THE ACHILLES’ HEEL OF INDIAN CORPORATE GOVERNANCE SYSTEM

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INTRODUCTION

Business history suggests that it often takes a scandal or two of unhealthy proportion to really bring into sharp relief the role of ethics and governance in business. True to that, the Satyam debacle, India’s Enron, has had a profound influence on the Indian business environment (Menon, 2010). The $ 1.47 Billion Satyam Computers scam that its chairman Ramalinga Raju has admitted to, has taken the wind out of corporate India. He has disclosed that the company’s balance sheets were dressed-up over several years. It is a crime for which he and his brother as well as the Chief Financial Officers of the company have been arrested. Surprisingly, prior to this turn of events, Satyam had been widely recognized for exemplary corporate governance, and Raju hailed as a role model for successful business and entrepreneurship. In September 2008, Satyam Computers was awarded the Golden Peacock award for corporate governance excellence for the second time by the UK-based World Council for Corporate Governance. And after a few months, the founder and his co-conspirators reported fictitious cash deposits, misstated accounts receivables and accounts payables, understated liabilities, and overstated assets; these falsities only came to the fore when Raju tried to buy two other firms owned by his family. Shareholders revolted against the acquisition proposal because they viewed the planned purchases as attempts to prop up other failing family businesses by siphoning cash out of the profitable software firm (Rajagopalan and Zhang, 2009).

Even before the Satyam scandal erupted, Indian shareholders had already lost more than $2 billion from corporate frauds and bad governance since 2003 (“Corporate India’s Governance Crisis,” 2009). An analyst’s report revealed only 4 out of 68 Indian companies were found to adhere to “highly desirable” disclosure standards; more than half the companies on the list that did not make the grade were well known firms with significant global presence (“Corporate India’s Governance Crisis,” 2009). The former CBI Director Joginder Singh (2009) asserted that most of the scams involve the same old tricks of cheating such as underwriting or fudging company books, one will not be wrong in saying that history is repeating itself. The only thing that distinguishes one scam from another is that the companies and the principle actors are different. But the motive remains the same in each case.
In the aftermath of the fraud there has been a lot of talk about effective and transparent corporate governance and a system of institutionalised checks and balances. There has been a redoubled effort on the part of both the government and other corporations to ensure governance codes were tightened. However, the past experiences of such efforts force us to believe that reforms in corporate governance system of the country will be effective if the cause of reoccurring failure (the Achilles Heels of the Indian Corporate Governance Systems) are identified and addressed to.

A SNAPSHOT OF INDIA’S CORPORATE GOVERNANCE REFORMS

In India, the urgent need for corporate governance came to the fore following several significant stock market scandals (many of which were linked to insider trading) that occurred following major liberalization in 1991. In addition to stock market frauds committed by large stock brokers, there were several incidents of companies allotting preferential shares to their promoters at highly discounted prices, as well as several instances of “start-up” companies that simply disappeared with their investors' money (Goswami, 2002).

The most significant event in the evolution of corporate governance in post-liberalization India was the establishment of the Securities and Exchange Board of India (SEBI) in 1992 and its increasing jurisdiction over matters related to corporate governance since then. Since its establishment, SEBI has constituted several major committees to review governance challenges, and to propose governance laws and reforms (Rajagopalan and Zhang, 2008). The first formal corporate governance committee, formed in 1996 and chaired by a leading Indian industrialist, Rahul Bajaj, submitted its recommendations in April 1998. The second committee, also chaired by a leading industrialist, Kumar Mangalam Birla (the Birla Committee), submitted its report in 2000. The third committee, chaired by Naresh Chandra (the Chandra Committee), was constituted in August 2002 to focus on corporate audit practices. The fourth committee — the Murthy committee, chaired by Narayana Murthy, founder and Chairman of Infosys, one of India's leading software companies — provided recommendations in 2003.

The Birla Committee's recommendations were formally implemented by SEBI through the enactment of Clause 49 of the Listing Agreements. The major recommendations (summarized below) focused on the board of directors, audit procedures, and shareholder rights.

• COMPOSITION OF THE BOARD: If there is a full-time chairman, 50% of the directors must be nonexecutives and 50% must be executives.

