The Ethical Corporation
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Lecture - 19
Specific Areas of Concern in Corporate Governance and Countermeasures - II

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Welcome back. We are going to pick up this lesson from where we left it last time, namely we were discussing the pay inequity and there are many more other issues related to specific areas of concern about corporate governance. So, we have lot to say today.

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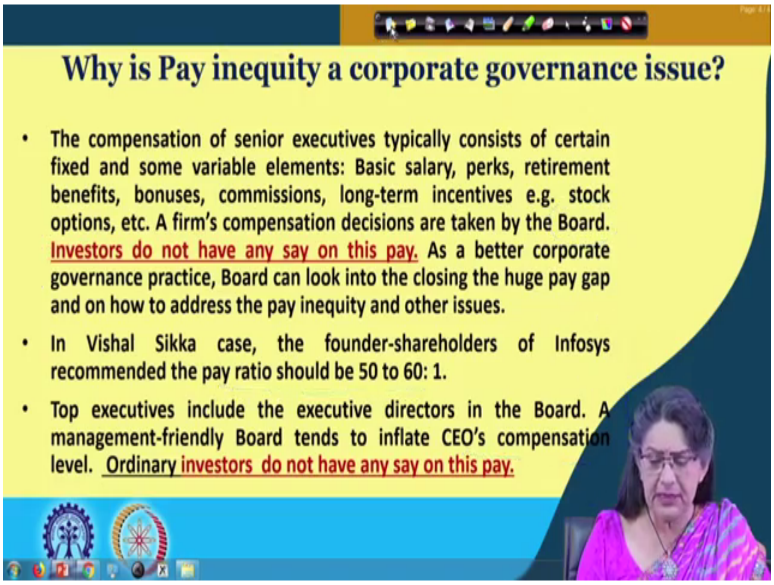

First of all why are we looking at the excessive pay of the top executive or pay inequity that is seen there as a corporate governance issue. Now, in my last lecture, I have told you that this pay inequity shows up in two different ways; one is it is disproportionate in comparison to the company's performance, and it is also disproportionate to the average worker's pay. So, why is it a corporate governance issue? To that my answer would be that first of all I remember whose job is it to decide the compensation package for the top executive.

The answer if you have listened to my lecture, then you already know the answer is that is decision is taken by the board. The board includes some of the executive directors, but the board does not include anybody from the ordinary investors or even the minority investors. So, investors do not have much of a say, even when they see that the farm is not behaving at par with the executive compensation, do not cannot say much. In fact, if you want to know about the Infosys case, then the Infosys minority shareholders promoter shareholders felt that the pay ratio should have been only 50 to 60 is to 1.

But I showed you in the last lecture that the chief executive compensation went up to something like 930 times more than the average worker's pay which is unacceptable, which was unacceptable to the other shareholders. And management friendly board because they have told you that board includes many of the top executive. So, management friendly board sometimes inflates the CEO compensation, they argue and they make the compensation package more lucrative for the chief executive. And again ordinary investors do not have much of a say. So, this is where the corporate governance issue comes in because that is the job of the board. They should have looked into this more carefully.

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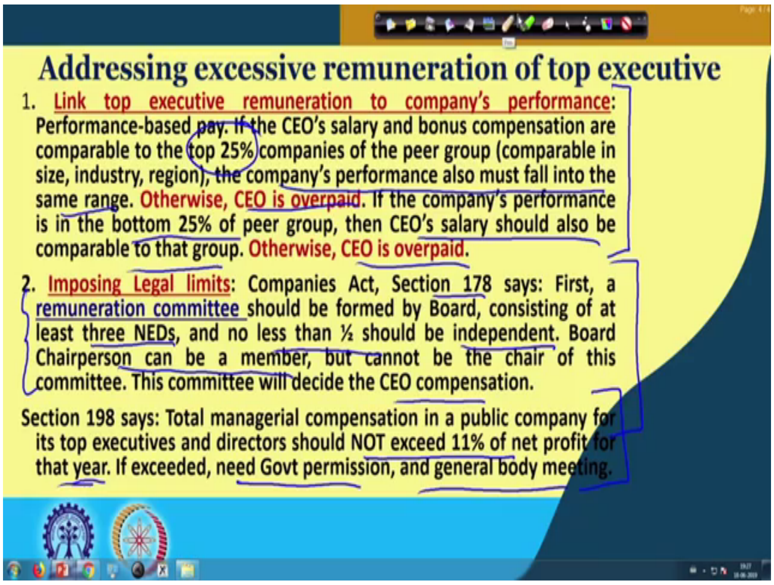

So, how can we address this issue? One of them one of the answers that is very common and nowadays discussed a lot is to connect link the top executive remuneration with the company's performance. So, it is performance based pay. If the CEO salary and the other fringe benefits in the compensation package are comparable only to the top 25 percent of the companies in the peer group, in the industry, in the region or in terms of size then company's performance also should be in that same range at the top 25 percent. If that is not the case, then the CEO is overpaid.

If on the other hand the company's performance is at the bottom 25 percent in its segment, then CEO's salary should be matching with that group; otherwise the CEO is over paid. So, there is a strong argument to link it with the company's performance, because that is why the CEO is hired to get the company and take it higher up.

