

Lessons In Corporate Governance From The Satyam Saga

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INTRODUCTION

Since the last few years, we have witnessed a range of corporate scandals and failures right from Enron, Arthur Anderson and WorldCom internationally to the recent Satyam Saga in India. Presently, the US is undergoing its own corporate governance crisis in the form of the Madoff scandal. This has happened even though corporate governance standards have been tightened by the Sarbanes-Oxley Act. More and more skeletons are tumbling out and the fact that this is happening in the bear market has further amplified the effect. Questions are being asked on audit and finance functions, board compositions and prevailing regulations. There is a war cry everywhere, "The system needs to improve! Why are all these things happening in a relatively stable Indian capital market?" Both institutional as well as small investors are feeling insecure. What is definitely clear is that the Satyam scam has raised many questions about corporate governance in India. This is in spite of a general feeling that India is one of the countries which is better regulated in terms of corporate governance. The question being asked by the entire country is "Do we need further tightening of existing regulations for corporate governance?"

DEFINITION OF CORPORATE GOVERNANCE

The National Foundation for Corporate Governance (NFCG) defines corporate governance as "Maximizing the shareholder value in an organization while ensuring fairness to all stakeholders, customers, employees, investors, vendors, the government and the society-at-large".

Narayana Murthy, Chief Mentor, Infosys Ltd, says, "Corporate Governance is about transparency and raising the confidence of stakeholders in the way the company is run. It is about owners and the managers operating as the trustees on behalf of every shareholder-large or small."

Report of SEBI committee on Corporate Governance defines corporate governance as the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their won role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the management of a company.

IMPORTANT MILESTONES TOWARDS EFFECTIVE CORPORATE GOVERNANCE IN INDIA

The Confederation of Indian Industry (CII) published India's first comprehensive code on corporate governance (Desirable Corporate Governance: A Code) in 1998. This Code was well received by Corporate India and many of its recommendations became part of subsequent regulations.

An important milestone has been the setting up of the National Foundation for Corporate Governance (NFCG). This was done by the Ministry of Corporate Affairs in partnership with the Confederation of Indian Industry (CII), Institute of Company Secretaries of India (ICSI) and Institute of Chartered Accountants of India (ICAI). The vision of the NFCG is to be a catalyst in making India the best in corporate governance practices. The internal governance structure of NFCG consists of Governing Council, Board of Trustees and the Executive Directorate. The Governing council works at the apex level for policy making. The Board of Trustees deals with the implementation of policies whereas the Executive Directorate provides the internal support and implements the decisions of the Board of Trustees.

Various committees have been appointed in the past to make suggestions for more effective corporate governance.

- The Kumar Mangalam Birla Committee set up by SEBI submitted its report in 2000. It's suggestions included suitable amendments to the listing agreement executed by the stock exchanges with the companies in order to enhance corporate governance standards of listed companies, drafting a code of corporate best practices, and suggested safeguards to be instituted within companies to deal with insider information and insider trading. Several of these committee's recommendations were incorporated in Clause 49 of the listing agreement of stock exchanges.
- The Naresh Chandra Committee gave its report in 2002. This was following the corporate scandals of the US. It made some important suggestions in terms of Disclosure of contingent liabilities and risks, recommended that the CEO and CFO certify financial statements. It also suggested that independent directors will not have a pecuniary relationship with company and that there will be a statutory limit on sitting fee for independent directors. Many of

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these recommendations were incorporated in the Companies (Amendment) Bill 2003.

- The Narayana Murthy Committee gave its report in February 2003. It talked about strengthening the responsibility of the audit committee, improving quality of financial disclosures, utilization of IPO funds. It also stressed on the importance of disclosing business risks in annual reports and advocated a whistleblower policy.

SATYAM- HEALTHY TO HOLLOW IN ONE YEAR

Satyam was awarded the “Golden Peacock Award” for global excellence in corporate governance-this was circa September 2008. One year later, Ramalinga Raju confesses to a Rs. 7000 crores fraud and is arrested. The Board is reconstituted and legal proceedings have been initiated on Raju. What went wrong? A supremely “healthy” company considered to be a global company following “best practices” in global governance, suddenly turns “sick” and “hollow”. What have been the reasons for this sudden “sickness”. How did it suddenly turn from a “Very Admired Global company” into a “company struggling to pay monthly salaries to its employees”. What made the company become almost a “**B.I.F.R.**” like “**C.A.S.E.**”?

