ISSN 2278-8808
An International Peer Reviewed
SCHOLARLY RESEARCH JOURNAL
FOR INTERDISCIPLINARY STUDIES

IS CORPORATE GOVERNANCE ALWAYS THE CAUSE FOR CORPORATE SCAM

Ruchi Jain, Ph. D.

Assistant Professor, Department of Commerce, Hindu College, University of Delhi

Email: Ruchi26jain@gmail.com

Abstract

The concept of corporate governance gained wide popularity in 190S to improve the effectiveness of corporate enterprises. Attention on role of corporate governance in economic development came as a consequence of adopting market-based approaches in defining economic policies. It attempts to remove corporate failures and dis-satisfaction of the stakeholders. In the era of globalisation, corporate governance plays an important role. Since reliance on private sector increased, it led to greater concern on how corporations operate and control and how suppliers of funds get fair return on their investments. Corporate governance aims to achieve balance between all the interests present in corporations: management, shareholders and other stakeholders. The corporate governance framework ensures that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance and ownership. It ensures that corporate managers run their businesses successfully and take care of long-term interests of their stakeholders. It improves capital efficiency of companies and attempts to deploy their wealth in productive areas of the economy.

Keywords: *Corporate Governance, Corporate failures, Birla Committee Report, Scams/Scandals*

Introduction

Governance is the process whereby people in power make decisions that create, destroy or maintain social systems, structures and processes. Corporate governance is, therefore the process whereby people in power direct, monitor and lead corporations, and thereby either create, modify or destroy the structures and systems under which they operate. Corporate governors are both potential agents for change and also guardians of existing ways of working. As such they are, therefore, a significant part of the fabric of our society.

Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making

decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.” OECD April 1999

Corporate governance can be narrowly defined as relationship of a company to its shareholders and broadly, as its relationship to society. It provides the structure of corporate enterprises. It defines objectives, means of attaining those objectives and monitoring organisational performance to ensure that objectives are optimally achieved. "Corporate governance is about promoting corporate fairness, transparency and accountability." J. Wolfensohn

Objectives & Research Methodology

Not all accounting scandals are caused by top executives. Managers and employees are also pressured or willingly alter financial statements for their personal benefits. Selfish advantages if mangers play a large role in these scandals. For example, mangers who would be compensated more for short term results would report inaccurate information, since short term benefits outweigh the long-term ones such as pension obligations. The present study is conducted with the aim to study the various corporate scams that occurred due to non-existence of effective governance mechanism in those corporations. The study is based purely on the secondary data as available in books, magazines, newspaper articles, research journals available online and from various websites in order to achieve its objectives.

History Of Corporate Governance

The first formal attempt to evolve a code of corporate governance for Indian companies was put forward by the Birla Committee Report (or Kumar Mangalam Report). The objective of this committee was “enhancement of the long-term shareholders value while at the same time protecting the interests of other stakeholders.” The major recommendations of the report are as follows -

1. Board of Directors: The Board of Directors guide and control company's operation and provide objective judgment, independent of the management, to the company. The Board remains accountable for its actions to shareholders. The basic responsibilities of Board include: strategic development of the company, maintain good relations, protect its assets and fulfil legal requirements.

2. Audit Committee: This committee shall have access to all financial information and power to investigate any activity within its terms of reference, seek information from any employee for effective financial reporting. The purpose of appointing audit committee is to present and disclose correct, sufficient and credible financial information of the company to stakeholders.

3. Remuneration Committee: The report recommended setting up of a remuneration committee that will determine and account for the policy on remuneration of directors. Remuneration also includes pension rights and compensation payment to them.

4. Accounting Standards and Financial Reporting: The committee recommended issuing of Accounting Standards by the Institute of Chartered Accountants of India regarding upgrading of accounting standards and financial reporting system in India.

5. Management: While the Board of Directors ensure that corporate policies and strategies are laid according to the code of corporate governance, management of the company ensures that policies and strategies are implemented successfully for attainment of corporate objectives. The role of management should be clearly defined by the Board of Directors.