• CONSTITUTION OF AUDIT COMMITTEE: The committee must contain three independent directors and a chairman with a sound financial background. A finance director and an internal audit head are to be special invitees, and a minimum of three meetings are to be convened. The committee is responsible for review of financial performance on a half-yearly/annual basis, appointment/removal/renumeration of auditors, and review of internal control systems and their adequacy.
• BOARD PROCEDURES: At least four meetings are to be held each year. A director cannot be a member of more than 10 committees, and a chairman cannot serve on more than 5 committees across all companies.

• MANAGEMENT DISCUSSION AND ANALYSIS REPORT: This should include a discussion of industry structure and trends, opportunities and threats, segment performance, analysis of financial performance, future outlook, and risks and concerns.

• SHAREHOLDER RIGHTS: Shareholders are entitled to have access to quarterly results, analyst presentations, half-yearly financials and significant event reports, reviews of complaints and grievances by non-executive directors, etc.

The Chandra Committee recommendations on audit reforms were also formalized as part of the Companies (Amendment) Bill, 2003. This committee recommended a list of disqualifications for audit assignments, such as: direct relationship with the company to be audited, any business relationship with the client, or a personal relationship with a director. In addition, it recommended preventing auditing firms from providing non-audit services to clients and requiring that the CEO and CFO of listed companies certify to, and take responsibility for, the fairness and correctness of their company’s annual audited accounts.

Finally, the Narayana Murthy Committee further reviewed the existing code of corporate governance in 2003 and proposed additional and more refined governance reforms and rules, particularly in relation to the role of the board of directors. Specifically, its recommendations included the implementation of formal training for board members, the elimination of nominee directors, the establishment of rules for treatment of independent directors, and board oversight of business risk and risk management strategies (Rajagopalan and Zhang, 2008). Other recommendations of the Murthy Committee, which are being implemented through amendments to Clause 49, include the strengthening of the responsibilities of the audit committee, improving the quality of financial disclosures, the establishment of rules for the utilization of proceeds from IPOs, the review of subsidiaries of holding companies, and the implementation of policies to protect “whistle blowers” who approach corporate audit committees.

CORPORATE GOVERNANCE SYSTEM: WHY DOESN’T IT WORK?

Though the regulatory bodies of India have advocated comprehensive and rigorous corporate governance reforms which emphasize the importance of the credibility and integrity of listed companies, the responsibilities of directors and management, the protection of minority shareholders, and the necessity for information disclosure, over-regulation and under enforcement are common themes that characterize the Indian corporate governance systems and thus can be termed as Achilles’ Heel of corporate governance in India.

1. CONCENTRATION OF OWNERSHIP AND CONTROL IN THE SAME HANDS
The governance failures stem from the concentration of ownership and control within state-owned, public-sector units, or family owned businesses, and from the pyramidal ownership structures that dominant shareholders use to achieve greater control of the firm (Rajagopalan & Zhang, 2008). For instance, in India a majority of the largest companies are family owned, and their founders as in the Satyam case often exercise control to such an extent that they can misstate financial reports and create shadow companies through complex cross-holdings that deal with one another in financially dubious and even potentially illegal ways ("Corporate India’s Governance Crisis," 2009; Rajawat, 2009).

The fundamental problem of concentration of ownership and control in the same hands is further exacerbated by: (1) the lack of incentives for firms and their managers to implement governance reforms, (2) underdeveloped external monitoring systems and weak regulatory agencies, and (3) a shortage of qualified independent directors. While India’s formal financial reporting standards essentially meet international standards for accountability and transparency, and its principal regulator—the Securities and Exchange Board of India—is set up to be independent of the government ("Bank Incentives," 2009), enforcement of governance laws is often weak and characterized by significant loopholes. Political connections also often undermine the independence and will of enforcement agencies ("Did SEBI," 2009). In other words, while the United States governance context needs to deal with the challenges posed by a decentralized and porous regulatory system, developing countries lack a regulatory structure with the political will and judicial support to enforce reforms that are enacted.

2. FAILURES IN IMPLEMENTATION

While many companies in India have in place basic governance structures such as boards of reasonable size, some independent directors, and independent auditors, few implement the whole range of governance mechanisms found more commonly in the developed world. There is widespread agreement that we are very weak when it comes to enforcing these reforms. Indeed, in a 2004 report on the implementation of corporate governance codes in India, the World Bank noted serious gaps and lapses, particularly in relation to the role of nominee directors from financial institutions, stock-listing laws and regulations, insider trading, and dividend and share-transfer transactions (World Bank, 2004).