Following are some of the reasons which have been causal factors for this:

- **Board Appointments**
- **Inflated Figures**
- **Frauds**
- **Regulation loopholes**
- **Communication with shareholders**
- **Auditor's Roles**
- **Stakeholders' carelessness**
- **Extreme Greed**

BOARD APPOINTMENTS

A study of the Satyam board shows that of the six non-management directors serving, four were academics, one was a former Cabinet Secretary of the Indian Government and only one, Mr. Vinod Dham, was a former head of a technology company¹. Only five of the nine directors on board were listed as “Independent of Management”. Although the Chairman and CEO were two separate individuals, both of them were brothers. The non-management directors also did not meet periodically without management directors. This gives an insight that maybe the entire board was highly “promoterized”. Most companies select these independent directors based on the comfort level with the promoter rather than their competency and ability to challenge and add value. Independent directors are used more for “Window Dressing”. It would definitely surprise many that Shah Rukh Khan, Javed Akhtar and Yash Chopra are on the board of Jet Airways! The Annual report of Jet Airways for the year 2007-08 also states that Shah Rukh Khan did not attend any meetings. Also, the two members on the Audit Committee of the airline were Yash Chopra and Javed Akhtar! The Companies Act only has a negative list of the kind of people who can't be independent directors.

Although there are a few organizations like Infosys who make the gold standard of corporate governance, more than 70% of the ET 100 boards still haven't split the Chairman and CEO posts². More than 80% of ET 100 boards still don't have lead independent directors in place. 390 companies have not even filed data on this aspect, although it is a mandatory requirement for listing as per clause 49 of the listing agreement. It may be argued that it is difficult to appoint truly independent directors as, especially in India, family ownership is widespread and there is a close-knit of corporate leaders³. It is also difficult for independent directors to challenge the promoter as, most often than not, they are appointed to support rather than question and criticize management.

INFLATED FIGURES

Profits at Satyam were inflated for past several years. For the September quarter 2008, revenues and operating margins were overstated at Rs. 2,700 crores and Rs 649 crores against actual of Rs 2112 crores and Rs 61 crores⁴. Of the reported cash and bank balances of Rs. 5361 crores as on 30 September 2008, Rs 5040 crores were non-existent. Debtors' position was overstated by Rs. 490 crores. Together with this overstated debtors' position and understated liabilities, there was a staggering hole of Rs. 7136 crores in the balance sheet.

FRAUDULENT INTENT IN MERGING WITH GROUP FIRMS

With Satyam about to collapse under its own financial weight, Raju also tried to merge with group firms, Maytas Infrastructure and Maytas Properties. These two firms were owned by Raju's sons and the deal therefore was full of “conflict of interest”. The reason given for this attempted merger was “De-risking strategy” as future of Infotech was limited. This merger would have cleaned up the balance sheet of Satyam and would have helped them add several high value assets and profit streams. The Board attempted to pass this merger but could not

proceed further due to a public outcry.

REGULATION

After the Enron scam in the US, there has been increased focus on corporate governance. The US Government passed the Sarbanes-Oxley Act in 2002 intending to restore public confidence in corporate governance. The audit committee became extremely cautious and enormous amount of work was undertaken by companies to achieve SOX compliance. In India, the NFCG was established and some modifications were done in existing regulations. Clause 49 of the Listing Agreement was also amended to state that listed companies in India (with paid up capital of Rs. 3 crores and above) were required to comply with the corporate governance related provisions. Satyam, on its part, also adhered to all these regulations by reporting in Form 20-F submitted to the Securities and Exchange Commission, US-but more from a point of view of reporting that they do not have a corporate governing committee. But somewhere down the line, this led to a “tick box” approach to compliance. The regulations were not followed in spirit, but more in letter.

COMMUNICATION WITH SHAREHOLDERS

The board should ensure that the corporation communicates with shareholders and other stakeholders effectively. Shareholders need access to regular, reliable and comparable information in sufficient detail for them to assess how well the organization is managed.

Satyam's balance sheets starting 2002-03 had a mismatch between the cash flow and reported cash and bank balance, including term deposits. Satyam also did not pay any advance tax in 2008-09 which implied that there was trouble brewing. Satyam also maintained \$ 550 million idle in a current account. Facts were either disclosed without any further explanation or were disclosed partially. Since shareholders take decisions based on material facts provided, they are misguided by untimely or inaccurate information.

AUDITOR'S ROLE

PriceWaterHouse Coopers were auditors to Satyam. It is surprising how such massive frauds in profits and cash flow can go undetected. A simple task like preparing an invoice for a sale requires preparation of an invoice, tax and duty formalities etc. It is near impossible that sales and profits figures were manipulated without being hand-in-glove with the auditors. The Institute of Chartered Accountants of India, the governing body for Chartered Accountant firms, is not very strict on offenders. Offenders are punished by a disciplinary committee and are invariably let off with a fine of not more than Rs. 5 lakhs. This is hardly a strong detriment. PSUs change their auditors every three years. Why can't this be done by private sector organizations also?

STAKEHOLDERS' CARELESSNESS

Auditors' fees have been increased three times in the past couple of years although other IT companies continued to pay the same amount. This should definitely have been looked at as a red flag. All stakeholders need to be vigilant and analyze all publicly available documents to sniff out any scams. Stakeholders need to keep an eye on composition of board, the changes, how many times have the board members attended meetings. If they are not satisfied, they should keep this in mind during re-election.

