The Ethical Corporation

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Lecture - 16
Understanding Corporate Governance

Hello, we are on our fourth week and we starting from today talking about the Ethical Corporation with reference to its functional areas. And today's topic is one of the most important for an ethical corporation which is corporate governance. This is a pillar for any ethical corporation. So, we will try to understand what this concept is.

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But sometimes you know to understand what a thing is it helps to look at what it is not. So, I am going to start you out with some notable, but very famous examples of failure of corporate governance and then I am going to talk about what is corporate governance. This explication of the concept will spill over to the next lecture also.

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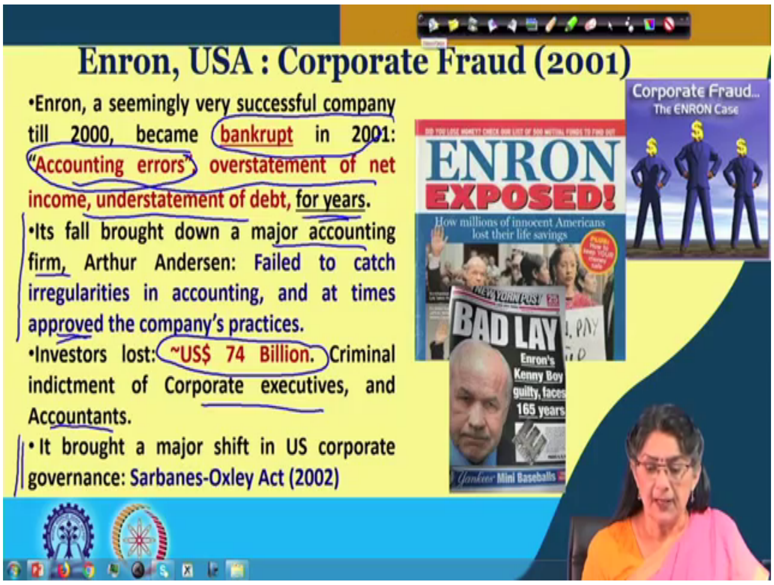

Let us start with the case of Enron. We are talking about a 2001 when the scandal about to the corporate fraud scandal about Enron exploded in the world as one of the biggest corporate fraud. Enron you see was really a starling company till the about 2000 and people actually wanted to invest in this company so much because of it is steady performance, because of it is wonderful share price and so on.

That it was an attraction for all the investors in stock market and then suddenly this happened, namely it became bankrupt in 2001. That was a shock. Why a company went bankrupt of this stature? Why did it go suddenly bankrupt and there were series of findings that for years not just you know, it is not it was not a flash in the bank. For a very long time the accounting, the fine financial data of the company have been manipulated, misrepresented and they were euphemistically called accounting errors, but you can see that they were actually created to mislead and to dupe people.

So, this is the Enron story. What it did the repercussions were really also very big a major fall of a major company, but it brought down many other things along with it. One of them was the downfall of a major accounting firm. Arthur Andersen, they were the ones who audited for Enron and because they failed to catch the irregularities in accounting and it was found that in fact, at times they have also approved some of the malpractices of the company.

So, they were also penalized. Investors lost a staggering amount 74 billion. Who were these investors? Ordinary people, it included some pensioners who had put their last savings into this company because it was doing extremely well according to the figures. The case led to long investigation and afterwards some of the corporate executives as you can see here were criminally indicted along with the accountants. Arthur Anderson was dissolved it changed many things in the United States and globally of course,. In United States, it brought a steeper corporate governance law the Sarbanes-Oxley act of 2002.

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In India if there has to be an counter part of Enron, then I would give that place to Sathyam, the set Sathyam case. This company also was really the favourite among all the companies, it was doing extremely well. In fact, till 2008, it used to be a flagship company where everybody wanted to invest. In 2008, it won awards in corporate governance in five categories.

It was doing extremely well and the financial data looked perfect, too perfect to be true. Perhaps in 2009, it was found out that chairman Ramalinga Raju, his brothers cousins were running actually corporates scam. Subsequently they were fined and jailed what they did was very similar to what I have already explained. They have manipulated and misrepresented it is financial data and they have cheated I have no other words, but to say this they have cheated. Their board was kept completely in the dark. They have lie to the stock exchanges, regulators, investors of course, till the last quarter Sathyam reported that it was doing very well. They were making substantial profit.