Interestingly, the areas in which significant governance lapses have been noted in practice are also the very areas where a plethora of formal rules and regulations exist. Clearly, then, the lax governance environment can be attributed not to the absence of formal governance laws, but to the relatively weak or absent enforcement mechanisms. For instance, the response of the Indian government following the Satyam crisis was still criticized as being too slow. In this particular case, while the disclosure of fraud was made on a Wednesday morning, the first resulting crucial decision—which was to dismiss the entire board of directors—was only made on Friday night. In a scathing critique of the Government’s response timing, published in India’s leading business journal, Dubey (2009) sarcastically notes:
So what if crucial time was lost in the intervening 70-odd hours when the company, its finances, its accounts, and IT infrastructure remained in the hands of people who were part of the management that committed the fraud. So what if the Centre and the State debated for three days about who would initiate legal action against the Rajus. So what if incriminating evidence may have been destroyed as Satyam investigators have discovered. . .they are unable to locate the company’s bank statements.

There is need to build a consensus on separating economic fraud investigators and offices such as the SIFO from political clutches such as the Ministry of Corporate Affairs. Business and politics are so well intertwined in the country that political control can potentially influence investigators. . . .The corporate fraud can be avoided if investigators are given the statutory authority and the independence to swing into action without waiting for a political nod.

3. POWER OF THE DOMINANT SHAREHOLDER

A closer scrutiny of the governance challenges in India suggests that a major problem in is the unaddressed conflicts between the dominant shareholders and the minority shareholders (Varma, 1997). Because the board derives its power mostly from the dominant shareholder, it is not practical to expect the board to discipline or punish the dominant shareholder; this, in turn, contributes to the ineffectiveness of boards of directors.

There are at least two types of dominant shareholders in the Indian contexts. The first type is state ownership, which is manifested in India's public sector units (PSUs). When the state dominates a firm, it is obvious that the state can use its influence to achieve the objectives of politicians, rather than protecting the interests of investors and shareholders. The second type of dominant shareholder is evident in large, often family owned or controlled business groups. In this corporate form, the promoters (together with their friends and relatives) are often the dominant shareholders, with large, minority stakes; government owned financial institutions often hold comparable stakes, and the balance is held by the general public. In 2002, the average shareholding of promoters (and their allies) in all Indian companies was in excess of 45%. Even with significantly smaller shareholdings, the promoters effectively become the dominant shareholders because a large proportion of the shares are then held by state-owned financial institutions that have historically played a passive role in the governance of firms.

Dominant shareholders can benefit, at the expense of minority shareholder interests, through both economic and social mechanisms (Dharwadkar et al., 2000). In economic mechanisms, dominant shareholders use pyramidal ownership structures whereby they can achieve greater control of the firm through interlocking ownership, and can benefit from related-party transactions. Using social mechanisms, dominant shareholders appoint allies, friends, and family members to top management positions, and these managers may then have incentives to disregard minority shareholders' interests. In summary, the dual challenge of governance reforms is how to simultaneously resolve the traditional agency
problem between shareholders and management, and the unique agency problem between dominant shareholders and minority shareholders.

4. UNDERDEVELOPED EXTERNAL MONITORING SYSTEMS

So far, India's corporate governance reforms have mainly focused on internal mechanisms, emphasizing the responsibilities of directors and management and the necessity to disclose information. It is important to note, however, that effective governance is contingent upon the existence and efficient operation of other (external institutional) regulatory, legal, and financial frameworks. The board of directors, shareholders, and management are the key internal components, and the external institutional framework includes the Securities and Exchange Board of India (SEBI), the courts, securities analysts, institutional investors, stock markets, professional auditing companies etc. Accordingly, effective governance mechanisms include both internal mechanisms, such as the board of directors and its major committees, and external mechanisms such as hostile takeover bids, leveraged buyouts, proxy contests, legal protection of minority shareholders, and the disciplining of managers in the external managerial labour market (Dharwadkar et al., 2000).

Given the short histories of India's economic liberalization, the external monitoring system is still in its infancy, and this can prohibit the effective implementation of governance reforms in these countries. For example, the family controlled businesses own over 45% of all Indian companies. The extremely high ownership concentration in these countries makes hostile takeovers and leveraged buyouts unlikely to occur, which means that as long as a firm's management can appease the dominant shareholder(s), it is unlikely to be challenged.

Effective government reforms also require determined efforts by government to clamp down on corruption. Over several decades of a centrally controlled and socialist economy, a large parallel black-market economy developed in India in which transactions were carried out in cash and typically not recorded in accounting and financial statements. Some industries in India were, at one stage, so strongly permeated by the black-market economy that it was almost impossible to carry on business without using black-market money.

