Corporate Governance

T.N. SATHEESH KUMAR
Professor
DC School of Management and Technology
Vagamon, Idukki

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CHAPTER 1

Governance on the Move

The corporate governance debate has done little to improve the constitution of many boards. If anything the attention has been switched from building larger and better corporate cakes to applying the boardroom icing to existing cakes in recommended ways.

– Prof. Colin Coulson-Thomas (2002), Member, Board of Examiners, IOD

LEARNING OBJECTIVES

After studying this chapter, you will be able to

- Describe the recurrent crises in corporate governance, the importance of good governance, and the early initiatives in the area
- Differentiate between managing and governing
- Define corporate governance
- Understand the present scenario of corporate governance
- Decipher the advantages and disadvantages of corporate governance
- Explain who has to play a major role in governance—boards of directors or regulators?

Opening Case

Where Were the Board and Its Independent Directors?

What happened in India's biggest private sector enterprise, Reliance Industries Ltd (RIL), during the years 2005 and 2006, owing to the rivalry between the two sons of the legendary Dhirubhai Ambani—Mukesh and Anil, led people to believe that everything was not right in the governance of the organization. Let us briefly discuss the issues that were thrown open by the episode.

Mrs Kokilaben, mother of Mukesh and Anil, reportedly issued a note to inform the media and public about the scheme of settlement after the demise of their father. How could a decision as important as the restructuring or demerger of companies all publicly held be taken by an individual? What role did the boards of different companies involved in the issue play? While the investors, the government, the capital market regulator, and the public were relieved that the spat between the brothers was amicably settled, what led Mrs Kokilaben as the head of the family, which at the time reportedly held only 34 per cent of the shares in RIL (without disclosing the details of holding), to assume that the demerger was in the interest of the remaining shareholders who accounted for 66 per cent of the holding? (The subsequent annual report put the promoter holding at 46.76 per cent, including the persons acting in concert.) Not even once when the entire episode was enacted did the board of RIL show any signs of exercising their power and authority as representing the interests of the larger group of shareholders. It seems unfortunate that no shareholder (including institutional holders) raised the question: 'Where was the board?' Anil Ambani might have become a worthy whistle-blower on governance practices of family-managed companies by writing to the Securities and Exchange Board of India (SEBI) on certain transactions that RIL and/or its board or Mukesh entered into and the governance shortfalls therein, but could we rightly say that he was passionate about corporate governance as he too failed to clear the fog over the issue of 34 per cent holding of the family? The board of directors of RIL had six independent directors (institutional nominees included) out of a total of twelve. Why did it not occur to them that they have a fiduciary duty to shareholders to ensure the future health of the company?

Discussion Questions

1. Do you think that the board of RIL played its fiduciary role?
2. In predominantly family-owned and managed companies, boards' roles are limited and the presence of independent directors is only for conformance to regulations. Comment.

Source: Taken from Indian Family-Managed Companies: The Corporate Governance Conundrum. Paper presented by T.N. Satheesh Kumar at The International Conference on Business and Finance 2005 at IBS, Hyderabad.

A BRIEF HISTORY OF CORPORATE GOVERNANCE

Corporate governance has been in vogue for many decades ever since the term was first used by Bob Tricker as the title of his book on the subject. However, a new emphasis emerged on the subject, thanks to the corporate and financial scandals of the early 2000s, starting with Enron. Every major government functionary, political party, industry association, and corporate captain has started advocating the need for better corporate governance practices, and many changes have evolved ever since. New standards of corporate governance, accounting, and reporting have been established. While many of the changes and new standards were welcome, most of them, however, related to the process of enforcement and compliance with external laws and regulations. In the US, the stringent Sarbanes–Oxley Act of 2002 had definitely helped in strengthening the internal processes of compliance. It had not, however, been found to be effective in curbing or preventing governance failures as most of the failures happened due to lack of character at the core of the company, which goes beyond just compliance with regulations. Governance issues have once again been pushed to the forefront in the years 2007 and 2008, and particularly more so in the year 2009, with the sub-prime crisis and financial turmoil that followed and the startling disclosures of the financial irregularity practised by the chairman of a global IT service provider from India.