The other solution might be is to put legal limits on the top executive compensation. Now, if you look into our country and Companies Act, then Section 178 says that there has to be the Board has to form a remuneration committee and in that the major; the major players are going to be the NEDs at least three NEDs, and no less than half should be independent, this is how they want. They do not want companies act does not want the board chairman to be the chairperson of this remuneration committee, instead the chairperson can be a member, but not the chair. And this committee decides what would be the CEO compensation.

So, leaving it to the discretion of the NEDs and independent directors that is what is coming out, but I talked about a limit. So, legal limit is you will find in Section 198, which says that in case of a public trading company the total managerial compensation must not exceed 11 percent of the net profit the company makes that year. If it exceeds then government permission is required and it has to be discussed and disclosed in the general body meeting which is where the shareholders are. So, this much power at least is given by the law.

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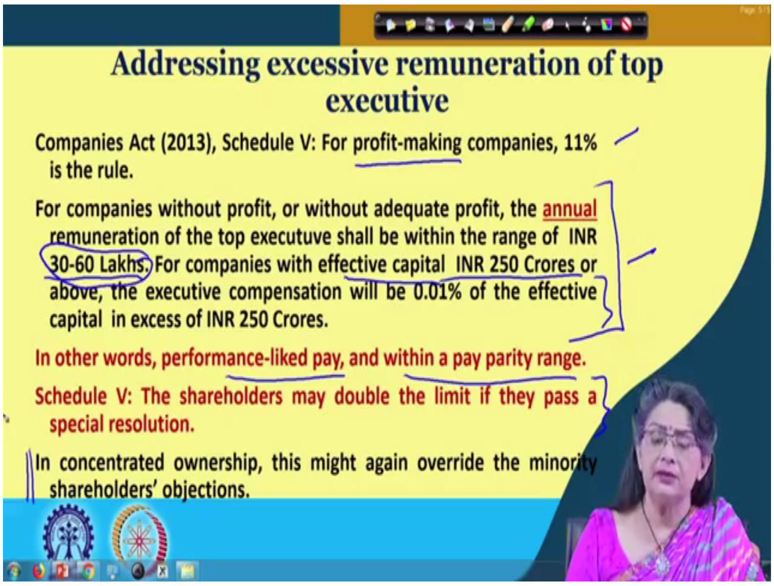

This limit is that we just talked about the 11 percent is about the profit making companies. What if the company does not make profit, it is going in the red not adequate profit or no profit in that case companies that clearly says that it would be based on the effective capital of that company. And the range comes they give certain blocks of if you belong if your company has capital of this, then the remuneration would be annually this. And it comes to annually 30 to 60 lakhs, 60 lakhs for companies with effective capital of 250 crores or more.

There is only way that you can exercise some additional payment provided it crosses the capital cross is 250 crores in other words which we are getting from the law is support for a performance linked pay. This is for profit making this is for non-profit I mean running into losses. And there is also an argument a hidden argument for pay parity that there is a ceiling maximum limit.

But it also gives the shareholders the discretion to change that limit it is schedule 5, this is where we might see problem with that is where there is concentrated ownership and the majority shareholders want to change the pay of the chief executive whereas the minority may not agree to that.

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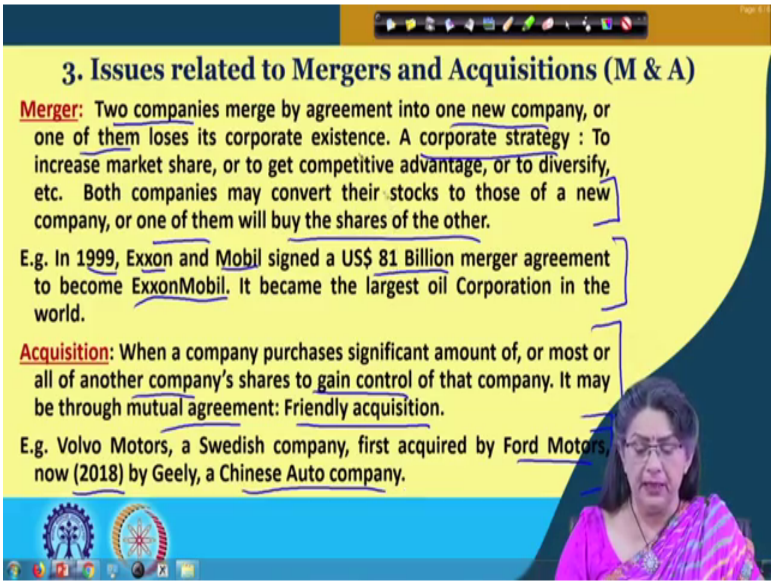

Let us now talk about we have talked at length about chief executive compensation. There are other issues now that also deserves our attention. And one of them is mergers and acquisition related. Now, what is the merger? When we talk about merger, we are talking about two entities becoming one. So, in this case, this would be two companies merging by agreement into one new company or it could be a merger means that one of them loses its corporate identity and it becomes merged into the second company.

