would try to micro-manage the delegated functions. However, after delegating, the Board needs to monitor and question the CEO and the Management whether they performed those delegated duties as expected. This, is what SLID seeks to do by providing training to Directors so they know to ask these important questions. One needs to ask these questions before accepting board positions because one will be held personally liable.

As regards solvency, Directors would normally wish to declare dividends to the shareholders. However, prior to declaring a dividend, they must consider if it could affect the solvency of the Company. This is a major responsibility placed upon the Board which must consider the longer term interests of the Company rather than take a short term view of satisfying the shareholders wish for dividends. If there is any doubt, they should consult the Companies legal advisors and their auditors who may qualify the accounts if solvency is questionable. However, the 1st responsibility lies with the Directors.

Next it was Samantha Rantunga's turn to cover the topics of the expected performance of a CEO, the expected role of an Executive Director and also the expected performance of an Independent Director.



Samantha-Ranathunge

“In Sri Lanka the role of the Managing Director and CEO and that of the Chairman are often amalgamated” observed Ranatunga. “In the local and regional contexts it is the CEO who in the hot seat. In the past, being on a board was very prestigious. But now it is no longer so. The process of judging board members is still evolving and there is no ready

made answer or a process. However, there are several aspects which I have gone into and experienced which I would like to share with you. The CEO's role includes corporate performance, succession planning, team building, setting the tone of the relationship with the environment and maybe if both the roles of Chairman and CEO lies with the same person, then the leadership of the Board. The Independent Director, who heads the Remuneration Committee, provides reasonable guidance to the CEO in the execution of his duties in respect of the above matters and the performance targets are set for the organisation.

There is a fair amount of clarity in the objective setting. The CEO will be given guidance on where and how he is expected to perform and what level of performance is expected at a particular point of time. All the Independent Directors review the performance of the CEO and judge to what extent he has succeeded in meeting the expected performance norms on the key aspects. Some Companies use a questionnaire which seeks to grade the CEO's performance on a scale of 1-5. The grading of a 3 or 4 is ambivalent. Independent Directors must develop penetrating questions aimed at developing a critical and objective assessment of the CEO's performance. The Lead Independent Director will take up these issues with the CEO.

The CEO reviews the performance of the Executive Directors in their respective functional areas. The CEO's review is discussed by the Lead Director and the Non-Executive Directors. Keeping with the general trend taking place in the west the number of Executive Directors on Boards has been reducing whilst the number of Non-Executive Directors has been increasing. The Executive Director has to be on par and be judged along with the Non-Executive Directors on how he contributes to the dynamics of the board, on the credibility, the objectivity, and keeping with the overall interest which goes far beyond his functional aspects. In the corporate body he maybe held responsible for the functional aspect but on board he has to contribute on a much wider aspect. This again can be the responsibility of a Lead Director.

As regards the Non-Executive cum Independent Directors, this is a grey area. There are many Independent Directors and Non-Executive Directors who fall short of being truly independent. The role of the Independent Director is crucial to the well being of a corporate body, which was well illustrated by the financial crisis of 2008. Many Non-Executives were found to have little knowledge and understanding of what the management of these Companies were doing. These Independent Directors were merely rubber stamping executive actions, ultimately bringing ruin on themselves and the entire society.

The role of the Non-Executive Directors, the attributes required of a Non-Executive Director, and practices of the Board must be reviewed and re-examined in the post 2008 era. Consideration should be given to "how the Board should counsel the CEO and key management people. Bearing in mind the diverse background and experience of Independent Directors, the Board should question the outcomes of performance, i.e. were these sufficient? Could they have been improved?"

Lastly, a large number of acquisitions are taking place resulting in a lesser number of Independent Directors on Boards. They are going to be a rare breed in time to come. Unless SLID can undertake to create independent thinking through a process, it will be very difficult to have independence at Board levels in the corporate world of Sri Lanka. SLID can make an important contribution by conducting seminars and training sessions on guiding Directors to develop a critical sense of independent judgement.

Dayananda getting on to the subject of Board room dynamics declared that it was mostly about balanced discussion. “There will be differences of opinion amongst the participants, but ultimately everybody participating must try to ensure that a sense of balance is maintained throughout the discussion. The level of discussion must not only be well mature but also very precise and succinct. The worse thing that can happen is for a discussion to take off in a number of different directions with each individual around the table trying to assume an authority and an importance that really goes against team spirit and team work which is essential to any board of directors. Each must be encouraged to freely express his views in a mature and civilised way. Mature disagreement must be encouraged. The discussion must have direction and be succinct. The success or failure of the meetings depends on the Chairman. As such, he must be a person with authority and be respected by all for his sense of absolute integrity. He should ensure that no person dominates the discussion, and decisions should be arrived consensually after intelligent deliberation.”

Dayananda in answer to a query from a participant on what SLID was doing to protect Directors in performing their duties stated that “SLID was well focused on enhancing the levels of training and education of Directors. It is a process that started 11 year ago and is an ongoing process helping directors improve their personal and professional effectiveness, updating their knowledge on corporate stewardship and master boardroom dynamics. SLID supports, represents and sets standards for Company Directors.”

The deliberations were of a very high standard and Dayananda with cool elegance handled the discussion very competently posing questions to the participants who included directors and very senior managers of a very representative cross section of Colombo’s corporate sector.

The next module in this series is scheduled for Thursday 17th March on “Contemporary Board Issues” at the Ivy Room of the Cinnamon Grand. This module will be led Mr. Mahendra Amarasuriya, Chairman Commercial Bank, supported by a very high calibre team with Mr. Kapila Jayawardena, Managing Director LOLC PLC; Mr. Sujeewa Mudalige, Partner PricewaterhouseCoopers; Mr. Asoka Peiris, CEO Singer PLC and Mr. Chrisantha Perera, former Chairman Forbes & Walker.