6. Shareholders: Shareholders have the right to obtain timely information from the company, right to transfer and register their shares, participate and vote in shareholders' meetings, elect members of the Board etc. These rights recommend that shareholders evaluate corporate governance performance of the company. Shareholders participate in general body meetings to ensure that it functions for their interests. In this regard, the committee recommended that company's quarterly results and various financial presentations may be put up on its website for access by shareholders.

Importance of Corporate Governance

Corporate governance is important for the following reasons -

1. It shapes the growth and future of capital markets of the economy.
2. Sound governance practices contribute to investors' confidence in corporations to attract long-term capital.
3. It links company's management with its financial reporting system.
4. It enables management to take innovative decisions for effective functioning of the enterprise within the legal framework of accountability.
5. Good corporate governance enhances the structures through which objectives of the corporations are set, means of attaining such objectives are determined and performance is monitored.
6. It supports investors by making corporate accounting practices transparency.
7. Companies present material price sensitive information to outsiders and ensure that till this information is made public, insiders abstain from dealing in corporate securities. It, thus, avoids insider-trading.
8. It improves efficiency and effectiveness of the enterprise and adds to wealth of economy. Corporate governance is, thus, an instrument of economic growth.

9. It improves international image of the corporate sector and enables home companies to raise global capital.

Major Corporate Governance Failures

Corporate scams or scandals arise with the disclosure of misdeeds by trusted executives of large public corporations. Such misdeeds typically involve complex methods for misusing or misdirecting funds, overstating revenues, understating expenses, overstating the value of corporate assets or underreporting the existence of liabilities, sometimes with the cooperation of officials in other corporations or affiliates. Accounting scandals are political and/or business scandals which arise with the disclosure of financial misdeeds by trusted executives of corporations or governments. Such misdeeds typically involve complex methods for misusing or misdirecting funds, overstating revenues, understating expenses, overstating the value of corporate assets or underreporting the existence of liabilities, sometimes with the cooperation of officials in other corporations or affiliates.

It is fairly easy for a top executive to reduce the price of his company's stock. The executive can accelerate accounting of expected expenses, delay accounting of expected revenue, engage in transactions that make the company's profitability appear temporarily poorer. He may simply promote and report conservative estimates of future earnings. Such adverse earnings will be likely to (at least temporarily) reduce the share price. It is common for top executives to do everything they can to window dress their company's earnings.

Bank of Credit and Commerce International (BCCI) (UK 1991)

The BCCI was an international bank founded in 1972 by a Pakistani financier, Agha Hasan Abedi. BCCI came under the scrutiny of numerous financial regulators and intelligence agencies in the 1980s due to concern that it was poorly regulated. Investigations revealed that it was involved in massive money laundering and other financial crimes, and illegally gained controlling interest in a major American bank. Investigators in the US and the UK revealed that BCCI had been "set up deliberately to avoid centralized regulatory review, and operated extensively in bank secrecy jurisdictions. Its affairs were extraordinarily complex. Its officers were sophisticated international bankers whose apparent objective was to keep their affairs secret, to commit fraud on a massive scale, and to avoid detection. BCCI became the focus of a massive regulatory battle in 1991 and on 5 July, 1991, customs and bank regulators in seven countries raided and locked down records of its branch offices. On 5 July 1991, regulators persuaded a court in Luxembourg to order liquidation of BCCI on the grounds that it was insolvent. According to the court order, BCCI had lost more than its entire capital and reserves the year before. At 1 pm London time that day, regulators in five countries marched into BCCIs

offices and shut them down. Around a million depositors were immediately affected by this action.