So, investors were always kept in the dark and all other stakeholders and this went on for years for years. The accounting was done in a in a in a way that is unbelievable. They even created some fictitious companies to show their expenses. Anyhow it is a long story to cut it short it was nothing, but a fraud a long time fraud. Its auditor was Price Waterhouse and again they were under investigation and they were finally, penalized for not doing their duty. They were supposed to also audit this. The loss was enormous, no matter how you look at it.

The major investors lost this much, but if you look at the total, it was a whopping 13600 crores; crores means a crore mean 10 million. This money has not been really recovered. Who were the investors? Once more ordinary people in fact, one of the board member also was investor and the person did not even know what was going on in the company because the chairman reported wrongly; they kept the board uninformed.

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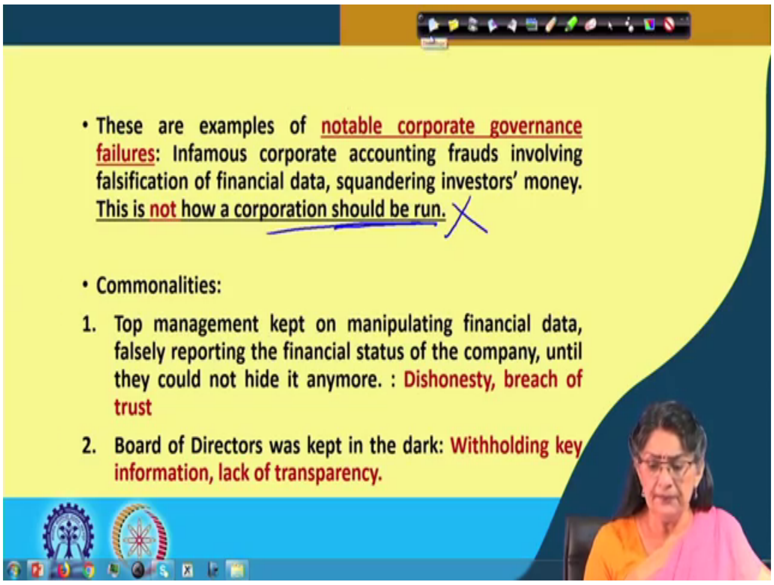

These are notable examples of accounting frauds, falsification of financial data and of course, squandering investors money and this is not how corporations should be run. So, that is why we are calling it failures of corporate governance because corporate governance means how a corporation should be run. We will talk about that separately. Now if you look at these two cases these two big cases, then you will see that there are some commonalities. For example, the top management kept on for years manipulating the financial data and falsely reporting. The board of directors, they should have had access to all the important information, but that access was not given to them.

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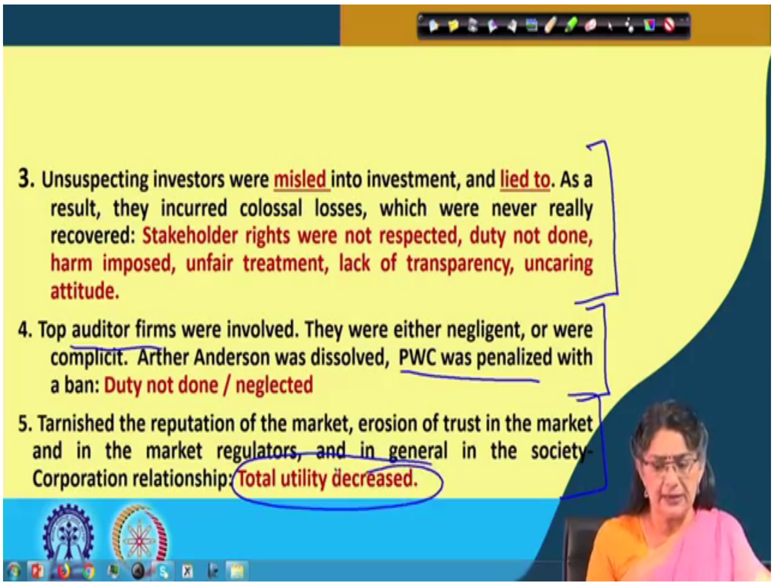

Then there is also unsuspecting investors were completely misled and they were lied to. This is why they ran into the scholars and losses and which as I said where never really recovered.

