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"WHAT WE HAVE ACHIEVED, IS NOTHING SHORT OF A MIRACLE," SAYS **MAHINDRA-SATYAM'S CFO, S. DURGASHANKAR,** IN AN EXCLUSIVE INTERVIEW WITH CFO INDIA

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TIGER-RIDING FOR FUN AND PROFIT

What the fall of Satyam and Lehman Brothers taught companies about corporate governance

BENNETT VOYLES

It has been two and a half years now since Lehman Brothers declared bankruptcy, and two since the Satyam Computer Services scandal broke.

Lehman's $600 billion implosion contributed to many other collapses and precipitated a global financial crisis. Satyam's revelation that $1bn+ in reserves were imaginary wasn't big enough to precipitate a crisis, but it too had an outsized impact, shattering an image not only of a respected company, but the probity of India Inc. itself.

What have we learned? It is easy to blame both disasters on bad leadership – one weak choice that led to a long string of others. Certainly that is part of it. But the misrepresentations of earnings quarter after quarter at Satyam, which chairman B Ramalinga Raju described memorably as "like riding a tiger, not knowing how to get off without being

eaten," took more than a conspiracy of executives. Lehman's troubles too -- so large that the company couldn't even estimate it – weren't only the product of the executive suite.

For Lehman and Satyam alike, the executives' tiger ride required a whole circus of witting and unwitting supporters – including levitating board members, acrobatic accountants, shortsighted regulatory ringmasters, and most of all, investors and lenders in the stands happy enough to keep watching the show. Without early detection, disclosure problems that began cub-sized gradually grew into man-eating beasts.

Of course, not many companies ever get into this degree of trouble. Ishaat Hussain, the CFO of Tata Sons, points out that out of the thousands of major global corporations, he can only think of five major corporate failures in the past decade which involved fraud. Even Lehman, he says, he would classify less as a cause of fraud and more of excessive risk-taking. "By and large, people want to do good and behave properly," he says. "...I sit on many boards and I don't think anybody is there to take the shareholder for a ride by choice."

Still, there are other good reasons to think about governance. "Good governance means running a corporation so as to make the best possible use of the savings people have invested in it," says Randall Morck, a finance professor at the University of Alberta School of Business and a specialist in global governance issues.

It is also a good way to get cheaper credit. A number of studies have correlated better corporate governance with a lower cost of capital, according to Krishnamurthy Subramanian, assistant professor of finance, Indian School of Business, Hyderabad.

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>
> — RANDALL MORCK, PROFESSOR OF FINANCE, UNIVERSITY OF ALBERTA SCHOOL OF BUSINESS

THE BOARD

Boards tend to be high on many governance fix-it lists, for obvious reasons. "In too many cases, like Lehman Brothers and Bear Stearns, the CEO virtually hand-picked the directors," says J. Richard Finlay, founder of the Toronto-based Centre for Corporate & Public Governance. "The lesson of this financial meltdown, as it was in the 1930s, is that directors need to ask discerning questions and they need to remind themselves that they are there to prevent disaster - not to be passive bystanders to it, as they too often have been."

In India, director independence is also an issue, but for different reasons. The average listed Indian company is 48 per cent owned by the promoter. In some ownership is as high as 80 per cent according to Umakanth Varottil, an assistant professor of law at the University of Singapore. "Due to the dominance of the controlling shareholders, they are able to determine the composition of the board and senior management," he says.

> A number of studies have correlated better corporate governance with a lower cost of capital

Varottil argues that this can be corrected through special elections that give minority shareholders more say, such as votes that exclude the promoter from voting on director hiring.

The idea is that independence breeds independent thought. But independence may be less of a guarantee of uprightness than it is billed. One case in point: Satyam, winner of the 2008 Golden Peacock Award for corporate governance, did have six independent directors, including four academics, a former cabinet secretary, and a retired executive.

So why do boards not seem to uncover more dirt?

One factor may be that it is hard to be in a group and yet maintain independence. "In all my life, working with the professional accounting firms... I have never seen a dissenting minute. That does not auger well," says Kaushik Dutta, New Delhi-based author of several books on corporate governance and an advisor on corporate governance to the Institute of Corporate Affairs of the Ministry of Corporate Affairs.

Another is that it is not easy to track a major company with thousands of employees and global operations as a part-time job – particularly if you have no particular training in the industry. "Boards don't meet that often. They have limited resources and yet we expect them to figure everything out," says Afra Afsharipour, acting professor at the University of California, Davis School of Law.

In India, the Satyam scandal seems to have acted as a catalyst in making the corporate world see just how difficult and risky board membership can be.

A large number of board members quit right after Satyam, particularly the most senior members who would have the most to lose from a scandal. "Many academics and people who cared for their reputations went flying for cover," Subramanian says. In January 2009, he says, 120 directors left, five or six times greater than the normal turnover.

Not surprisingly, directors' salaries have risen 12 to 15 per cent since January 2009, according to Subramanian, a reflection of how much more work is being required of directors now -- and how much harder it is to find someone who will take the job.

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—ISHAAT HUSSAIN, CFO, TATA SONS

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—AFRA AFSHARIPOUR, UNIVERSITY OF CALIFORNIA, DAVIS SCHOOL OF LAW

UNDER THE BIG TOP

But no matter how closely the nobs hob-nob, one of the biggest lessons of both collapses is that they need to talk to everybody else too. "The biggest governance problems always seem to come where people are afraid to argue with a powerful CEO or a business family patriarch," says Morck.