EXTREME GREED

The overlying issue above all is extreme greed. No amount of regulation can prevent promoters from fraudulent transactions if his greed outweighs all other factors for corporate governance. Satyam failed because of extreme greed of Raju. An excellent organization with a proven business model and trained manpower found it difficult to manage monthly cash flows only because of extreme greed shown by the promoter.

LESSONS TO BE LEARNT

It is said that prevention is better than cure. It is better to be “inoculated” by learnings from the past instead of letting the disease happen again and trying to cure it. The Satyam saga has some important lessons for all the three pillars-the investors, the regulators and the companies themselves:

For the investors:

1. Before investing, the board composition needs to be studied. The reported non-management directors need to be observed. Who are they? What is their credibility in the market place? Are they related to the promoters? Are they only there for window dressing? How many meetings do they attend? Are they competent enough to challenge the promoters? Of which other company are these people also directors?
2. Mergers where promoters merge privately held unlisted companies with a publicly traded profitable company need to be looked at very carefully.
3. At any time, if there are additional shares issued to individuals or firms, it is critical to delve deeper- more

questions need to be asked about the real purpose behind it.

4. Company's past record (including significant events that reflect management excesses), qualitative and quantitative disclosures (vis-à-vis peers) and consistency in delivering on promises need to be studied in detail.

5. If it is a small company, this vetting needs to be done even more strongly.

6. If an investor has invested in one company, he should look out for other companies in the same group, especially if it is ailing. Is there any capital shifting from one to another?

7. Minority shareholders groups need to be established where individual shareholders communicate with institutional shareholders for taking up their concerns with the company's management.

8. Institutional investors have an important role to play in providing checks and balances in the board room. This would help in keeping a check on the internal processes in the company.

FOR THE REGULATORS

1. Rules regarding appointment and rotation of independent directors need to be strengthened.

2. Board appointments should be linked to credibility and experience rather than dummy directors.

3. Auditors need to be made more accountable. ICAI needs to penalize offenders so that it serves as a very strong detriment to future frauds. Offenders should have their licences to practice as Chartered Accounts struck off and legal action should be taken against them.

4. Enforcement is often the issue with Indian corporate laws. These need to be implemented in a swift, transparent and uniform fashion.

5. Stricter enforcement of Clause 49 should be done. An audit panel with at least three non-executive directors with majority of them being independent needs to be set up. This should be done keeping in mind competency of these directors, rather than just nominating any "big" name directors. SEBI needs to be given more teeth for penalizing firms that don't comply with provisions of clause 49.

6. Requirement of having an independent director is not adequately matched by the quorum requirements in Companies Act. Companies Act, Section 287 mentions that one-third of the total strength or two directors, whichever is higher is necessary requirement for a board meeting.

7. Each person should be allowed to become a director in only 5-6 companies. Presently, the law allows being on board of 15 listed companies.

8. Accounting firms now have "Relationship Managers". Objectivity and arms-length relationships may suffer because of this.

9. A negative list of people who can't be directors is provided by the Companies Act. However, there are very few databases of qualified people who could make good directors. Such a database needs to be maintained and updated by a regulator.

10. Reporting to external investors by non-executive directors need to be strengthened.

11. Attention needs to be paid to remuneration and incentives paid to both executive and non-executive directors.

FOR THE COMPANIES

1. Do not look at corporate governance regulations as "box ticking". Look at these in spirit as well as letter. Compliance to law is one aspect, transparency to stakeholders is another aspect.

2. Board should be committed to ethical practices.

3. Risk Management processes should be designed to periodically assess impact that changed strategies have on risks. There has to be proper processes to mitigate risk, clarity of roles, responsibilities and authority, manpower planning and succession planning.

4. Board needs to constantly challenge the executive members and promoters and keep shaking them out of their comfort zone.

5. Board members need to constantly upgrade their competence and spend more time in strategizing rather than only discussing compliance issues.

CONCLUSION

The corporate governance framework is largely in place in India. However the same has to be implemented more in letter as well as in spirit. The investors, the regulators/auditors and the companies themselves have important roles to play in this. Directors need to be a balance of independent directors and management appointees. "Promoterization" of the board should be discouraged and investors (both institutional as well as retail shareholders) need to be constantly active in addressing this. Maybe, Satyam will serve as a catalyst towards this!

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translates into establishing rapport with clients and providing great customer service. This perhaps is the reason why many women tend to launch businesses that are client based or service-oriented. Globally, women are enhancing, directing, and changing the face of how business is done today. Ultimately, female business owners must be recognized for who they are, what they do and how significantly they impact the world's global economy.

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thoughtful and diligent leap is crucial to sustain a brand non-stop for the long term. At the implementation stage, the creative execution must be provoking and reflect the values associated with the brand. A brand is a brand as long as it connects with the consumer, remains relevant & excites her, it doesn't matter whether it's Indian or not.

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