In the US, the highly respected and century-old organization Lehman Brothers came to naught, insurance giant AIG had to be taken over by the US government, Goldman Sachs needed fresh injection of capital, and the US government had to announce a $700-billion bail-out package for banks and other financial institutions. The world seemed to be heading for a recession following the high inflation rates, high interest rates, liquidity crunch, and lower demand. What was initially perceived to be an isolated problem in the housing mortgages area soon spread over the entire spectrum of economy and presently, recession is still looming over the global economy. Acts initiated for maximizing profit and shareholder value actually have resulted in the drastic reduction of profits (even pushing firms to losses) and erosion of value for shareholders.

In India, the proposal of the hitherto IT bellwether Satyam Computer Services Ltd (popularly known as Satyam) to acquire two associate companies in totally unrelated areas was given a go by its eminent board. However, the uproar of the investors against the merger proposal led to its call off by the promoters. The subsequent revelation by the promoter chairman that the company has been reporting inflated profits and other financial parameters has stunned investors, the regulator, accounting bodies, and even the government, leading to the dismissal of the board and installing a board of government nominees. The Satyam episode has brought to light the deficiencies in the corporate governance system in the country, and the role of the board, independent directors, auditors, audit committees, and regulators are being put under the microscope.

If one analyses the failures from a framework of realism, one can identify that most of these failures squarely rest on poor corporate governance founded on a few factors namely, short-termism; greed of managers, corporates, and even investors; the laid-back attitude of the major investors including institutional investors; and the lack of a questioning culture in the boardroom.

The credit for providing a guideline for corporate governance among the US corporations goes to General Motors and that for enforcing the governance norms goes to the California Public Employees Retirement System (CalPERS) and the UK-based industry-constituted Cadbury Committee. In India, the Confederation of Indian Industry (CII) is to be given credit for kick-starting in 1998 the formal thinking process on the needs of corporate governance. However, there have been well-governed companies like Tata Iron & Steel Company Ltd (TISCO, rechristened as Tata Steel) because of the enlightened corporate behaviour of its founders.

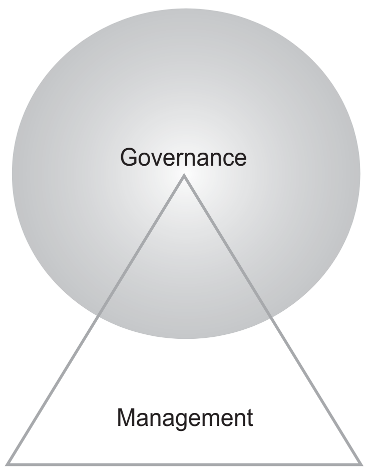
While many countries have created regulations to see that organizations practise better governance processes, these mechanisms have not been found very encouraging. Even though legislating new laws such as the Sarbanes–Oxley Act can help in strengthening the internal processes, the market for corporate control, which is very essential for good governance to happen, cannot be made strong since the minority shareowners are too widely dispersed to show any strength of unity and solidarity, and the larger shareholders such as institutions and mutual funds or private equities have other vested interests on their investments. Governance failures and corporate/bank collapses have happened more in the US, which is home to governance-conscious institutions like CalPERS and TIAA-CREF (Teachers Insurance and Annuity Association-College Retirement Equities Fund) than anywhere else.

MANAGING VERSUS GOVERNING

Governance is essentially different from management. While managing refers to running an enterprise to meet operational and financial objectives, governing aims to ensure that the enterprise is being run well and being guided in the right direction, in the pursuit of the very purpose or goal of the enterprise. The responsibility of governance rests with the board of directors of the enterprise. But this governing body of the enterprise, the board of directors, very rarely appears in the organization chart. The organization chart usually depicts a management hierarchy with the chief executive (managing director) at the apex, heading the organizational pyramid, and various managerial levels working with the concept of delegation of authority and responsibility for management functions downwards while demanding accountability upwards.

