Whistle Blowing at Corporate Governance-Lessons to Learn from Satyam's Episode: A Study

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Abstract:

Corporate Governance is concerned with establishing a system whereby directors are entrusted with responsibilities and duties in relation to the direction of a company's affairs. An effective Corporate Governance system should provide mechanisms for regulating directors' duties in order to restrain them from abusing their powers and to ensure that they act in the best interests of the company in its broad sense. Corporate governance is also concerned with the ethics, values and morals of those involved in the management of a company. Corporate Governance includes the relationships among the many stakeholders involved and the goals for which the corporation is governed. The principal stakeholders are employees, shareholders, board of directors and the government.

There is a strong incentive for corporate managements themselves to adopt transparent processes and good governance practices. They have sought to cultivate an image of being honest with their investors concerned about shareholder value maximization. This article describes various mechanisms of Corporate Governance, various reasons for failure of Corporate Governance in general and Corporate Governance failure at Satyam Computer Services. The reasons for Corporate Governance failure in such big organization and changes required to Corporate Governance after Satyam episode are the focus of this article.

Introduction:

Corporate Governance is a system of making directors accountable to stake holders for effective management of the companies, in the best interest of the company along with concern for ethics and values. It hinges on complete transparency, integrity and accountability of management that includes executive and non-executive directors. Its genesis can be traced to the internal audit function. Its importance was enhanced after the Stock Market Crash of 1987. Corporate Governance is an important concept to achieve corporate excellence. Managements should pursue the path of dynamic success to achieve corporate excellence. Ethics are important for dynamic success. Ethics of success is entwined in corporate governance. If ethics of success is ignored or sidelined, failure inevitably results. And failure increases costs considerably and erodes profitability. Dynamic success keeps on raising the expectations of everyone and managements face on-going challenges. As success depends on corporate governance, managements must believe in and practice good governance principles. Corporate Governance is not just only for the shareholders, but it is as much important for the corporations themselves. To experience the goodness of corporate governance and to realize its immense benefits, corporate should have staunch belief in the concept and its practice.

Corporate Governance has been in place for ages and still one can see fiascos like Satyam taking place in modern India, which really raises doubt about financial and commercial ethics of businesses. For a nonprofessional, corporate governance is almost an alien concept but even they understand something called Corporate Social Responsibility (CSR) and they expect the corporations to be honest and maintain very high level of integrity. Today large numbers of retail investors are entering in to stock market in order to search for better returns or may be even for getting future security. In this scenario a big IT and Outsourcing player like Satyam gets involved in false accounting practices, which hurts the financial position of millions of investors who not only loose their hard earned money, savings but even their faith in corporate houses and their hope for better future.

Objectives of the study:

The main objective of the study is to discuss the failure of corporate governance at Satyam Computer Services. However, the following are the specific objectives of the study:

1. To present objectives, principles and need of good corporate governance.
2. To examine the mechanisms of corporate governance.
3. To present the characteristics of critical stakeholder players in different countries.

4. To suggest the changes required to corporate governance after satyam scam.

Methodology:

The study is based on secondary data. The secondary data source is research journals, books, news papers, magazines, internet etc. The secondary data is collected by visits to libraries for accessing books, research journals, news papers, magazines, browsing internet etc. The data is compiled in the form of tables wherever necessary.

Objectives of Corporate Governance:

Corporate governance is basically a system of making directors accountable to stake holders for effective management of the company along with concern for ethics and values. The following are the basic objectives of Corporate Governance:

1. To provide stability and growth to the companies.
2. To build confidence to the stakeholders by adopting good corporate practices.
3. To reduce perceived risks, consequently reducing cost of capital.
4. To leverage competitive advantage in the financial market.
5. To promote stability and long-term sustenance of stakeholders' relationship.
6. To enhance the reputation of a business organization.
7. To make the business organization more efficient and effective to avoid disasters.

Basic Principles of Corporate Governance:

Effective corporate governance requires a clear understanding of the respective roles of the board and senior management and their relationships with others in the corporate structure. The following are the basic principles of Corporate Governance:

1. The board of directors of a public corporation is to select a Chief Executive Officer and to oversee the CEO and other senior management in the competent and ethical operation of the corporation on a day-to-day basis.
2. Management should operate the corporation in an effective and ethical manner in order to produce value for stake holders.

3. Management should produce financial statements that fairly present the financial conditions and results of operations of the corporation.
4. Management should engage an independent accounting firm to audit the financial statements prepared by the management.
5. Share holders must accept their own responsibilities to achieve a truly robust corporate governance system. They should vote on important resolutions.
6. The auditors should act as agents of stake holders.
7. The companies should disclose in their annual report and accounts whether they meet the terms of codes of good practice.