Maxwell Communication Corporation and Mirror Group Newspapers, (UK) 1991

Ian Robert Maxwell, MC (10 June 1923 - 5 November 1991) was a Czechoslovakian-born British media proprietor and Member of Parliament (MP). The collapse of Maxwell Communication Corporation was evident in November 1991. Maxwell's death created instability in business as the banks started calling on their massive loans. His two sons, Kevin and Ian, struggled to hold the empire together, but were unable to prevent its collapse. It appeared that Maxwell had used hundreds of millions of pounds from his companies' pension funds, without prior authorization, to enhance the shares of the Mirror Group, to save his companies from bankruptcy. Mirror Group Newspapers (MGN) revealed that Mr Maxwell, who died a month ago removed £350m from its pension fund in the weeks before his death apparently without proper authority. Pensioners lost their financial security and retirement benefits in the collapse. This clearly shows the importance of ethical disclosures and governance and monitoring mechanisms with effective internal and external control in place. The role of auditors is indispensable and should be followed rigorously with utmost detail.

Enron, 2001

Enron scandal is one of the largest scandals in the history of US revealed in 2001. The company was founded in 1985 through the merger of Houston Natural Gas and Internorth, a natural gas company based in Omaha, Nebraska. The business of Enron was diversified into coal, shipping, steel & metals, pulp & paper, weather commodities and credit derivatives. In the year 2001, investors lost market confidence and disclosure of losses made Enron file for bankruptcy. Its stock price fell from an all-time high of August 2000 at $90.56 to just 70 cents in November 2001 and the share was downgraded to "junk" status. A month later, Enron was delisted from the NYSE. As a result of loss of investors' confidence, the following consequences emerged:

1. The company lost its reputation and the investors' losses were close to $74 billion and 20,000 employees lost $2 billion from the pensions.
2. The auditors surrendered their license to practice auditing.
3. Banks started withdrawing credit facilities to Enron.
4. Rating agencies reduced the credit ratings given to Enron.
5. It was clear that Enron could not revive its operations and, thus, filed bankruptcy in 2001.

WorldCom, 2002

Not long after the collapse of Enron, the equities market faced another billion-dollar accounting scandal. Telecommunications giant WorldCom came under intense scrutiny because of some serious "book cooking”. Formerly known as WorldCom, now known as MCI, this U.S-based telecommunications company was at one time the second-largest long distance phone company in the U.S. It resulted in massive accounting Scandal that led to the company filing for bankruptcy protection in 2002. WorldCom executives effectively fudged the company's accounting figures, inflating the company’s assets by around $12 billion, The bankruptcy that followed led to massive losses for investors. WorldCom's bankruptcy filed in 2002 was the largest in U.S. history. The WorldCom scandal is regarded as one of the worst corporate crimes in history, and several former executives involved in the fraud faced criminal charges for their involvement. Most notably, company founder and former CEO Bernard Ebbers was sentenced to 25 years in prison and former CFO, Scott Sullivan received a five-year jail sentence. Under the bankruptcy reorganization agreement, the company paid $750 million to the Securities & Exchange commission in cash and stock in the new MCI, which was intended to be paid to the aggrieved investors. The employees suffered the most in this deal. Thousands of them lost their jobs. The investors suffered as the WorldCom's stock price went down. It declined from more than $60 to less than 20 cents.

Tyco International, 2002

Tyco International was formed in 1960 in Bermuda as a parent company of Tyco Semiconductor and Materials Research Laboratory and went public in 1964. By 2001, its revenues rose to $38 billion with an employee strength of 2,40,000 engaged in various business units of security, electronics, plastics and adhesives, health care and engineered products. The company expanded through inorganic route and thus incurred amounts of debt in its balance sheet. In September 2002, SEC filed action against Kozlowski and two more executives that they did not disclose loans that were given to Kozlowski and later, forgiven. In 2005, Kozlowski and the company s EO (Mark Swartz) were sentenced to imprisonment and fines totalling $240 million. Share prices of Tyco declined from $ 635 to $12 in mid-2002 in a period of six weeks. Kozlowski resigned on 2nd June, 2002 as CEO of the company on account of mishandling of funds, fraud and conspiracy. The company had to shut down about 240 operating facilities and fire 13,000 employees. The code of ethical practices and conduct is necessary for growth of any company as the company and management are answerable to the stakeholders.