The board, the body responsible for governance, doesn't have any hierarchy. Every director has equal responsibility and similar duties and powers. According to the Companies Act 1956 in India and company law worldwide, there is no boss for the board. While members of the management might find a place on the board (as is usually the case in a unitary board), their role as member of the board is different from their role as member of the management (Fig. 1.1).

The directors are so called because their primary task is to direct the enterprise towards its goal by overseeing the managers and the management process.



Source: Tricker 2001

Fig. 1.1 Unitary board

CORPORATE GOVERNANCE DEFINED

A definition for corporate governance is in order now. In 1988, two American scholars—Philip Cochran and Steven Wartick—defined corporate governance as 'an umbrella term that includes specific issues arising from interactions among senior management, shareholders, boards of directors, and other corporate stakeholders' (Tricker 2001). Bob Garratt has defined it in more clear terms in the context of the new century after the high profile corporate failures that shook the way the corporations are governed: 'Corporate governance deals with the appropriate board structures, processes, and values to cope with the rapidly changing demands of both shareholders and stakeholders in and around their enterprises' (Garratt 2003).

CORPORATE GOVERNANCE IN THE CURRENT ERA

The original conceivers of the corporate concept did not envisage such complex organizational structures of change as we see in today's dynamic scenario. Consequent to globalization, companies have gone and established entities by crossing the borders, and such operations can involve complex networks of subsidiary and associate companies, limited partnerships controlling listed public companies, public companies controlling privately held companies, and cross-holdings of shares and cross directorships. Such corporate frameworks may operate under multiple legal and regulatory systems, jurisdictions, organization structures, and cultures. Such complexities usually raise puzzling questions for issues related to corporate governance, accounting, and financial reporting. Such structural changes in the corporates are dynamic in nature and evolve very rapidly.

The legal and regulatory framework needs to keep pace with the dynamic nature of corporate structural evolutions. Hence, the challenge before businesses, boards, regulators, and the government of any country is to evolve governance practices and processes that are sensitive to these complex and dynamic organizational forms, and the equally complex, dynamic, and ever-evolving methods of financing in a dynamic capital market scenario.

Modern Corporation—The Poster Boy of Capitalism

The creation of the corporate form for running businesses or enterprises was a milestone in the advancement of capitalism. The corporate form or the joint stock company enabled businesses to sell stock to the public to raise the necessary capital, which was considered permanent unless the management consciously decided to change the course of the company. The investors, while being owners (part owners), had their liabilities limited to the extent of their investment itself, which meant that in case the corporation fails, creditors could not be in hot pursuit of the individual investors for the payment of dues beyond their stakes in the company. Over time, corporation has become the most sought after vehicle through which enterprises could be established and grown. If one reads business history, 'big business' can be found to be the result of the corporate form of enterprise not only in the US (the place where the 'firm' achieved enormous presence and clout), but also in other parts of the world.

As a corollary, or natural outcome, arose the scenario where the owners who did not have the necessary expertise or who did not want to be managing the affairs of the enterprise but were content with the fruits of ownership, entrusting the management of the enterprise with professional managers, who were not required to have any significant ownership in the enterprise. These professional managers were in effect acting as 'agents' on behalf of the owners. This invariably resulted in 'agency conflicts'—conflicts between corporate managers and their owners. With the managers trying to further their own individual interests, their acts at many times were in conflict with the interests of the owners. This has, more often than not, given rise to governance-related issues.

The majority of enterprises in most parts of the world have been promoted by families and a good percentage of them are also managed by family members. A large percentage of them become public companies in order to mobilize more resources for growth. While institutions and other shareholders hold stakes in them, the majority of the holding usually rests with the family and promoters, who sometimes act in total disregard to the interests of other shareholders who are a minority. Some of them even run companies as their private properties, using them as vehicles to further their own interests of aggrandizing personal wealth or other personal interests. For instance, the owners of Satyam wanted the company to acquire family-promoted companies in totally unrelated sectors and even pushed the board for the approval of the same, which the board did, even though the stakeholding value of the promoters was only a meager 8.6 per cent on record. The outside investors, especially the institutional investors who together held about 60 per cent of the stakes cried foul and forced the promoters to call the proposed deal off. Subsequently, the promoters confessed to having been responsible for inflating profits and disclosed that the company did not have the Rs 50 billion cash depicted in the balance sheet and that the revenue figures, profit figures, and collectibles were all fudged over a period of seven to eight years. The Satyam saga has been watched with intense interest in India as well as abroad not only because the company is listed on the major US stock exchange NYSE, but also due to the fact that it raises questions on the roles of the board, independent directors, audit firms, audit committees, regulators, and investors. The corporate form and the very professional management it envisages have once again been put under close scrutiny by all concerned.