Need of Good Corporate Governance:

Corporate governance has neither a static, nor a prescribed form. The Australian standard on Corporate Governance (AS8000, 2003) says, there is no single model of corporate governance. To remain competitive in changing world, corporations must innovate and adapt their own corporate governance practices so that they can meet new demands and grasp new opportunities. Need of good corporate governance may be summarized as follows:

1. Due process – doing things in an agreed, documented, controlled and appropriate way.
2. Transparency- doing things in a way which is open to appropriate way.
3. Accountability- having to answer for the things one does.
4. Compliance- having systems to ensure that things are done properly.
5. Laws- meeting applicable legal obligations.
6. Security- having systems to ensure protection of information.

However, to have good corporate governance companies should focus on the following issues:

1. Chairman and CEO:

The Chairman is head of the Board and the CEO heads the management. If the same individual occupies both the positions, there is too much concentration of power, and the possibility of the board supervising the management gets diluted. It is considered good practice to separate the roles of the Chairman of the Board and that of the CEO.

2. Audit Committee:

The audit committee is one of the most important committees of the board. It not only oversees the work of the auditors but also expected to independently inquire into the workings of the organization and bring lapse to the attention of the full board.

3. Independence:

Good governance requires that outside directors maintain their independence and do not benefit from their board membership other than remuneration. Otherwise, it can create conflicts of interest, by having a majority of outside directors on its board.

4. Flow of information:

A board needs to be provided with important information in a timely manner to enable it to perform its roles. A governance guideline of General Motors, for instance, specifically allows directors to contact individuals in the management if they feel the need to know more about operations than what they are being told.

5. Many directorships:

A board might meet only four or five times a year but the director needs to have the time to read and reflect over all the material provided and make informed decisions. Good governance suggests that an individual sitting on too many boards looks as a sinecure but he or she will not have the time to do a good job.

Mechanisms of Corporate Governance:

In India, there are six mechanisms to ensure good corporate governance:

1. Companies Act:

In India companies are regulated by the Companies Act, 1956. It is one of the biggest legislations with 658 sections and 14 schedules. The arms of the Act are quite long and touch every aspect of a company's insistence. The Act confers the following legal rights to shareholders:

1. To vote on every resolution placed before an annual general meeting;
2. To elect directors who are responsible for specifying objectives and laying down policies;
3. To determine remuneration of directors and the CEO;

4. To remove the directors and
5. To take active part in the annual general meetings.

2. SEBI Act:

The primary securities law in our country is the SEBI Act, 1992. The board has taken a number of initiatives towards investor protection. One such initiative is to mandate information disclosure both in prospectus and in annual accounts. While the Companies Act itself mandates certain standards of information disclosure, SEBI Act has added substantially to these requirements in an attempt to make these documents more meaningful.

3. The Capital Market:

Capital Market has considerable impact on corporate governance. The minority shareholders also can play effectively. They can refuse to subscribe to the capital of a company in the primary market and in the secondary market; they can sell their shares, thus depressing the share prices. A depressed share price makes the company an attractive takeover target.

4. Nominees on Company Boards:

Development banks hold large blocks of shares in companies. These are equally big debt holders too. Being equity holders, these investors have their nominees in the boards of companies. These nominees can effectively block resolutions, which may be detrimental to their interests.

5. Statutory Audit:

Statutory Audit is yet another mechanism directed to ensure good corporate governance. Auditors are the conscious-keepers of shareholders, lenders and others who have financial stakes in companies. Auditing enhances the credibility of financial reports prepared by any enterprise. The auditing process ensures that financial statements are accurate and complete, thereby enhancing their reliability and usefulness for making investment decisions.

Major Players in Corporate Governance:

Corporate governance systems vary across countries and these differences directly affect both the process for developing global strategies that can be adopted. Global strategic decision poses a very tough test for the effectiveness of corporate governance system. They seek maximize profit and global competitiveness. There are four critical stakeholder players that affect the company's decision. They are;

1. Employees
2. Shareholders
3. Board of directors
4. Government

1. Employees:

Labor market influences the flexibility and mobility of employees in a country. Countries such as U.S, Germany and Japan have different kind of employees. The company workers use considerable power partly through co-determination rights that require employees to be consulted on corporate decision. The characteristics of employees in three different countries are as follows:

United States of America	Germany	Japan
Flexible labor Low unionization Employment a will	Work council Co-determination High skill Non flexible labor market	Enterprise union Life-time employment Medium skill