Anderson World Wide Scam (USA)

The firm of Arthur Andersen was founded in 1913 by Arthur Andersen and Clarence DeLany as Andersen, DeLany & Co. In 1918, DeLany left, and the firm changed its name to Arthur Andersen & Co. Arthur Andersen's first client was the Joseph Schlitz Brewing Company of Milwaukee. Arthur Andersen, based in Chicago, is one of the "Big Five" accounting firms among Price water house Coopers, Deloitte Touche Tohmatsu, Ernst & Young and KPMG, that provides auditing, tax, and consulting services to large corporations. It acquired strong g0odwill in accounting and auditing business in the world. In 2002, Andersen was convicted of shredding documents related to its audit of Enron. The relationship between Enron and Arthur Andersen was lenient which made it easy to maintain the improper accounting practices by both parties. When Enron came under investigation of federal authorities, Arthur Anderson had a huge "shred" campaign. Anderson completed the Enron report by sending untrained auditors to the company and adopted other unethical methods. Enron was one of the biggest clients of Anderson and paid huge fees ($52 million) for providing better auditing reports. On December 2, 2001 Enron Corporation had filed for bankruptcy, which was the largest bankruptcy petition in U.S. history. These selfish acts led both companies into an eventual downfall in bankruptcy. They set out to make as much money for themselves as possible. Since the Securities and Exchange Commission does not allow convicted companies to make audits, Anderson agreed to surrender its licenses and its right to practice. The firm voluntarily surrendered its licenses to practice as Certified Public Accountants in the United States after being found guilty of criminal charges relating to the firms handling of the auditing of Enron. Enron had filed for bankruptcy in 2001 and later failed. The other national accounting and consulting firms bought most of the practices of Arthur Andersen. Profits cannot be placed prior to ethics and law. Accounting ethics is important for the company and the society, Ethical misconduct can cause financial and non-financial loss to the public.

Kirch Media (Germany), 2002

Kirch Group was a German media group (Kirch Media) founded by Leo Kirch in 1970s as a programming and entertainment company. The group collapsed in 2002 largely due to the debts that arose because of purchase of sports rights for its television channels and the launch of pay TV services. The core business of the company was to buy foreign movie rights, dub them into German and resell within Germany. It later diversified into other media related businesses through acquisitions. Kirch had collected huge debt that included: bank debts of around euros 5.5 billion ($4.8 billion) and billions of euros in other liabilities. In 2002, the founder realised that restructuring of the company was the only solution left, but by that time

the debt had become unmanageable which led to filing for bankruptcy. On April 8th, 2002, Kirch Media, the free-TV and rights-trading group, filed for insolvency, sending a farewell letter to its employees. The significance of proper disclosures and effective monitoring is evident from the case of Kirch, where failure on the part of auditors to monitor the huge amount of debt in the company eventually led to the collapse.

Vivendi Scam (France), 2002

In 1853, a water company named Compagnie Genérale des Eaux (CGE) was created. For more than 100 years, CGE remained in water business. In 1976, the activities of the company were spread from water to waste management, energy, transport, construction and property following a series of takeovers. The CEO was found guilty of embezzlement amongst the massive financial reshuffling. Its chairman and CEO, Jean-Marie Messier was forced to resign and was subsequently replaced by Jean-Rene Fourtou. Messier was found guilty of embezzlement in 2011.The company started selling its stake in all the companies to raise funds to meet its liquidity problems, It announced a strategy to sell non-strategic assets and reduced its stake in Vivendi Environment to 40% and sold its stake in Vinci Construction. The effectiveness of the Board and the alignment of strategic vision of the Board members with that of the shareholders is essential for growth of the company. The need for effective leadership at the top level and efficient governance mechanisms cannot be undermined for efficient corporate working.