CORPORATE FORM—BOON OR BANE?

While the corporate form had enormous advantages in the establishment and mobilization of resources, as well as the management of the productive enterprises, it is also beset with lots of discrepancies. The basic premise of the corporate structure was to maximize profits by competing in the marketplace, but many experts feel that while the structure has been proven to be successful in making profits, every single mechanism—shareholders, directors, regulators, and even the market itself—that has been set up as some kind of check to prevent the externalizing of costs has been neutralized, short-circuited, or co-opted (Monks and Minnow 2006).

In the corporate structure, the management acts as an agent for the owner but it may not be always right to assume that their interests are in alignment. The assumption is that the managers, as agents, will treat other people's (owners') property with such care as if it is their own. But does this happen? Legal systems have tried to solve this problem by designing the director board for a corporation, who is expected to exhibit the highest standard of behaviour by assigning them fiduciary responsibility. With fiduciary responsibility comes accountability. Shareholders delegate authority to directors in their fiduciary capacity, and this necessitates them to be accountable to shareholders.

According to Monks and Minnow (2006), 'accountability is what makes delegated authority legitimate; without accountability, there is nothing to prevent abuse.' This was what went wrong with Satyam. The board and the directors did not show accountability.

The concept of fiduciary duty, while being the fundamental premise on which the corporate structure functions, has been under attack because many of the corporate failures happened as a result of the directors not acting in a fiduciary manner.

Even people like Adam Smith and Karl Marx were skeptical about the very corporate form of organizations and rendered it unworkable and both questioned whether it is possible to create a structure that will operate effectively and fairly, despite the fact that there is a separation between ownership and control. They wanted to fetch an answer to the question: is there any system to make a manager care as much about the company's performance as a shareholder does? (Monks and Minnow 2006). The issue gets complicated when there is no separation between ownership and control as in the case of family-managed companies where major owners adorn the roles of agents and also act as fiduciaries for the entire owners, like in the case of Satyam.

DIRECTORS' ROLE

The directors' role is integral to the very concept of the corporation. While company law may vary from country to country, there are many points that are common across the countries. The directors as a legal body draw enormous power because of the very nature of joint stock companies that gives the corporation the status of a separate legal entity. Though this enables the corporation to be separate from the owners, and also is beneficiary for the corporation in owning assets and/or entering into transactions in assets, it can also act as a monster in an extreme scenario.

Consider the hypothetical example of a corporation who has grown big and the capital outstanding getting reduced through the process of buyback. Suppose the corporation buys every shareholder including the promoters (who wouldn't sell if they are offered very attractive prices?), the resulting scenario could be creation of a deadly monster who becomes a legal entity without any owners to enforce compliance and without accountability. Thus, while the corporate form has many advantages, taken to the extreme, the form can be dangerous. Thus, the directors as a body (the board) have to play a very constructive and meaningful role in shaping, directing, and controlling the character and behaviour of a corporation or a company as an economic entity. In today's competitive world, the board has to work and act in a highly informed and learned manner, raising the board functions to such a level that it becomes a competitive advantage.

REGULATOR'S ROLE

While most countries have regulations on corporate governance, the failure of regulations to prevent frequent governance-related disturbances and troubles in many corporates, and sometimes the eventual failures of some of them, have given rise to questions on the efficacy of regulations to perpetuate better governance. There are contradicting views as well as evidences on the issue. There are practitioners like Bill George (2003), former CEO and later chairman of Medtronic Inc., and currently professor of management practice at Harvard Business School and director on the boards of Goldman Sachs, Novartis, Target, etc., who feel that 'although some changes in regulations are appropriate and necessary, they do not address the deeper issues at stake here. It is impossible to legislate integrity, stewardship, and sound governance.