A key approach to addressing the corruption issue is improving transparency. Without greater transparency, new governance laws and codes will do little to improve governance. Further, recent reforms in the Indian banking sectors mark a fundamental shift toward letting market forces encourage competition and accountability in banking (Reddy, 2002). The emerging market orientation in the banking sector accompanies the evolution of stronger disclosure norms and the emphasis on more regular surveillance by these countries' regulatory bodies.

5. DUBIOUS ROLE OF AUDITORS

Those who do not learn from history are condemned to repeat it. The investigation into the Enron fraud had also shown its auditors, Arthur Anderson, as guilty as Enron’s CEO. There is hardly any worthwhile punishment for the collaborators and the auditors in such cases of fraud. The Companies Act undoubtedly lays down the duties and powers of the
But the penalty for non-performance is pathetic and puny. If an auditor fails in carrying out his duties properly, the maximum penalty is a fine of Rs. 10,000 (Singh, 2009).

Incidentally, Pricewaterhouse Cooper, the firm which audited the books of Satyam, received a consolidated audit fee of Rs. 4.3 crore for the financial year 2007-08, almost twice as much as Satyam’s peers like TCS, Infosys and Wipro pay to their auditors. Satyam promoters and others who have benefitted — some by insider trading — could not have carried out their scam with the fear of being found out by the auditors. According to one report, about Rs. 800 crore was made by insider trading and sale of shares in this scam.

The truth is that there can be big or small money involved in auditing, depending upon the size of the company. No auditor, unless he wants to be out of the business, would be too harsh or expose any wrongdoings. There are many Ketan Parekh, Harshad Mehta and Satyam scams waiting to emerge if company auditors are willing to put their neck on the block and lose their business. But it is doubtful, if anybody would commit harakiri.

No doubt the Companies Act does provide for special audit, investigation, reconstitution of the board of directors and even ‘dawn raids’. But the penalties for non-compliance are as good as non-existent. Moreover, there is no mechanism even for test-checking a few corporate balance sheets and accounting statements certified by auditors.

6. SHORTAGE OF QUALIFIED INDEPENDENT DIRECTORS

The governance reforms have emphasized the importance of independent directors, and the governance laws in the country define the minimum number, and the roles and responsibilities, of these directors. A major obstacle to implementing the governance reforms in India, however, is that there are few qualified candidates; that is, individuals who understand and can carry out the role of an independent director. One solution to this challenge is training. However, these training programs, most of which are short, can provide only very general guidance. In addition, the unique cultural and business environments of India can limit the applicability of best governance practices developed in the West. Western experience must be combined with local knowledge in order to be effective in responding to the specific requirements of listed companies in India. Another solution to the shortage of qualified independent directors is to appoint more foreign directors. As India continue to open up their capital markets to foreign investors, it is likely that more foreign directors will fill the boardrooms.

An even more important issue is that most directors view their directorships as sinecures, without real responsibilities. Most independent directors are government officials, university professors, and nominee directors from large financial institutions who have traditionally shown little interest in monitoring the actions of management. In order to motivate independent directors to really carry out their responsibilities, their liabilities must be made credible so that those who fail to exercise due diligence have to make serious financial restitution. Ultimately, India will have to develop a business culture in which directors know what is expected of them and are motivated to carry out due diligence.

7. LACK OF INCENTIVES
Despite the encouraging changes in India's governance laws, key parties (e.g., regulatory bodies, boards of directors/supervisors, management) do not yet possess compelling incentives to implement these changes. It often takes scandals to truly motivate legislators and regulators to become stringent in applying the rules. Unless spurred into action by such events, regulatory bodies may not have the political will to investigate improprieties; indeed, the government's desire to promote short-term economic growth often makes it less willing to go after large corporations to protect minority shareholders. Moreover, investors, both domestic and foreign, are reluctant to get involved in implementing governance reforms as they are largely seeking short-term price gain rather than long-term shareholder value (Barton et al., 2004).

Further, outside directors often do not have strong incentives to implement governance reforms. In emerging economies, outside directors are often political allies or friends and relatives of the senior managers/owners (in the case of family controlled businesses). These directors may represent a dominant interest group but not all shareholders. Overall, unless such incentive problems are alleviated, implementing governance reforms will continue to be much more challenging than passing additional governance laws in India.