Parmalat (Italy), 2003

Parmalat is a multi-national Italian dairy and food corporation. It has operations in Europe, Latin America, North America, Australia, China and South Africa. Having become the leading global company in the production of long-life milk using the ultra-high-temperature process, the company collapsed in 2003 with a loss of 14 billion euros in its accounts, Europe’s biggest bankruptcy. In early 1993, Parmalat began to cook financial transactions to cover its balance sheet. It posted profits with many fictitious transactions and aggressive acquisitions, thereby, hiding its problems. In 1997, Parmalat financed several international acquisitions with debt. But by 2001, many of the new divisions were incurring losses, and the company financing shifted largely to the use of derivatives, in part with the intention to hide the extent of its losses and debt. Tanzi, once a symbol of success, was detained for hours after the firm was declared officially insolvent in late December. He admitted that there was a forgery of euros 8bn in Parmalat’s accounts. This was followed by the arrest of five other executives. The auditors of the administration determined that the debts amounted to euros 14.3 bn, which was almost eight times the sum originally stated. Several of the company's subsidiaries subsequently went

insolvent. Tanzi was eventually charged with financial fraud and money laundering. The huge empire, thus, came to an end. The company was liquidated with a debt or euros 14 billion, making it the largest corporate failure in the history of Europe. Tanzi was sentenced to 10 years in prison for fraud relating to the collapse of the dairy group.

Satyam Computer Services Ltd., 2009

Satyam Computer Services Ltd. was founded by Ramalinga Raju in 1987 along with his brother Rama Raju as a private company with 20 employees. The major business area of the company was offering consultancy and information technology (T) services across various industries. It was listed on Bombay Stock Exchange in 1991, National Stock Exchange and NYSE in 2001. It was one of the most reputed Indian corporates and a recipient of the Golden Peacock Award twice for excellence in corporate governance. It was called as India's "IT crown-jewel”. The initial investigations by the Registrar of Companies into the Satyam scam revealed large-scale selling of the company's shares by institutional investors just days ahead of Ramalinga Raju's confession of manipulating company accounts. In January, 2009, Raju resigned from the chairmanship and confessed to manipulating the company's accounting numbers for many years by overstating assets by $1.47 billion. Also, the company claimed to own $1.04 billion in bank loans and cash which was non-existent. With under reporting of liabilities and overstating of income, Satyam was the biggest corporate scandal of India. To meet the expectations of analysts, it generated fake customer invoices backed by greed for money, power and success. Satyam is stated to be the “Indian Enron". The fraud took place to divert company funds into real-estate investment, keep high earnings per share, raise executive compensation, and make huge profits by selling stake at inflated price. The auditors, Price Waterhouse Coopers, were negligent and could not identify the fraud in 9 years. In April 2009, Mahindra Group acquired Satyam Computer Services and renamed it Mahindra Satyam. The scandal of Satyam was the biggest in India. It lays emphasis on the need to reform corporate governance in India by taking harsh policy measures. Even though corporate governance mechanisms cannot prevent unethical activity by top management completely, they can act as a means of detecting such activities before it is too late.

Reasons Of Corporate Governance Failure

The common causes of corporate governance failure that led to frauds and scandals are:

1. Misrepresentation or company accounts like in case of Satyam, inflating earnings and falsifying business records.
2. Embezzlement of company funds by fraudulent means.
3. Reporting fictitious transactions and misappropriating company funds.

4. Forged investments and fraudulent practices by directors and top executives.
5. Greed and power, dishonesty leading to breach of trust pocketing heavy salaries and bonuses, perks and amenities without any regard to the company performance.
6. Misuse of confidential and price sensitive information by the directors and close family members.
7. Non-disclosure of material information.
8. Insider trading by the directors for making abnormal profits and gains at the cost of other stakeholders.
9. Mal administration and misfeasance, corruption.
10. Deficit internal control and monitoring mechanisms.
11. Loose attitude and inadequate control of audit committees.
12. Heavy cost of financing and debts that eventually led to greed.
13. Poor diversification and business expansion strategies that led to massive debts.
14. Window dressing of documents that led to financial irregularities.
15. Inaction of independent directors and failure in monitoring the transactions of the company.