Why this takes place? The answer is because of strategic reasons. A corporation may want to expand or it might try to increase its market share or it may try to diversify, these are strategic reasons. And the what happens to the shares is that you know in case there is a new company, then the shares of both the earlier companies would merge into get converted into the shares of that new company. If it is one of them losing the identity, then one of them will buy the shares and the liabilities of the other.

Example would be something like this you know Exxon and Mobil two very large corporations in 1999, they signed a merger agreement for 81 billion US dollars and they became a new company called ExxonMobil which became the largest oil corporation. This is an example of what we would call the vertical merger, same industry both oil corporations and there was suspicion that they merged in order to become almost like a monopoly in that.

Now, if you compare this merger with acquisition; acquisition is about you know taking over. So, when a company starts purchasing significant amount of shares or majority of the shares of another company, the I the objective is to gain control of the second company, this is acquisition. Company A trying to acquire company B.

Now, sometimes it can happen through mutual agreement and that is what we call a friendly acquisition sometimes it exists things happen for example, in a Volvo which was Swedish out and out was acquired by Ford Motors which is American. And then now I mean last year 2018, it has been acquired by a Chinese Auto company called Geely. So, this is merger and acquisition.

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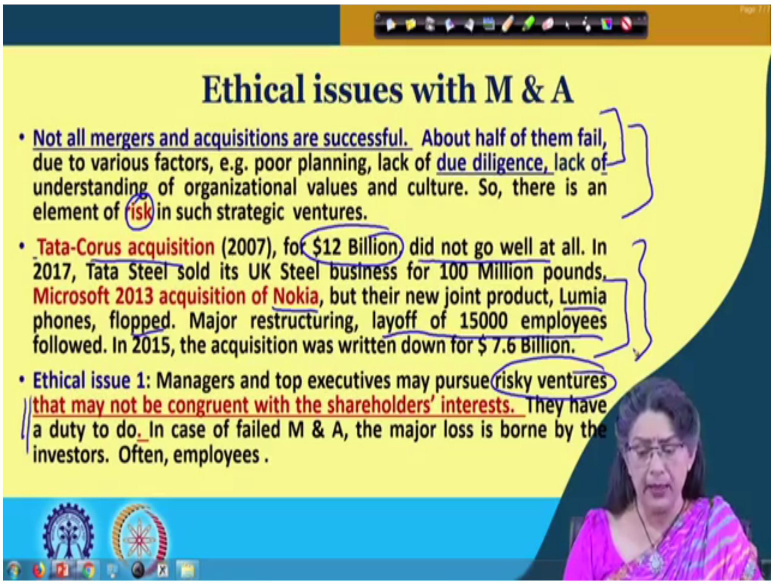

What could be problematic here, the ethically problematic part is here you need to understand that there is an element of risk in mergers and acquisitions, not all of them are successful. In fact, research shows that about half of them fail for a variety of reason, you know poor planning or maybe all the things that should have been seen or considered were not and so on. And sometimes there is also values clash, culture clash. So, there is an element of risk.

Now, you might say, but how can we see in the future whether it is going to work out. Well, this is a projection right I mean you do not know the future true, but at the same time you need to take all the reasonable steps to avoid risky mergers and acquisitions, because it contains certain kind of risky elements. I have a great examples to share with you may remember this also Tata-Corus acquisition it came out in a newspaper because that was the first time an Indian steel company acquired European steel company for 12 billion US dollars, but that did not go well at all. And finally, Tata steel heaved a big sigh of relief when they could sell its UK Steel business in 2017.

Similarly, Microsoft and Nokia, Microsoft in 2013 acquired Nokia and they thought the new product Lumia phones are going to really take over the market, but it flopped, the idea flopped as a result. There were a lot of what we call repercussions throughout the company major restructuring and about 15,000 employees were laid off that is not a nice thing. So, ultimately the acquisition had to be written like.

So, what is the issue here? The issue here is that the idea about mergers and acquisitions which are inherently risky, at times the top executives may step forward taking excessive risks; excessive risk, beyond our reasonable limit which may not be congruent with the shareholders interest all right. Why they do that, I have told you already the ambition personal ambition bonus you know there may be many incentives for them, but whose money is riding on that. And you saw that there are tangible intangible different kind of losses if the merger and acquisitions fail. So, this is why investors become very concerned about this.