Business should learn from governments, Morck advises. Most governments he says, have learned over the years that opposition is ultimately beneficial. "Leaders in power understandably hate this, but most people in most countries think it delivers better governance than any alternative system on offer. The criticism slows down decisions, but democracy protected India from great leaps forward and cultural revolutions."

Such transparency is also valuable externally. Vikramaditya Khanna, a professor of law at the University of Michigan, says that in most of the major corporate implosions of the past decade, earnings management – whether inflating revenues or hiding losses – has been a consistent thread.

THE ROUSTABOUTS

It is no coincidence, then, that accountants have been implicated in many of the recent corporate scandals and disasters. "In Lehman, Satyam, Enron, even Parmalat, auditors seem to have had some sense of what was going on," says Khanna, "and yet you do not seem to see a great deal of disclosure about it."

Despite the destruction of Arthur Andersen in the Enron scandal and stricter supervision of external auditors by audit committees mandated for large US traded-companies by Sarbanes-Oxley, problems still seem to crop up.

This is perhaps not too surprising. As American social critic Upton Sinclair once quipped, "It is difficult to get a man to understand something when his salary depends upon his not understanding it."

Some critics charge that the credit rating agencies also played a role, giving positive, investment-grade ratings to Lehman Brothers right up to its collapse. Standard & Poor's analysts denied it, in a report released a few weeks after the collapse, countering that in fact what happened was the result of escalating fears turning into a loss of confidence, that "ultimately becoming a real threat to Lehman's viability in a way that fundamental credit analysis could not have anticipated."

However, analysis may not have relied so much on the numbers as on a long-standing reputation as a successful high-flier. Credit analyst Ann Rutledge, a principal at R&R Consulting in New York, recalls that even back in the 90s, Lehman had a reputation for taking outsized risks. Rutledge, a Moody Rating Agency analyst at the time, says she knew that in certain investment areas, Lehman had a reputation for maintaining extremely aggressive positions.

Some critics of the rating agency system have charged that the agencies have a vested interest in giving good ratings, because they are paid by the issuer. However, even aside from the potential of such conflicts of interest at the rating agency, it is often not that easy to get the right information out of a company when the managers or promoters are determined to keep information to themselves. There are many ways for executives to avoid answering even direct questions, citing confidentiality, regulations, or competition,

according to Niren Shah, an analyst for the Mumbai branch of Kroll, the global investigation service.

As an equity analyst for another firm in May 2008, he recalls a presentation where analysts, acting on a rumour about an American hedge fund report about Satyam, asked company executives again and again about the company's cash position – and were repeatedly rebuffed.

In fact, financial information is often so problematic that Kroll investigator Richard Dailly advises prospective investors to look elsewhere. "One of the things that we tell our clients when they ask us to assess companies is that it is much better to spend money investigating the person running the company than investigating the company's accounts," he says.

"Until we start to look at the credit exposures of all these institutions on a more continious basis, we won't be able to eliminate the bubble."

—ANN RUTLEDGE, PRINCIPAL AT R&R CONSULTING, NEW YORK

THE BIG PUZZLE

The last elements of the financial circus are perhaps the most vital of all in this circus – the equity holders and lenders. Why do they make such risky bets?

The reason shareholders take risks is easy -- they gain if a company takes on an outside risk and wins. What is much more puzzling to Lawrence White, a professor of finance at New York University's Stern School of Business, is why sophisticated, institutional lenders kept on lending to such a highly leveraged enterprise as Lehman Brothers, which before its dissolution was operating at 33-1 leverage, not counting $50bn in off-balance sheet debt disclosed after the collapse.

"I have not seen any satisfactory answer to that puzzle other than that this was just indicative of the whole era that there was an under-appreciation of risk, an excessive belief that nothing could go wrong," White says.

Again, Rutledge points to the investment bank's long track record: Lehman Brothers had been in business for over 120 years, and succeeded with plenty of big bets before they made a fatal decision to pile up on sub-prime mortgage paper.

COMING ATTRACTIONS

High-profile collapses tend to lead, rationally enough, to new regulation. But opinion is divided about whether the new rules will work.

Rutledge, for one, is suspicious of Dodd-Frank, whose new rules, she says, do not really address the essential problem of measuring credit risk. "Until we start to look at the credit exposure of all these institutions on a more continuous basis, we will not be able to eliminate the bubbles," she says. Massive credit exposures are traded every day, she says, but the accounting still reflects only a moment at the end of the quarter, making it impossible for investors and lenders to see the true state of affairs. "You are just never going to be able to monitor the buildup of risk, ever," she stresses.

The reason shareholders take risks is easy -- they gain if a company takes on an outside risk and wins

In India, the slowly simmering Companies Bill is also getting mixed reviews. Dutta is optimistic that the bill will help improve governance, through such measures as mandatory rotation of auditors. Khanna wants the proposal to strengthen audit committee rights, and for creating the possibility of suing companies on a class-action basis, which he believes would help protect minority shareholders against majority abuse.

Others aren't as optimistic about the bill, or indeed about the prospect of regulatory change being truly transformational for Indian businesses, except perhaps by opening up the possibility of hostile takeovers, and the liberalisation of those older industries still somewhat protected from competition through licensing, such as power, infrastructure, and mining.

Although better rules and more skeptical investors and lenders may limit the risk of another Satyam, Dailly and Shah of Kroll believe that what will really make the biggest difference for governance in India is generational change, as an increasing number of companies gain executives with international experience and awareness of the importance of compliance, and the old guard retires. CFO