So, if we talk about the shareholders rights; investors rights; those were never respected. In fact, harm was imposed on them which is not what how company should behave. If you talk about you know cheques and balances, then they were where supposed to be audited by top auditor firms, but either the firms did not do their duty or where complicit you know, I have already talked about Arthur Andersen, but PWC also did not remain the same.

They were penalized for that overall what they also did was to erode, the trust in the stock market. You know it seemed like I mean people the some rogue business can do whatever with investors money and there is no way to prevent that the losses showed that. So, the total utility was really diminished by their acts.

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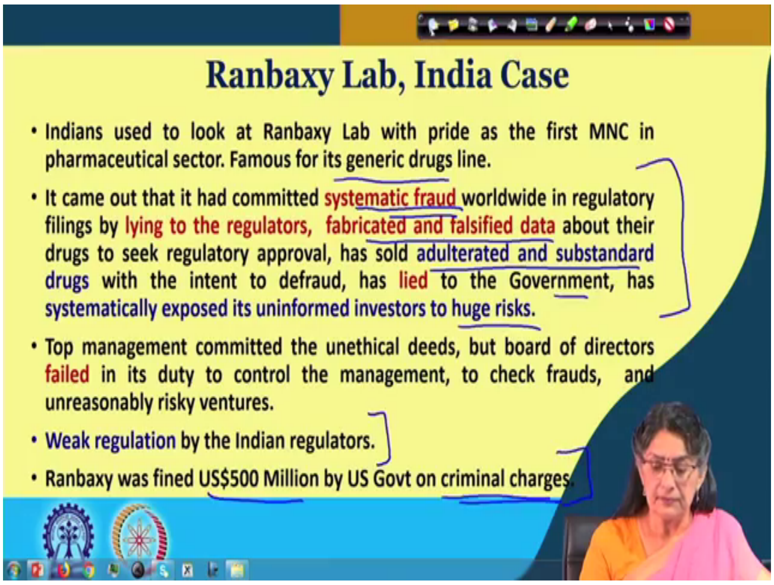

Here is another case Ranbaxy Lab, you know this is a company which we Indians used to be proud of because they were the first multinational corporation in the pharmaceutical sector. And they were doing fabulous business outside of India and making a name reputation because they also ran the generic drugs line, Giving affordable medicines for life threatening diseases. So, there was there were enough reasons to be proud of this company. But it came out in their global business that they actually were committing systematic fraud when they were filing with the regulatory bodies, they have lie to the regulators.

Their fabricated and falsified data about the drugs and the medicines in fact, when they sold adulterated and sub standard medicines, they hid those information. They have lie to the government and systematically, they were exposed their investors to risks huge risks which they had no right to do the investors trust and they put their money and the company has no right to put that money into unreasonable risk.

The top management in fact, were implicated in this that they were the ones who drove this whole systematic fraud operation. The board of directors who were there and it is not that the board did not know what was going on, but the top management apparently overrode the board.

So, the board actually failed in it is duty to control the top executives. It is true that there are failures on the Indian regulation side also, but finally, look at the upshot that in the

United States, the company was fined 500 million us dollars on criminal charges on criminal charges.