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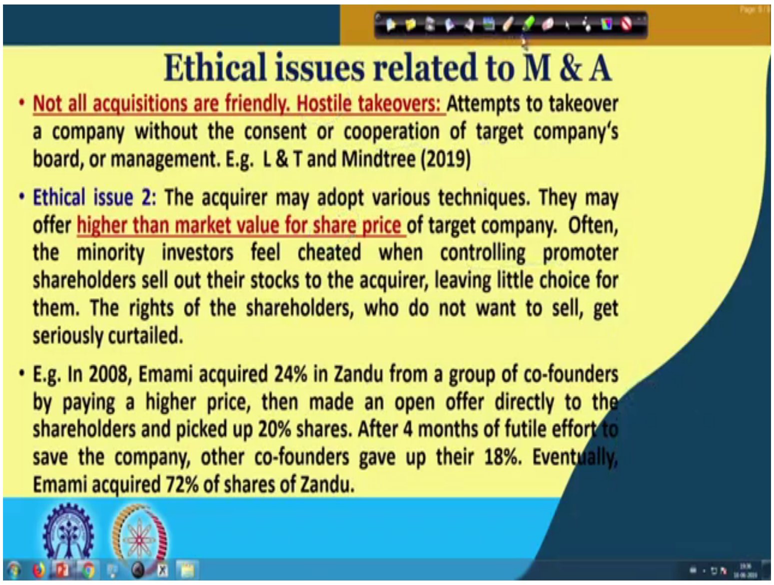

Also the other kind of ethical issue turns up if you understand that not all acquisitions are friendly, you know some takeovers are what we call hostile. This is trying company A trying to take over company B without the consent of company B or without the cooperation from company B. So, it is a predatorial move, it is an invasion almost like the enemy invasion. You know this year there is a lot of talk of Larsen and Toubro, L and T trying to buy a lot of shares significant amount of shares in this IT company called Mindtree and Mindtree does not like it one bit and that is what is being portrayed as a case of a hostile takeover.

Now, where does the ethical issue comes up, well it might come up like this that you need to understand that the acquirer company may adopt many different kind of techniques. So, one of them might be to throw money, they are willing to pay higher than the market price for the shares of this target company.

And often the promoter and the founder, shareholders, the controlling shareholders, they sell and when they do they are because they are the majority shareholders you know the minority who may not agree to that sell out get their rights, their choices get seriously curdled. This is what happened in fact in the case of Emami and Zandu which I have tried to explain here.

So, there is this ethically issue about overriding the minority or the other shareholders interest. This is you are losing the company. Company being acquired by somebody that you do not want to be acquired that somebody that you do not want to even get into a business relationship with.

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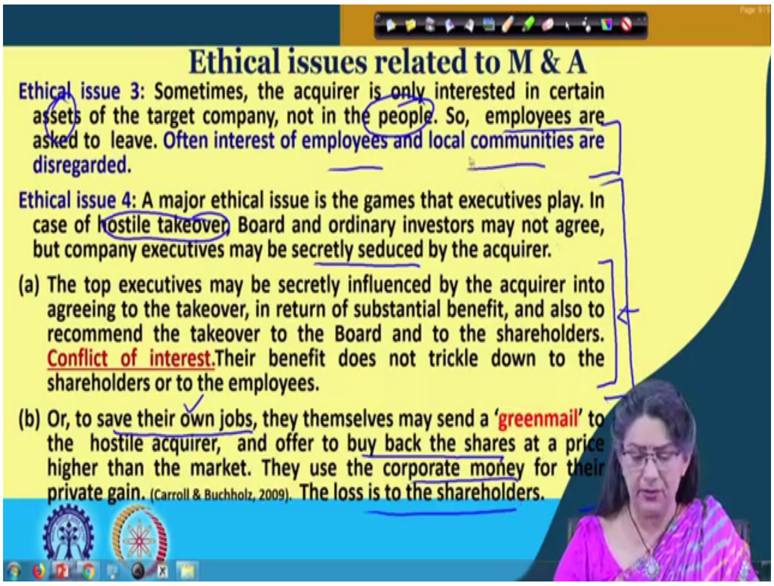

The third ethical issue is like this that often there are acquirer who are asset strippers. They are probably interested only in the assets of the target company. So, the reason for acquisition is to get to the assets. Now, who are left in the in as you know things that the acquirer is not interested in it is typically the people, namely their employees. So, it translates such acquisitions translates in major lay layoffs, you know terminations and the employees are actually at loss including the shareholder. So, often the ethical issue here is that in such acquisitions often the interest of the employees and the local communities are not really given due consideration.

The fourth ethical issue that could be here is interestingly about the behaviour of the top executives. When there is a power play going on for merger or acquisitions you know proposals keep coming. So, specifically in a hostile takeover there are many manoeuvres that the acquirer the predator company might use.

One of them might be to secretly seduce the top executives. So, the top executives may be offered some substantial benefit by the acquirer and to argue in the board in favour of the takeover. The board is not willing to even go in the takeover, but the top executives because they have already been seduced by the other side, they start persuading the board.

So, but the you need to remember that it they are pushing the company in the hands of somebody else, ordinary investors they do not get any of these benefits. The benefit does not get trickled down to the investor's level, it is only the top executives who run away with the benefit. So, this is one ethical issue.

The other thing is that sometimes the corporate executives when the acquisition is or the hostile takeover is happening that in order to save their own jobs in the acquired company, the corporate executives made themselves start buying back the shares at a much higher price, but not with their own money, but with the corporate money. So, they are using the corporations money to buy its own shares back at a much higher price, why to save their own jobs. This is their personal interest it is not in the interest of the shareholders, the loss is to the shareholders.

