Getting REAL with Corporate Governance

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One would have imagined that after the economic meltdown that shook the earth's tectonic plates, corporate governance ought to have become the bible for businesses. It may be the sexiest word in business diction but has failed to arouse action because so much of it seems unreal, artificial, fake, fanciful, repetitive and rhetoric.

Even in India where Satyam episode generated so much heat, emotion and commotion and made corporate governance a household word little has changed in real terms. There was a huge initial scare which led to some 524 independent directors quitting boards out of 2355 companies that have submitted data to the Director's Database on BSE website. It made Audit committees defensive after the arrests of Satyam auditors and put pressure on external auditors to ensure they perform their roles effectively. Other than that business continues as usual.

Fewer companies are using their boards effectively even after this deep crises which put India's national image on the mat. Board meetings continue to remain rituals with no effort to involve outside directors.

Independent directors are regarded more like trinkets to be displayed on the mantle piece. So appointment is largely from a known gene pool of smooth talking elite whom everyone knows and who know everything that needs to be known. It is based on who they are and not on what they can contribute.

When it comes to activities like setting the board agenda, allotting time for discussion and the quality of discussion, little has changed. Conscientious independent directors grumble they are being under utilized. The total number of hours they spent in board meetings last year averaged 14 hrs. What output of any substance can be achieved in 14 man hours a year?

Empirical evidence (Economic Times Team CD 31 July 2009), shows Indian company boards continue to be a cosy nexus. Same elite serves on multiple boards as independent directors in addition to holding their own jobs. Out of BSE100 companies, all blue chip companies, 66 independent directors hold five directorships and more, 40% have non-executive chairman, and only 14 have a woman on board. Can experts who serve on multiple boards and also hold regular jobs do justice to such assignments?

But ask a company on how board affairs are conducted, and how they have changed for the better the answers become platitudinous. Here's one from a CFO using a plethora of motherhood statements. "As a responsible corporate, we follow good corporate governance practices in all spheres of our business activity. Transparency in dealing with all our stakeholders and being a good corporate citizen towards society forms the basis of our good corporate governance principle. Half of our board comprises of eminent personalities as independent directors, which establishes our commitment towards good corporate governance."

A chairman who sits on the boards of six prestigious companies complains: "I sometimes feel the board is using me and milking my goodwill." But ask him what he is doing about it, instead of feeling helpless, he has no answer.

Nonetheless compared with the West, India is doing much better. At least its banking system is not in a such mess. In any event, West is in no position to sermonize the rest after the exposure of disgraceful practices of Wall Street steeped in greed, conceit, concealment and corruption. UK is only repackaging the same stuff through the same fossilized city bosses who caused the problem in the first place. The latest example is review of corporate governance practices in banking sector in the UK being conducted by Sir David Walker.

Sir David Walker is a leading City grandee and was the chairman of Morgan Stanley, the investment bank. In 2007 Walker was commissioned to produce a report into the then hugely controversial private equity business. His findings on transparency were rated toothless and in the eyes of many paved the way for the excessive opacity of markets that in turn engendered the current crisis. Sir David identifies four fundamental flaws:

1. The boards of the bank failed to understand the scale and type of risk they were running
2. Non-executive directors were hopeless in holding powerful executives to account
3. Bonus schemes rewarded short term performance and therefore encouraged dangerous risk taking.
4. Institutional shareholders caught up in exuberance of skyrocketing returns failed to exercise proper stewardship.

These flaws are no different from the ones exposed in the dotcom debacle of 2000 and the raft of scandals such as ENRON, WorldCom, Tyco etc that followed. Indeed these transgressions are now enshrined as standard text in books such as "Corporate Governance" (McGraw-Hill Executive MBA Series, New York, 2003, p. 229):

1. Executive compensation grossly disproportionate to corporate results;
2. Stock promotion, such as initial public offerings (IPO), that has gone to an extreme in the creation of very questionable or unproven business concepts;
3. Misuse of corporate funds;
4. Trading on insider information, particularly by managers exercising stock options that have rewarded short-term thinking;
5. Misrepresentation of the true earnings and financial condition of too many companies; and
6. Obstruction of justice by concealing activities or destroying evidence.