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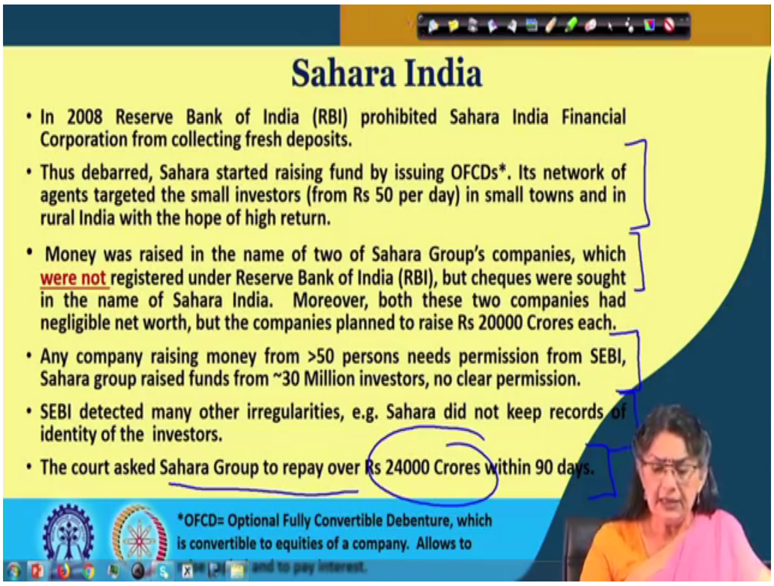

Sahara India is another story and there are many twist and turns in this story, but I am just going to summarize here that Sahara collected money from people, from small investors you know an in small amount, from small towns and from rural hinterlands of the country.

Money was raised in the name of two companies which were not even registered with RBI and there were other irregularities also. You know for example, you know the checks were sought in the name of another company and they did not have the permission from SEBI, the regulatory body in India to raise funds in this way, but they have really collected a huge amount of money.

So, SEBI detected many irregularities. They did a thorough investigation. They in fact, found that you know Sahara did not keep even the records properly. So, in case they had to return the money to the investors, they did not even know who they took it from. So, in any way this was considered as a failure of corporate governance and the group was asked to pay back 24000 crores back to the people. These are cases very well known.

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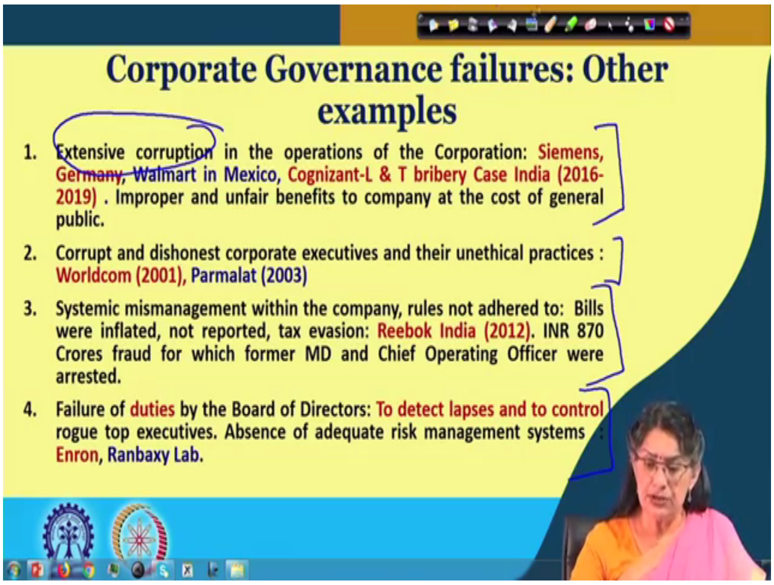

And cases of how company should not be run corporation should not be run. I will give you more examples Siemens in Germany, Walmart and it is operations in Mexico, Cognizant and Larsen and Toubro bribery case; these are examples of clear bright payment, to get to secure a share of the market to safe secure orders. It is it is a example of extensive corruption by corporate entities. This is these are examples of where corporate executives have been corrupt and dishonest out loud. There have been also cases where management is practically nonexistent no rules have been add here to.

So, be if there are bills, they were not properly accounted no reported in income tax or sales tax have not been paid and there are also cases where board of directors have failed in their duties. You know we will talk about what those duties are, but there are a number of such situations.