2. Share Holders:

Countries vary in their mixed types of shareholders. The rise of the institutional investor has brought some increase of professional diligence which has tended to improve regulation of the stock market. At one extreme the U.S has natural shareholders who are focused on shareholder value maximization. The basic characteristics of shareholders in USA, Germany and Japan are as follows:

United States of America	Germany	Japan

Institutional investors Individuals Dispersed	Other non-financial firms Companies Banks	Financial companies Industrial corporations

3. Board of Directors:

The Board of Directors is at the core of corporate governance practice. Effective corporate governance requires a clear understanding of the respective roles of the board and the senior management, and their relationships with others in the corporate structure. The relationship of the Board and the Management with stockholders should be characterized by candor; their relationship with employees should be characterized by fairness; their relationship with the communities should be characterized by good citizenship; and their relationship with the government should be characterized by a commitment to compliance. However, the board of director's characteristics is different in USA, Germany and Japan.

United States of America	Germany	Japan
High activism High per cent of outsiders	Moderate activism Stakeholders as a significant minority Medium size	Low activism Large per cent of insiders Large size

Government: Government intervention is usually in the form of market regulation. A representative measure for government intervention in the economy is regulation around takeovers. The Vodafone, the U.K telecoms company made a successful hostile bid for Mannesmann, a German telecoms company and the German government was worried that other local companies might fall into foreign land. For example, Volkswagen is protected from takeover by special law. Sweden, which fall in the continental governance model that use multiple voting rights to help and prevent its companies from becoming vulnerable to takeover. France is also particularly active in preserving national ownership of major companies. In 2004 the French government brokered the takeover of Aventis a French Germany pharmaceutical company by France's Sanofi-synth and Laboratories. So the government intervention is required to regulate the businesses from such practices. The government intervention is different in USA, Germany and Japan.

United States of America	Germany	Japan
Liberal policies Weak takeover barriers	Protectionist policies Medium takeover barriers	Protectionist policies Strong takeover barriers

Corporate Governance Failures:

Corporate regulations are often linked to perceived failures of corporations and expect their management to behave in the way society expects them to. Corporate governance is not an exception to this trend, and, as with accounting, different countries may well experience difficulties at different times. For example, the development of British codes of best practice, which began with the Cadbury Committee, can be related to governance scandals such as Polly Peck and Coloroll in the late 1980s and early 1990s. However, the wave of corporate scandals, at the turn of the century has been marked not only by the number of cases but also by the effect on investor confidence and market values worldwide. The International Federation of Accountants (IFAC) claims that there has been a lot of strategic guidance for business but there has been too little said about the need for good corporate However, the following are some reasons for many corporate failures:

1. Poorly designed rewards package.
2. Excessive use of share options.
3. The use of stock options, or rewards linked to short-term share price performance.

Corporate Governance Failure at Satyam:

Corporate Governance Failure at Satyam is one of the Corporate India's worst unfolding chapters. Corporate governance is a field which constantly investigates how to secure and motivate efficient management of corporations but it is failed to estimate the intensity of the gangrene in the organization. Questions also arise on the role of the auditors, and how such a magnitude of financial fraud could have gone unnoticed. It has begun as a corporate governance issue and turned into a major financial scandal for the ages in India.

The Founder & CEO of Satyam Computers, B. Ramalinga Raju, announced that the company had been falsifying its accounts for years. Corporate India was hit governance.

by its first market scandal on January 7, 2009. The chairman of Satyam admitted to fraud and inflating the revenue and costs and resigned from the company and the board. The promoters inflated the revenue and profit figures of Satyam. In the event, the company has a huge hole in its balance sheet, consisting of non-existent assets and cash reserves that have been recorded and liabilities that are unrecorded. According to the 'confessional' statement of Mr. Raju, the balance sheet shortfall is more than Rs.7000 crores. It is shocked that the money had been recorded in Satyam's balance sheets and books of accounts had been audited by the internationally reputed firm of auditors, Price Waterhouse Coopers (PWC). A most alarming aspect of the episode was that Raju acknowledged that his company's financial records had been manipulated for the last several years.

The down fall of Raju began when Satyam attempted to acquire two companies controlled by his sons- Maytas Properties and Maytas Infrastructure for 1.6 billion dollars in order to compensate the holes in the books of accounts. That abortive attempt precipitated a collapse in the price of the company's stock and a shocking confession of financial manipulation and fraud from its chairman, B. Ramalinga Raju.

One possible cause could be the desire to drive up stock values. The benefits derived by promoters from high stock values allowed them to buy a real wealth outside the company and gave them the invasion money to acquire large stakes in other firms.