BUILDING STRONG CORPORATE GOVERNANCE CULTURE IN INDIA

Each scam that comes to light seems to be bigger than the previous one. And each of them is due to greed and the lack of any deterrence. No doubt that there are a number of very good companies with impeccable records, though the same cannot be said about every company. Corporate tragedies in the last decades have had a serious impact on shareholder value and have led to searching questions on the legitimacy of the purpose of modern corporations, as these failures have betrayed stakeholders. Therefore, we must not only understand the challenges of corporate governance, there is dire need to take preemptive measures so as to curb corporate frauds and strengthen the governance system in India Inc. Though, there cannot be one-size fit all solution, the following steps may prove helpful in building a strong corporate governance culture in India:

INCREASING THE COSTS OF COMMITTING CORPORATE FRAUD

The costs associated with committing a governance fraud generally depend upon three factors. The first is the probability that the deviant behaviour will be discovered, which substantially depends upon the monitoring mechanisms in place. The greater the probability that the fraud will be discovered, the less likely it is that a company or its management will commit a fraud.

The second factor is the size or extent of the punishment (e.g., financial fines, loss of liberty) if a fraud is detected. Severe punishment will discourage a company and the management. In many cases, however, because the company pays for the punishment, the threat of punishment may have limited effect in disciplining management behaviour. For instance, in May 2002, Merrill Lynch paid a $100 million fine to settle with the State of New York after its analysts were caught denigrating the companies they touted to investors during the technology bubble era. The requirement for CEOs and CFOs to personally certify their companies’ financial statements may narrow the legal loophole between a company’s
financial statements and its senior executives’ individual responsibilities, thereby enhancing the quality of a company’s financial disclosures (Zhang & Wiersema, 2009). Once they have certified their companies’ financial statements, subsequent revisions of the statements could potentially expose executives to criminal charges.

The third factor is the likelihood that the punishment will be enforced, which depends upon the effectiveness and speed of the legal system in place. The major problem regarding corporate governance in India is not the absence of laws but the lack of timely and consistent enforcement of the laws that already exist (Rajagopalan & Zhang, 2008).

EXPANDING THE ROLE OF SEBI

Though the SEBI has performed reasonably well so far, the role, functions and powers of the SEBI need to be suitably expanded. Furthermore, the expertise gaps and number of professionals required in the SEBI type of regulating agencies should be attended to first, as no single regulator in India can be effective in the absence of a suitable support infrastructure and harmonisation of rules and regulations.

STRENGTHENING AUDIT COMMITTEE

The composition of an audit committee is prescribed under Section 292 of the Companies Act, and any departures from the rules governing such a composition should be dealt with severely. No nominee directors or any other category of directors should be allowed to be part of the audit committee. The audit committee should ensure that management has a minimum risk-management capability, and that auditors do not get any consulting assignments from the company.

MAKING BOARD PROCESS TRANSPARENT

One of the methods of making corporate boards more effective is to ensure a transparent board process. Furthermore, there is increasing evidence of divergence of objectives and interests among shareholders, the board and management of corporations, and hence serious corporate governance problems persist. The practice of noting dissent from outside or even nominee directors ought to be encouraged. This is obviously the role of the non-executive chairman of the board and also the company secretary, since the latter records the board proceedings and is furthermore expected to safeguard the board process.

ENSURING ACCOUNTABILITY OF BOARD OF DIRECTORS

It is the duty of the boards of companies to impress upon the management that corporate governance processes and practices not be confined merely to compliance with various laws; many other critical aspects are involved. Corporate governance is a process of self-regulation, and corporations need to abide by a code of conduct. Once the internal mechanism is sufficiently sound, it would not be too difficult for a corporation to meet even the most stringent regulations and legal requirements imposed by external corporate governance mechanisms.
CONCLUDING REMARKS

India is not new to corporate scams — they have plagued us right from the time of independence. But the regularity with which they are taking place is truly shocking. It often takes a scandal or two of unhealthy proportion to really bring into sharp relief the role of ethics and governance in business. True that, there was a redoubled effort on the part of both the government and other corporations to ensure governance codes were tightened. But the recurrence of corporate governance crises reminds us that the price of economic growth and opportunity is indeed eternal vigilance and addressing the Achilles Heels of the Indian Corporate Governance System. Eventually, corporate governance reforms in India will only prove effective if many more companies and all relevant regulatory bodies strictly implement the provisions.

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