Some like Aparna Ravi (2009), a lawyer specializing in corporate and securities law, feel that regulation about processes and disclosure rather than board action is more essential for better governance. Still others like J.R. Varma, professor, IIM Ahmedabad, feel that investors 'becoming nasty and even barbaric' will lead to better governance (as they will not hesitate in attempting a hostile takeover) or in effect, the governance of a corporate shall be taken care of by the investors and markets (Varma 2008).

CONCLUSION

Keeping in mind that the corporate form is the most common, and by and large the most advantageous for businesses and firms to grow, the governance issues of corporates has been the most important puzzle for management practitioners, shareowners, firms, regulators, academics, and the public. The chapters that follow attempt to unravel the multitude of issues that affect governance of corporations. The book is intended to cover the major aspects of corporate governance not only in India but also in different parts of the world as in a rapidly globalizing world, firms operate out of many countries, making global exposure a necessity.

SUMMARY

The corporate and financial scandals in the US at the turn of the century, starting with Enron, led to massive corporate failures, resulting in investors losing their money and employees their jobs. This brought into the limelight the need for stringent regulations that ensure better governance of corporates, and the US government enacted a specific law—the Sarbanes–Oxley Act—in 2002. But the happenings in 2007 in highly respected corporates such as Lehman Brothers and AIG led to a global economic meltdown from which most economies are yet to recover, indicating a need to improve on the post-Enron regulations. The Satyam scandal in India in 2009 has raised further questions about the roles of directors, especially the independent directors, the audit committee and the statutory auditors, the regulators, and the government, resulting in India and other countries too strengthening their corporate governance regulations.

The necessity for corporate governance has arisen from the very concept of the corporate form of enterprise. While the corporate form has many advantages, it has many discrepancies too. Governance issues arise because ownership is dispersed, making control difficult. Professional managers or experts are appointed to manage the affairs of the enterprise, and this can lead to agency-related issues. Corporate laws have tried to overcome this problem by creating a board structure that will act as a fiduciary on behalf of the owners and be accountable to them. Though the board and its directors have definite roles and responsibilities, they enjoy enormous powers under most laws and hence regulators also have to play a definite role in ensuring that such powers are not misused and corporates are well governed.

KEY TERMS

Accountability Being responsible to somebody

Capitalism An economic system in which enterprises can be owned privately for profit

Corporate A company form of enterprise with limited liability

Corporation A business firm whose articles of incorporation have been approved in some state

Disclosure The process of making the happenings known

Integrity Being honest and upright in character

Regulations Laws or rules to make sure that the system works in a fair way

Short-termism Tendency to look at short-term benefits alone

CONCEPT REVIEW QUESTIONS

1. What is the importance of good governance?
2. Distinguish between management and governance.
3. Discuss the advantages and disadvantages of the corporate form of business entity.
4. Briefly explain the roles of the board and the regulator in furthering corporate governance.

CRITICAL THINKING QUESTIONS

1. You are the promoter of RQP Do-It-Yourself-Products Ltd based in India. You want to have a board of directors constituted, with you as the CEO. What will be the structure of the board? Explain the rationale behind your choice. Make suitable assumptions.

PROJECT WORK

You want to invest in a particular cpmpany of your choice. Before you commit, you would like to check whether the company is reasonably well-governed. Since you are concerned about the reputation of the company as well as the liquidity, you would choose one of the constituents of a stock exchange index like BSE Sensex or NSE Nifty. Analyse the company's governance practices critically to enable you to make investments.

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Closing Case

Satyam Computer Services Ltd

Satyam in Sanskrit and many Indian languages means truth. The recent unfolding of events at Satyam Computer Services Ltd is a story of how truth was distorted by the 'untruthful' conduct of the promoters who were in the management of the company.