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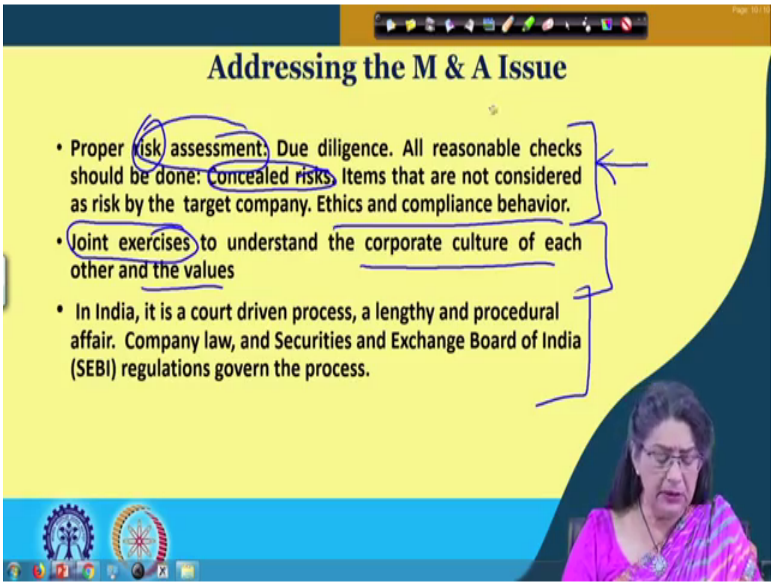

So, there are a number of such issues as I try to show you with related to the merger and acquisitions in terms of corporate governance. So, what can we do or what are the countermeasures that are possible. The very first thing that comes to that the board needs to do its job. Namely the proper risk assessment has to be done. I have told you earlier also that due diligence here is the operative word, but what kind of risks we are talking about not just financial risk, there are social risk, there are reputation risk and so on. And there is also concealed risks.

So, you need to really do a proper research to find out whether it is going to be a risk free or relatively risk free venture here. Sometimes there are risks which the target company do not even see as risk. For example, you know failure in ethics and compliance behaviour, but the acquirer need to understand that there are these pitfalls that if I acquire it I am going to take that also on my head. So, there are lot of research is needed and proper risk assessment and risk management mechanisms must be in place.

Second because I said there can be cultural clashes, value clashes, so joint exercises are needed just like you know him, when two families meet, you need first of all we need to understand each other you know. So, that is the first thing to understand the corporate culture of each other and the values. When there is that value conflict, the pairing, the coupling is never going to work.

In India mergers and acquisitions these are core driven processes. So, it is a going a lengthy process the company law, the SEBI law, these regulations actually rule the process.

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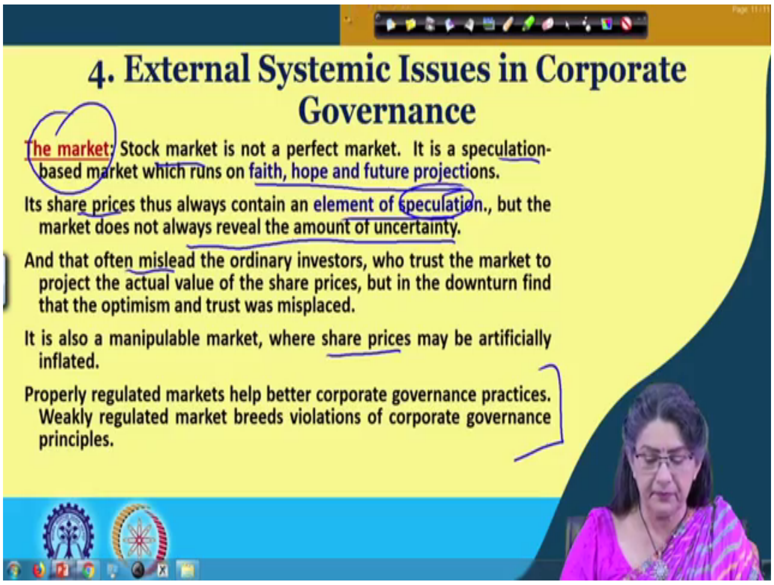

Then we come to the external factors. You see a business corporate governance is an internal process within the corporation true, but the business is not in the space, it is not in a vacuum, it is happening in a social space in a public sphere and the public sphere has certain things in it. There are external factors which also influence the quality of corporate governance. So, one of them is the market. When we say market, we mean the stock market.

The nature of the stock market is not perfect, it runs on speculations. You know speculation is about you know predicting what is going to happen in the future. So, there is a lot of this kind of elements in it, faith, hope and future prediction projections and that is what decides the share prices. So, the share prices always contain an element of speculation. There is uncertainty in speculation and the prices are not really the actual prices, but speculations based on where it is going to go, but the market does not always tell about the amount of uncertainty involved in that.

So, ordinary investors often get misled about it because they trust the market to project the actual value of the shares which is not the case. So, when they lose their money, they become really disappointed and they lose the trust in the market. Share markets are also manipulable market, you know companies can artificially inflate share prices. So, what we are talking about here is that if the market is well regulated, if the market is not too much manipulated, then there is it is likely that the corporate governance also would be somewhat better.