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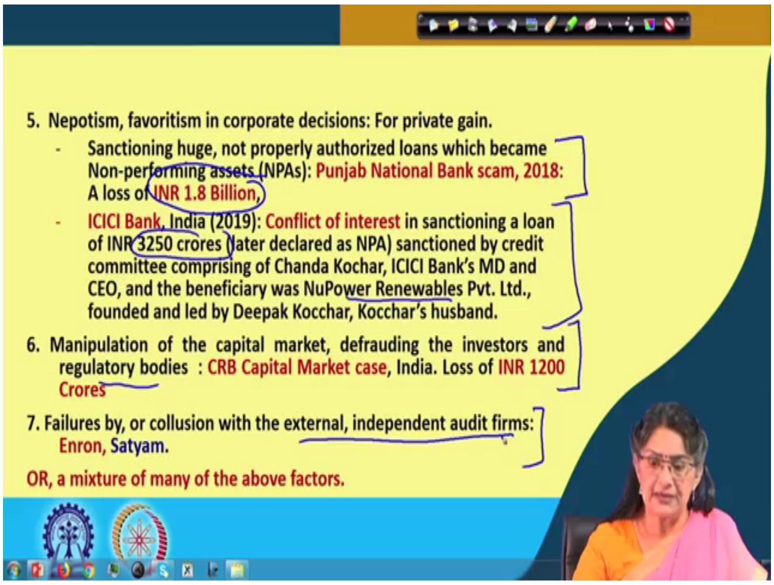

There is also favouritism and nepotism in corporate decisions that is not again how corporate decisions are to be made and we will give you two recent examples. You probably know that the whole banking sector in India is still reading from the blow it got from the Punjab National Bank scam in 2018.

It was a case of sanctioning huge and not properly authorized loans which later on became non-performing assets, bad debts, bad loans. And the amount is 1.8 billion Indian rupees, we know that there is still investigation going on, but you know that this is not a rightly sanctioned loan. The entire countries actually will have to pay back somehow in this way or that way for that.

ICICI bank case also you may remember which happened this year in 2019 which is a an example of conflict of interest because a loan was sanctioned; a huge loan was sanctioned by a credit committee which included Chanda Kochhar who was ICICI banks ben md and CEO and the loan was sanctioned to a company which was founded and led by Kochhar's husband, Deepak Kochhar

So, there was a conflict of interest clearly and there was also abuse of authority. There are other instances also where the capital market has been thoroughly manipulated and clearly investors have been defrauded, regulatory bodies have been mislead and then there are some mal practices or negligences by external independent audit firms.

So, what I am laying out in front of you are complicated cases, but these are all mal practices and these are all what we would call which leads to failure of corporate governance.

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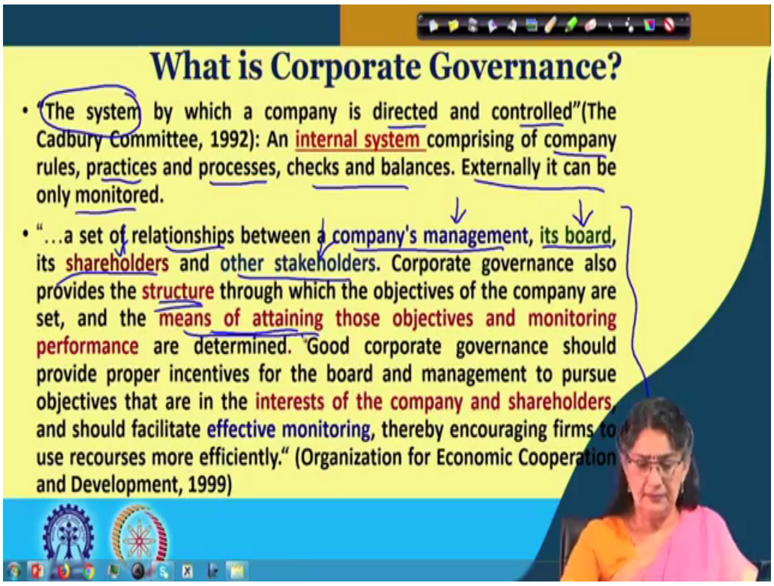

So, the question is now what is corporate governance. I will have to say that this is first of all is the backbone of a corporate entity. It is what runs the company because corporate governance is a system by which a company is directed and controlled. The system is internal you know when government governs that is countrywide that is outdoor in the environment. In that environment when a corporate entity is born and it carries out it is day to day operations, it has to have an internal system which will allow you to function.