Satyam's Philosophy on Corporate Governance

The following is the opening of Satyam's Corporate Governance Report for the years 2006–07 and 2007–08.

Corporate governance assumes a great deal of importance in the business life of Satyam. The driving force of corporate governance at Satyam are its core values—belief in people, entrepreneurship, customer orientation, and the pursuit of excellence. The company's goal is to find creative and productive ways of delighting its stakeholders, .i.e., investors, customers, and associates, while fulfilling the role of a responsible corporate representative committed to best practices.

Satyam believes that sound corporate governance practices provide an important framework to assist the board in fulfilling its responsibilities. The board of directors is elected by shareholders with a responsibility to set strategic objectives to the management and to ensure that the long-term interests of all stakeholders are served by adhering to and enforcing the principles of sound corporate governance. Thus, the management is responsible to establish and implement policies, procedures, and systems to enhance long-term value of the company and delight all its stakeholders (associates, investors, customers, and society). The principle of 'delighting the stakeholder' is imbibed in everything we do at Satyam and is depicted in our value emblem (depicted below) as a mark of our commitment towards this principle.

On 16 December 2008, Ramalinga Raju announced that the twenty-year-old company would 'derisk' itself by diversifying into the infrastructure and realty business by acquiring two family-run firms: (1) a listed Maytas Infra Ltd where the Rajus had a stake of 35 per cent and (2) an unlisted Maytas Properties Ltd where the family ownership was around 36 per cent (Maytas is Satyam spelt backwards), using the $1.6 billion cash reserve of Satyam. Maytas Infra had Teja Raju, elder son of Ramalinga Raju, as the vice-chairman of the board, and Maytas Properties had his younger son Rama Raju Junior as its chairman. 'These arrangements have the flavour of a managing agency—a family controlling a clutch of companies by means of financial engineering' (*Businessworld*, 5 January 2009). On 17 December 2009, Raju announced the withdrawal of the proposal following the outrage of institutional investors.

> An unprecedented shareholders' revolt that crashed Satyam's American Depository Receipts by 55 per cent on 16 December on New York Stock Exchange and plunged the stock 27 per cent to Rs 165.5 in mid-session the next day on the BSE, forced the Rajus to beat a hasty retreat. Satyam had already been slapped with suits for fraud and breach of contract such as the one by UK-based Upaid. But, amidst several questions of ethics and corporate governance lies an exclamation about the long-term intent of Rajus to stay in the information technology business.
>
> 'A design to quit', *Businessworld,* 29 December 2008, pp. 22–24

The promoter holding in Satyam has been declining over the years as is evident from the following table.

Historically, family firms have been alleged to be siphoning funds from a publicly listed company where the public holding was more than that of the promoters in favour of privately owned (private limited companies or partnerships) organizations through various means even

Promoter holdings in Satyam

Period ended	Holding (%)
March 2001	25.60
March 2002	22.26
March 2003	20.74
March 2004	17.35
March 2005	15.67
March 2006	14.02
March 2007	8.80
March 2008	8.74

Source: 'The writing on the wall', *Businessworld*, 12 January 2009.

to the extent of bleeding it to further their private interests. SEBI, in its initial years, had insisted on the promoter, holding at least 25 per cent of the post-issue capital whenever a company wanted to raise public money, presumably for the promoters to be committed to the venture. However as time went by, this provision got diluted.

On the Satyam move to acquire the two family-promoted companies the following observation was made in a newspaper. 'There was a time when industrialists used to run companies in whose equity they had a minute share; they were called managing agents. The government thought it improper. In the mindless manner of governments, it banned managing agency in the Companies Act of 1956. Bans do not remove institutions. Managing agents stopped calling themselves by that name, and continued as before' ('New-style promoter', *Businessworld*, 5 January 2009).

Even the other key executives of the company had been selling the Satyam shares just before the takeover drama was unveiled. 'Top executives, including Director Vinod Dham and CFO S. Vadlamani, sold Satyam shares in bulk just two months ago'('A design to quit?' *Businessworld*, 29 December 2008).