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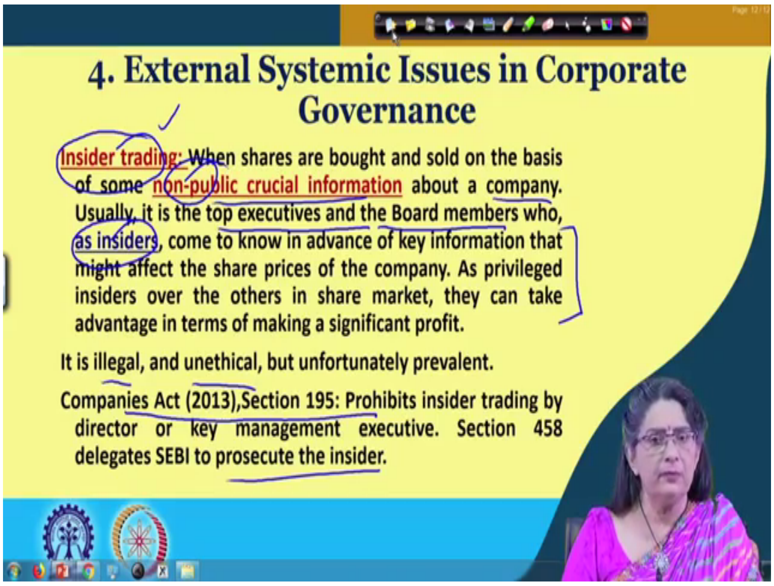

There is this factor that we need to then say because it is part of that system that I where we say the companies are placed. This phenomenon is called insider trading. This is shares trading means buying and selling shares. When shares are bought and sold on the basis of a crucial information that is not yet made public, but privately available to some person or persons about a company. You come to know about a very sensitive information about a company that the company is going to now merge into some other company with some other company.

But this information has not been made public. So, the market and other investors have no idea about it, but you know. Now, who can you be in order to know such a sensitive information in advance, it has to be you have to be one of the insiders. By insiders we mean where the key decisions are made, you have to be member of that inner group, we are talking about the top executives and the members of the board, where all these critical decisions are taken strategic decisions.

And on having that key information if you sell or buy shares in advance to the rest of the investors, then this is insider trading, because there is personal advantage you are making a significant profit before others. And you are doing it on the basis of a private information that you have obtained. It is illegal, it is also unethical, illegal in many countries. In our country it is prohibited, but SEBI is asked to prosecute the insider. So, the stance is somewhat unclear, but in many other countries it is in completely illegal. This may remind you about the very famous Rajat Gupta case in the United States.

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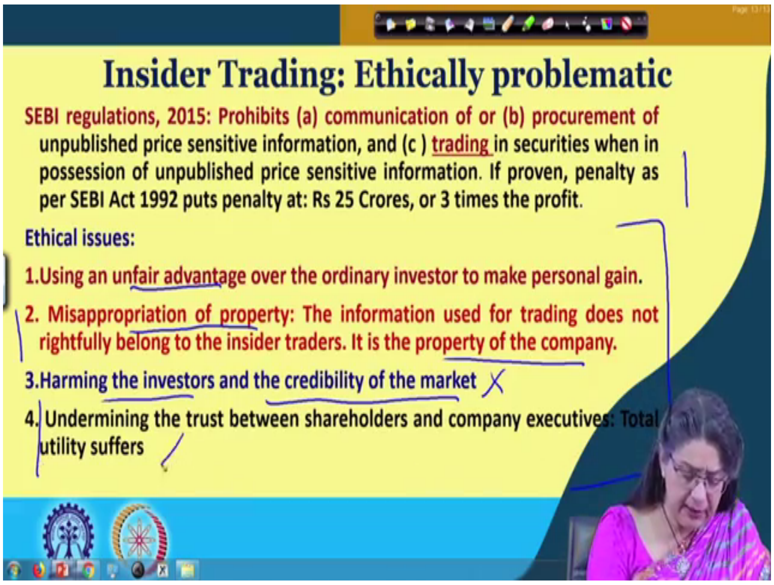

The SEBI regulations, prohibits many things regarding insider trading, communication, procurement or even trading in this and there is a steep penalty for that. But let us talk about why I called it also unethical, one of them is that this is putting the ordinary investors in an unfair position. Second point is that the information that you are trading on is not yours to start with, it is the property of the company. So, there is misappropriation of property issue. By your action you are harming the investors and you are also affecting the credibility of the market.

So, if you go by consequentialist judgment this is wrong. And then it erodes also the market the credibility of the market, the trust between the company and the shareholders. So, again the total utility is diminished by this.