Year	**Promoters share (in per cent)**
2001	25.6
2002	22.26
2003	20.74
2004	17.35
2005	15.67
2006	14.02
2007	8.79
September, 2008	8.65
January, 2009	5.13

Table-I: Satyam promoters share of equity in the company

Source: CMIE database

Table-I reveals that the state of the promoters fell sharply after 2001. The promoters share was 25.60 per cent of equity in the company in 2001. This fell to 22.26 per cent in 2002, 20.74 per cent in 2003, 17.35 per cent in 2004, 15.67 per cent in 2005, 14.02 per cent in 2006, 8.79 in 2007, 8.65 at the end of September 2008, and 5.13 per cent in January 2009. The earlier declines must have been the result either of sale of shares by promoters or sale of new shares to investors. But the recent decline of promoters share attributes that the promoters had driven up the stock values by falsifying account books then they sold their shares at high market price to acquire large stakes in other firms.

Table-II: Number of shares held by promoters in Satyam Company

Year	No.of shares (in crores)
2001	7.16
2008	5.8

Source: CMIE database

Table-II reveals that the number of shares held by the promoter group fell from 7.16 crore to 5.8 crore between september, 2001 and september, 2008. This points out to a conscious decision by the promoters to sell shares, which may have been used to acquire assets elsewhere. The more inflated the share values, the more of such assets could be acquired.

Mr. Raju’s confession is also suspect for another reason. Even he and his colleagues were inflating revenues and profits; the actual revenue earning capacity of the company seems to be extremely low. If Satyam Computer Services was cooking its books, it was engaged in activities similar to that undertaken by other similarly placed IT or ITES companies and it too had a fair share of Fortune 500 companies on its client list.

Company	PBT(in per cent)
Infosys	32.3
TCS	23.1
Satyam	27.8
Wipro	19.2

Table-III: Ratios of profit before tax of its total income of different companies

Source: CMIE database

Table-III reveals that the ratios of profit before tax to its total income of Infosys were 32.3 per cent, that of TCS 23.1 per cent, of Satyam 27.8 per cent, and that of Wipro 19.2 per cent for the year ended March, 2008. This suggests that either Mr.

Raju is exaggerating the hole in the balance sheet or there is some other, more complex, and more disturbing explanation.

Despite indicators of these kinds, which could raise suspicion, Satyam Computer Services remained a leading player with substantial investor support for many years. The promoters continued to hold control over the company despite the small share in equity they held and built an empire with land assets and contracts for executing prestigious infrastructural projects. And despite its award-winning reputation for corporate governance, its impeccable board with high-profile independent directors, and its appointment of big-four member PWC as its auditor, this mysterious accounting fraud occurred.

Conclusion and Suggestions:

Corporate Governance is not merely about preparing 'Corporate Governance Report' to comply with listing agreement. It is about transparency, openness and fair play in all aspects of business operations. The biggest stumbling block for the adoption of the true spirit of corporate governance is the independent directors. But many Indian promoters think a controlling stake makes the public company their family estate and fill the boards with pliable independent directors; eminent people who fulfill the criteria of "independent director" but are not directors of an independent mind. Most of the independent directors sitting on the boards of listed companies to improve corporate governance are "home" members, relatives, friends, neighbors etc. In India, 62 per cent of audit committees comprise only of independent members while in the US and the UK 100 per cent of audit committees are independent members. And these are just some metrics on which corporate governance standards can be judged. That's one part of the entire picture though; the real devil lies in board malpractices that are often shrouded in secrecy under the convenient excuse of board confidentiality.

The Satyam episode did manage to shake Corporate Governance system. Satyam was a watermark in terms of corporate governance in India. There has been a shift in the attitude of promoters. Corporate governance is moving to meaty issue from being ritualistic. It's not a complete shift but a journey that has started. However, the following suggestions are given to have good corporate governance:

CEO and board chair roles should be segregated.

Independent directors need to spend more time in understanding the various business opportunities, environment and culture.

Independent auditors need to conduct various exclusive sessions on a one-on-one basis with the management, internal auditors and external auditors.

Exclusive background checks should be carried out on senior managers joining the organization.

Companies should screen customers, vendors, joint venture partners with whom it does business for their commitment and adherence to ethical practices.

The scope of whistle-blower policies should be extended to the wider stakeholder group.

Investors, lenders, analysts should proactively question management on areas pertaining to corporate governance.

Stakeholders should ensure that the composition of the board is a balanced mix of independent directors and management appointees.

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