The board of directors of Satyam on 16 December 2008 is given below.

Name	Designation
B. Ramalinga Raju	chairman
B. Rama Raju	managing director
Ram Mynampati	whole-time director
Mangalam Srinivasan	non-executive, independent director
Krishna Palepu	non-executive director
Vinod Dham	non-executive, independent director
M. Ram Mohan Rao	non-executive, independent director
T.R. Prasad	non-executive, independent director
V.S. Raju	non-executive, independent director

Role of Independent Directors: Meaningless, Difficult, and Risky?

Prithvi Haldea, chairman and managing director, Prime Database, wrote in *Economic Times*:

Satyam is a watershed event for the institution of independent directors (IDs). It has demonstrated that even highly credible, qualified, and educated persons are no insurance for corporate governance, that they are no watchdogs of the minority shareholders whose interests they are supposed to serve. In fact IDs end up serving a negative purpose, that of providing a false sense of security to the minority shareholders.

The natural conflict between promoters, whose primary motivation would be to unduly enrich themselves, and the IDs who are supposed to prevent this from happening, is at the core of the problem. However, how this conflict is resolved in India? By allowing promoters themselves to get such persons on their boards who will not even recognize this conflict, leave aside resolving it.

Haldea classifies independent directors into four categories.

Home directors These comprise persons known personally to the promoter's relatives, friends, neighbours, ex-employees, ex-teachers, etc. Several loopholes exist to get them on the board. For example, according to the Companies Act 1956 all persons from the wife's and mother's side are not considered as relatives.

Value directors Value directors are those that either bring knowledge and expertise to the company, such as lawyers, finance professionals, technocrats, civil servants, and so on, or they provide networking to the company by opening doors to the government, politicians, and institutions. Such persons are also hired to give a sense of comfort to the investors. Many of these would be people of high integrity.

Celebrity directors This is the category that comprises people whose main reason to be invited to become an independent director is to add an aura of respectability and new value to the company, as also to impress the retail investors. This category includes film stars, lyricists, sportsmen, defence personnel, fiction writers, and the like. Most people in this category also would be people of high integrity. However, they would have very little clue to the corporate world or of promoters' designs.

PSU directors This is the category that comprises people who are appointed on the boards of listed PSUs, typically by the political high command or the minister concerned. These people either carry out the mandate of the respective ministries or simply pursue their personal agenda of benefiting from these PSUs, and are clearly not concerned about the minority shareholders.…

Courtesy Satyam, many value and celebrity directors are now seriously worried. They are worried about the possibility of their life's reputation getting ruined overnight, media ridicule and government prosecution. Between 15 December 2008 and 1 March 2009, as many as 195 individuals had resigned from the position of independent directors, and the number is growing by the day ('Independent directors: The bare truth', *Economic Times*, 14 May 2009).

Thus, the role of independent directors has been hotly debated post the Satyam episode.

According to P.R. Agarwala, chairman, Rupa & Co, a Kolkota-based hosiery manufacturer, 'After the Satyam scandal, no one wants to take a risk as there may be some hidden skeletons. Besides you must understand that independent directors could be unaware of some promoter-driven initiatives as they attend only a few meetings a year.' ('The Omerta followers', *Business Today*, 8 March 2009). Agarwala quit as independent director from the board of Khaitan Electricals within a month of joining. *Business Today*, in the same article, mentions other high profile exits from the position of independent directors from a number of companies. P.R.S. Oberoi, chairman, East India Hotels, resigned from the board of Jet Airways; N.S. Raghavan, former joint MD and one of the founders of Infosys, and founder, Nadathur Holdings and Investments, a venture capital firm, resigned from the board of Sobha Developers; and Hemendra Kothari, chairman, DSP Merril Lynch from Peninsular Land of Ashok Piramal Group, and T.K.K. Bhagavat, left the board of D.S. Kulkarni Developers, the Pune-based real estate firm.

Does the policy of independent directorship lack punch?

According to *Business Today*, 'The policy for IDs-prescribed under the Act (The Companies Act) and by SEBI in Clause 49 of the Listing Agreement – is weak, feel most experts.'