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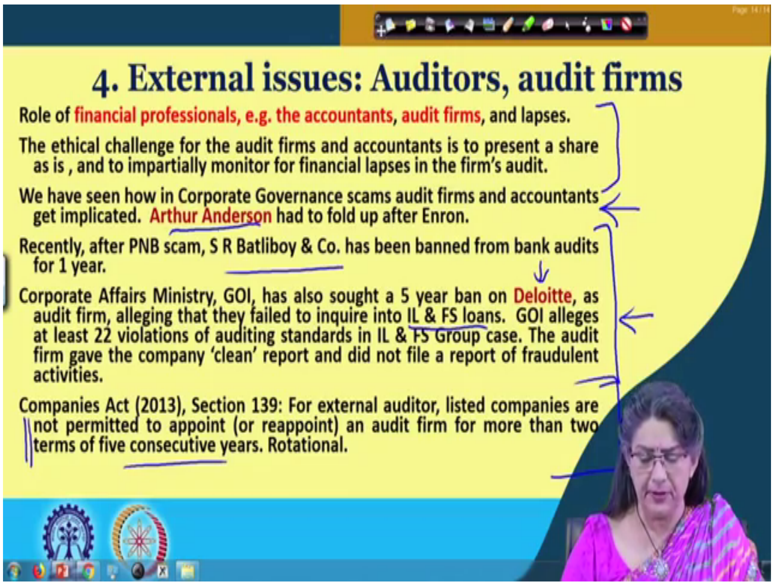

Then we come to this big question about the role that the auditors, external auditors and the audit firms play. In any you have heard about so many examples of the corporate governance camps and you must remember that we have talked about you know Enron for example, there is an implication about the external audit and the auditor for.

In case of Enron, it was Arthur Andersen. The job of the external audit firm is to look for any lapses, errors or intentional mistakes by the corporation in their accounting. The company's auditors, internal auditors will do their job, but this is the job of the external auditor to be the third party and to be the impartial one. When that fails, a lot of scams happen. So, this you know there are major fall outs recently after the Punjab National Bank scam, S R Batliboy has been banned from bank audits for 1 year because of their connection with the case.

There is also a proposal from corporate affairs ministry to apply a 5 year ban on famous audit firm Deloitte, alleging that they fail to inquire into the IL and FS loans. So, in fact, it is claimed that they have found some 22 audit violations here. So, what is the redress or what is the way to address that Companies Act says that you know in order to intervene in the formation of some collusion you know let the appointment of the audit firm be rotational so not for too long; so, only five consecutive years for and two terms after that you need to have a gap here.

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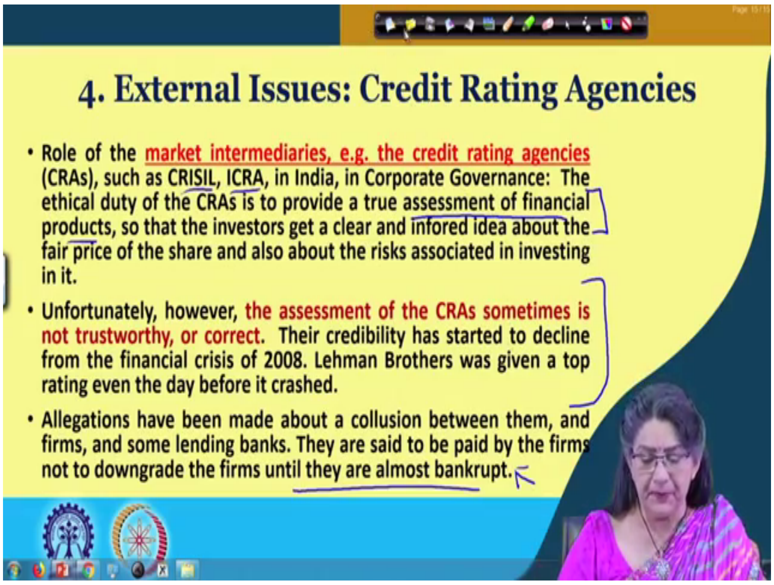

And then we come to the credit rating agencies. You know if you look into the share market and the share prices you will find that the there are some side grades given like AA or AA, triple A, AA plus and so on. These are the rating by the credit rating agencies. In our country we have the CRISIL rating and ICRA, there are many credit rating agencies.

Now, in corporate governance the role of the CRS in short is to provide a true assessment when you give those grades, you are actually assessing the financial, product and their status. And so that the investors can have an informed judgment about investment and they can also tell whether the share price is fair or not.

But unfortunately many a times we have seen the assessment of the CRS, sometimes it is not trustworthy, it is not correct. In fact, it started from the financial crisis of 2008 that allegations have been made that there must be collusion between credit rating agencies and the firms that are not doing well. The firms apparently pay the credit rating agencies not to downgrade them until they are almost bankrupt. So, people the ordinary investors have no idea, they look at this ratings that they keep on investing in the sinking company, and you know the scam continues until they reach the point of absolute no return.