Conclusion

In most of the cases, flaws in corporate governance have been the causes of corporate failures. Corporate governance failures have often been followed by development and refinement of corporate governance standards. Good corporate governance practices prove beneficial for the company and contribute to long term growth and sustainability while poor practices eventually lead to failures. Unethical conduct and non-compliance of provisions prove to be disadvantageous tor the company. In almost all the cases of corporate frauds, the basic cause for failure has been low level of ethics and greed of the promoters, directors, auditors or others who manage the affairs of the company.

To improve corporate governance practices to avoid the scams and corporate failures are:

1. There should be separation of Chairman and CEO. The concept of duality leads to conflict in the roles and duties. Same individual occupying both the positions leads to concentration of power in his hands, ultimately leading to higher probability of misuse.
2. Independent directors who do not benefit from the board membership must be set up in the company to monitor and regulate the work.
3. A mindset of transparency and ethics should be encouraged in the organization.
4. Auditor rotation must be compulsory so as to avoid probability of misrepresentation of statements.

5. A Chief Ethics Officer to overlook the practice of corporate governance, accountability, and ethics should be appointed. A sound whistle blower policy must also be included in the company.
6. Class action suits for those who fail to follow the governance norms, rules and regulations should be initiated to protect the interest of all stakeholders.
7. Auditing facilities should be made separate from consultancy. The same audit company should not be allowed to provide consultancy service to avoid conflict of interest.
8. Norms for rating agencies must be laid down. Internal audit should be made mandatory tor rating agencies for close supervision of their activities.
9. Too many directorships for the same director should not be allowed. An individual sitting on the board of many companies cannot contribute much due to shortage of time.
10. Transmission of risk information has to be through effective channels, and solo approach to risk management must be avoided.

References

Bates, Stephen (2010) 'How Polly Peck went from hero to villain in the City', The Guardian London, 26-08-2010.

Beasley, Mark S., Joseph V. Carcello, Dana R. Harmanson and Terry L. Neal (2010) COsO Fraudulent Financial Reporting 1998-2007- An Analysis of U.S. Public Companies Kroll Global Fraud Report 2010

Bodurtha, James N. (2003) "Unfair Values" - Enron's Shell Game. McDonough School of Business. Washington, D.C.

Cornford, Andrew (2004) Internationally Agreed Principles for Corporate Governance And

The Enron Case' G-24 Discussion Paper Series No. 30 (New York: United Nations Conference on Trade and Development): 30

Dharan, Bala G. and William R. Bufkins (2008) Red Flags in Enron's Reporting of Revenues and Key Financial Measures, Social Science Research Network. July pp. 101-103

Gillan, Stuart and John D. Martin (2002) Financial Engineering, Corporate Governance, and the Collapse of Enron, Alfred Lerner College of Business and Economics, The University of Delaware, November

Kerry, John and Hank Brown (1992) The Origin and Early Years of BCCI' The BCCI Affair: A Report to the Committee on Foreign Relations, United States Senate. 102d Congress 2d Session Senate, December http://www.fas.org/irp/congress/1992_rpt/bcci/03hist.htm

Lyke, Bob and Jickling, Mark (2002) Worldcom: The Accounting Scandal CRS Report for Congress (http://fpc.state.gov/documents/organization/13384.pdf)

Paul, Healy M. and Krishna G. Palepu (2003) The Fall of Enron' Journal of Economic Perspectives 17(2): 3.

Raghavan, A., A. Latour, and M. Schroeder (2003) Questioning the Books--A Global Journal Report: Ahold Faces Scrutiny Over Accounting' Wall Street Journal (February 26)

Rosen, Robert (2003) ' Risk Management and Corporate Governance: The Case of Enron' Connecticut Law Review 35 (1157): 1171

Stephen, Bates (2010) How Polly Peck went from hero to villain in the City The Guardian, London 26-08-2010.