According to these experts, there are three major policy lacunae: lack of norms, insiders as independent, and lack of stipulation of role or a code of conduct ('Ensuring independence', *Business Today*, 22 February 2009):

Lack of norms: Clause 49 stops at laying down a few disqualifications which do not include criminal backgrounds or illiteracy. There are no norms on qualifications or experience required for independent directors. Companies, therefore, often tap celebrities, especially just before hitting the market for funds through IPOs (initial public offers). Jet Airways, for instance, has Shah Rukh Khan, Yash Chopra, and Javed Akhtar on its board.

'It is important to have independent directors with strength of character, who are willing to blow the whistle and be assertive,' says Virendra Jain, founder, Midas Touch Investors Association. In reality, however, companies often induct retired bureaucrats as independent directors to take advantage of their lack of domain knowledge.

Insiders as independent: 'Independent directors more often than not tend to be insiders such as former employees,' says Prithvi Haldea, founder and managing director, Prime Database. Though regulations disallow promoters to appoint their relatives as independent directors, a 'relative' excludes cousins and other close relations from the wife's and mother's side.

Lack of stipulation of role or a code of conduct: The existing policy for independent directors doesn't stipulate the role or a code of conduct. Thus, even though minority shareholders at Satyam have plenty of reasons to blame its independent directors, it cannot be automatically said that they violated Clause 49. 'The concept of independent directors is a myth, offering false sense of security to small shareholders,' says Haldea. He says several independent directors have told him they think their role is to add value to a company or help it network better, while in reality, it is to protect small shareholders' interests.

On 7 January 2009, Ramalinga Raju, chairman, in his letter to the board of directors disclosed that

1. The balance sheet as on 30 September 2008 carried
   (a) inflated (non-existent) cash and bank balances of Rs 50.4 billion (as against Rs 53.61 billion reflected in the books)

(b) an accrued interest of Rs 3.76 billion, which is non-existent
(c) an understated liability of Rs 12.3 billion on account of funds arranged by me
(d) an over-stated debtors position of Rs 4.9 billion (as against Rs 26.51 billion reflected in the books)

2. For the September quarter (Q2), revenues of Rs 27 billion and an operating margin of Rs 6.49 billion (24 per cent of revenues) as against the actual revenues of Rs 21.12 billion and an actual operating margin of Rs 0.61 billion (3 per cent of revenues), which has resulted in artificial and cash bank balances going up by Rs 5.88 billion in Q2 alone.

He also stated that the gap in the balance sheet has arisen purely on account of inflated profits over a period of last several years (limited only to Satyam standalone, books of subsidiaries reflecting true performance).What started as a marginal gap between actual operating profit and the one reflected in the books of accounts continued to grow over the years. It attained unmanageable proportions as the size of the company operations grew significantly (annualized revenue run rate of Rs 112.76 billion in the September quarter, 2008, and official reserves of Rs 83.92 billion).The differential in the real profits and the one reflected in the books was further accentuated by the fact that the company had to carry additional resources and assets to justify higher level of operations—thereby significantly increasing the costs.

He confessed that every attempt made to eliminate the gap failed. As the promoters held a small percentage of equity, the concern was that poor performance would result in a take-over, thereby exposing the gap. It was like riding a tiger, not knowing how to get off without being eaten. The aborted Maytas' acquisition Deal was the last attempt to fill the fictitious assets with real ones. Maytas' investors were convinced that this is a good divestment opportunity and a strategic fit. Once Satyam's problem was solved, it was hoped that Maytas' payments can be delayed. But that was not to be. What followed in the last several days is common knowledge.

On 9 January 2009, the government superseded the Satyam board and appointed its nominees Deepak Parekh, Kiran Karnik, and C. Achuthan on 11 January 2009.

Discussion Questions

1. In the backdrop of the Satyam incident, comment on the state of corporate governance in India.
2. Could outside directors and/or the regulator have averted the crisis?
3. What do you think could have led to the crisis and what should be done to prevent such instances of corporate failures in future?