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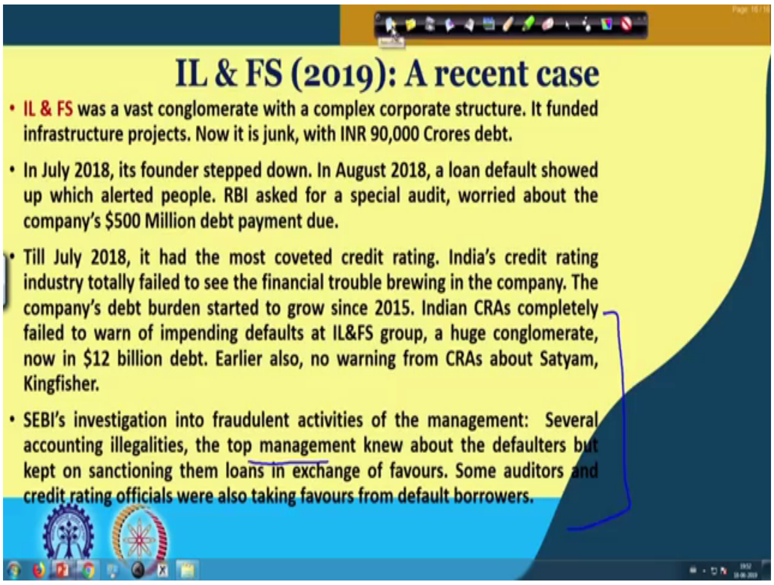

So, this is also very uncomfortable to talk about, but nonetheless it is a story. So, here regarding this what to do about this is a major story, but I will just quickly go over IL and FS that this was a company which was a big lender to the infrastructure segment. And suddenly it was a doing just fine and credit ratings were really high, but suddenly it ran into absolutely humongous date.

And there was no inkling there was no warning from the credit rating agencies. And therefore, there has been investigations and SEBI says there were collusion clear collusion the top management was in collusion and they knew about that this was coming in, but they kept on you know further taking the company into the red with the help of many others.

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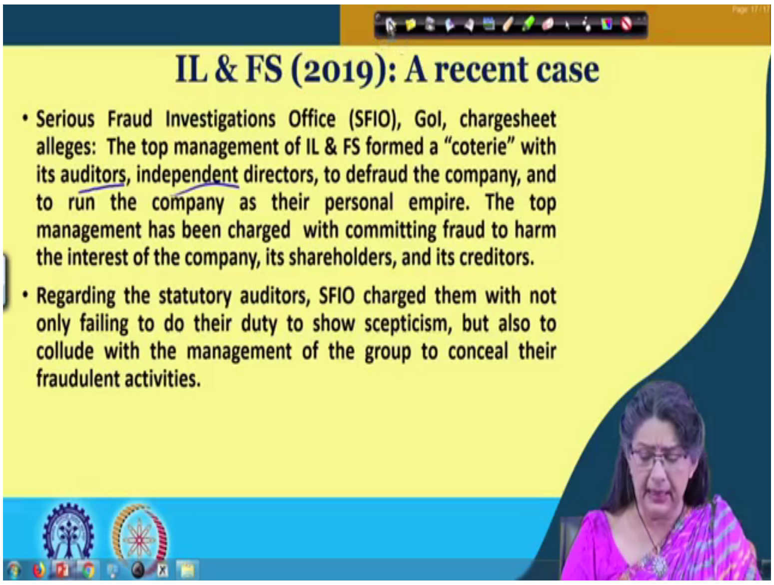

The Serious Fraud Investigations Office the SFIO in fact charged that there must have been a coterie of lot of people including the auditors, independent directors to defraud the company and the credit rating agencies also must have been implicated in that. It is not a nice story.

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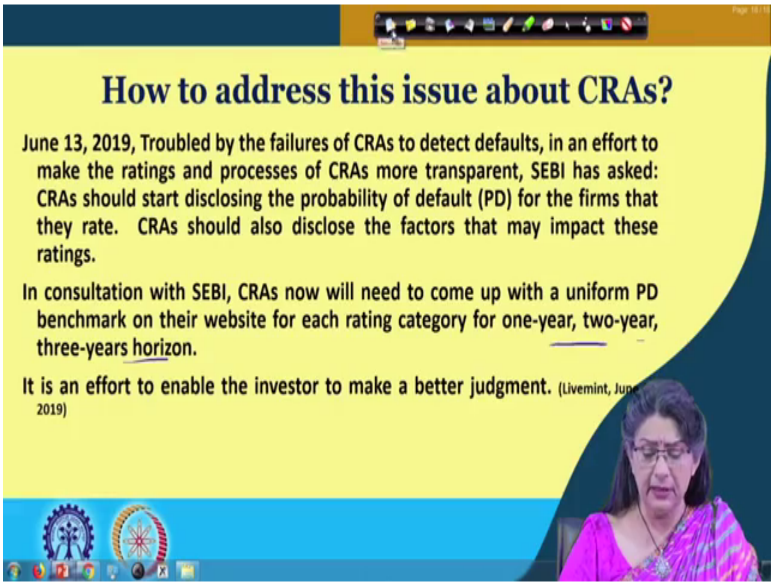

But what can we do about it there are proposals now from the ministry that they are serious now I have to declare the probability of default probability of default it as in whether they are going to be suddenly into troubled financial trouble. And this is they said that they should come up in one-year, or two-year, three-years horizon, so that the investors know have some sort of an idea that there might be trouble ahead.

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This is where I am going to stop. I understand this is a lot, but that is what I was trying to tell you that corporate governance is a major topic and there are so many dimensions, but I have tried to give you an overview of that. So, with that I will end this lecture.

Thank you very much, we will see you again.