So, there will be some rules that the company will set, certain practices that company will set, certain processes and mechanisms that the company will set and there will be some checks and balances to see whether the performance is reaching to the objective and so on. This is an internal system run by internal members of the company; externally it can be only monitored, but you cannot run it externally, it is run by the company.

So, corporate governance is this internal system of running a company. If you look at this definition, you will find that it OECD has explained corporate governance as a relationship. Between whom and whom? Between the company's management, the board of directors, its shareholders and other stakeholders by. When you say other stakeholders, you might remember the employees you know or the creditors and so on.

But there is it is a set of relationships between remember the actors here are the company's management. I am going to explain this in a fuller details in subsequent lectures, but for the time being the main actors are the company's management namely the corporate executives, the company's board of directors, the shareholders or the investors and then there might be other stakeholders also.

What does corporate governance bring in? It bring in brings in a structure through which the organizational objectives of the company are set and are also pursued. It also sets the means of attaining those objectives; meaning what steps you are going to take the strategic planning that might be necessary the financial planning that might be necessary, the operational planning that might be necessary; all of that is corporate governance.

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Why this is important? I think goes without saying, but let me just touch upon these points that it is needed for the company also for that the business system in which the corporate entity exists for the country in which the corporation operands.

So, it is important. First of all I say I said for ethical corporation, this is one of the foremost requirement that it there should be good corporate governance in an ethical corporation. First of all it is important for the integrity of the corporation; you know it actually gives the accountability. If your operations are run in a certain transparent way in an honest way and it keeps the company out of trouble it, it allows the corporation to achieve it is goal without getting into difficulty or problems.

So, some there is a plus point right there. It is also needed for maintaining a healthy relationship with the investors. The investors have to trust the corporation in order to invest with their hard earned money, there has to be some trust element in that relationship. And good corporate governance protects ensures that trusting relationship. If you go by consequentialist measures, then or good corporate governance keeps you away from a lot of undesirable outcome; you know scandal scams, frauds, dissolution, termination, penalisation you know imprisonment who wants all of that.

So, that and then also to manage the risks to the corporation; this is also needed. So, these are all what we I would say is necessary for the survival and growth of a corporation. You need corporate governance for that, but also corporate governance is necessary for the economy in it itself; you know with good corporate governance, the fundamentals of a good economy becomes stronger.

So, these are the reasons why I would say this is an important topic for us.

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I have just introduced this concept corporate governance. There is a lot to be said till after this.

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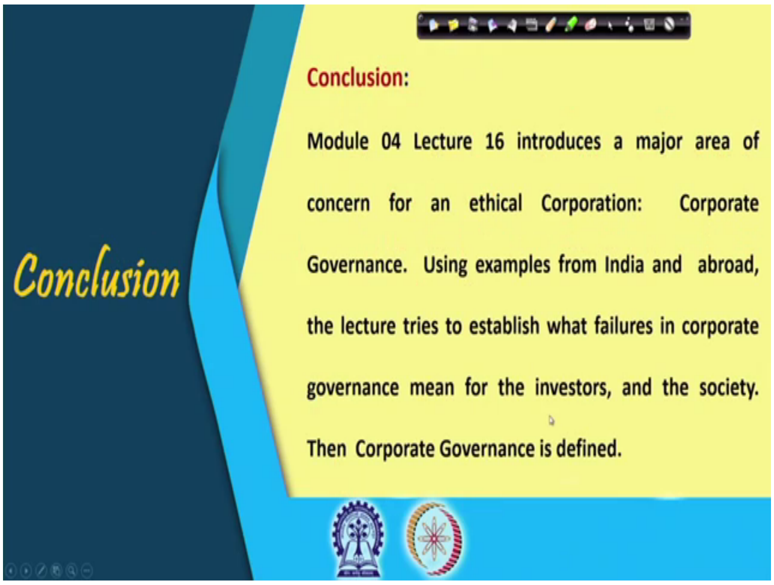

And we will continue with this as we do this, but today this is where I will end my lecture. We have just introduced what corporate governance is, but before that I have shown you that some very well known cases of failures of corporate governance all right. So, we will come back; see you then.