So the question on everyone's mind is why these transgressions keep happening? Why even the draconian Sarbanes Oxley Act, which apparently inspired Mr Raju to confess and take refuge in the Indian prison rather than be hauled up in the US and serve 24 years prison sentence like Jeffrey Skilling, did not work? This is where UK with its extra light touch regulation, comply or explain, will find it difficult to escape the blame in starting a race to the bottom of regulation. When companies found that listing in NYSE was tough going with SOX, London Stock Exchange welcomed them with open arms and government was in thrall with the prospect of rising revenues. Tragedy is that by 2007 despite the success of SOX in reducing frauds in previous years faced with competition from other international bourses, US rolled down the laws, and Christopher Cox , the new chairman of Securities and Exchange Commission, went easy on enforcement.

It is, therefore, not surprising that Sir David's recommendations while welcomed by the government that appointed him have met with adverse reactions both from bankers and investors. In a show of untamed arrogance and audacity, reminiscent of heyday of Wall Street, Goldman Sachs has declared record profits in the second quarter of 2009 and announced hefty bonuses for its staff - equivalent to a US$ million for each staff. The public was furious at bankers' irresponsibility in forgetting that they were in business because of tax payer had bailed them out with – a stunning sum of £904 billion in UK alone. Banks had cheated to raise their stock values in order to get bonuses which are in vast multiples of the remuneration of ordinary, but equally hard working and honest people. They criticised recommendations as "pretty similar to the countless others before it. We need radical thinking - but we got tinkering".

Sir David claims his proposals - taken with those put forward by the Financial Services Authority - would be the "toughest remuneration regime in the world". Sir David warns, "there is no reason why his proposals - with the exception of the suggestions on risk - could not be applied to "any other listed company board". But looked at from the most eye-catching of Walker's proposals: that the compensation of all highly-paid bankers should be publicly disclosed, have no teeth. The highly paid would not actually be named; their compensation would just be disclosed in bands. Besides these proposals cannot be implemented until adopted in the Combined Code and subjected to the same Comply or Explain regime.

We are unlikely to find effective answers unless we self-introspect and ask ourselves why despite a rash of regulations, the world economy has again been thrown into turmoil? What is it that is new and different that we can do now that will be more effective to secure it? The irony is that everyone knows the problem. Greed is a given in human nature. It is beyond class, creed, clan, caste or calling. It is the key driver of business. Economists refer to it as self-interest. But businesses when questioned are often in a muddled state of self denial.

The holy cow of corporate governance is that It is board process that most impacts board performance. The key criteria constitute the number of outside directors, the separation of the role of chair and of chief executive officer, the size of the board, the composition of committees, the independence of directors and so on. Since directorship of boards was confined to a small elite the selection was invariably restricted to the same gene pool.

So let us examine board membership of Goldman Sachs, Lehman Brothers, Merrill Lynch and City Group Smith Barney. These boards consisted of some of the leading business leaders in the United States. Indeed, the approximate 61 members of the boards of these companies also were on the boards of approximately 183 leading U. S. corporations -- most of them on more than one. In other words, the boards of directors of these leading financial institutions were primarily made up of directors of major business corporations.

These boards were constituted according to best accepted board practice -- they averaged about 14 members, had one or two prominent women members, they drew some of their membership from institutions of higher learning -- the Ivy League schools seemed to be a fertile place to find directors -- and there was not an excessive amount of interlocking among directors. So why were these boards so totally ineffective in preventing malfeasance.

Having come from similar backgrounds – class, creed, education, schools, even the independent outside director had the same values, the same standards, the same attitudes about running an enterprise and board functioning emphasized uniformity, cohesiveness and consensus. Group dynamics -- not board structure-- was the determining factor in how the boards operated.

It does not need rocket science to prove that such a process would have very little impact on the financial performance of a company. Nonetheless regulators have continued constantly to advocate and provide protection for shareholders by concentrating on board structure.

Groupthink, a term coined by social psychologist Irving Janis (1972), occurs when a group makes faulty decisions because group pressures lead to a deterioration of “mental efficiency, reality testing, and moral judgment” . Groups affected by groupthink ignore alternatives and tend to take irrational actions that dehumanize other groups. A group is especially vulnerable to groupthink when its members have similar background, the group is insulated from outside opinions, and there are no clear rules or incentives for departure from norm.

In the past quarter-century, a dramatic shift in the thinking about the goals of the corporation took place and measurement of its value. In their book “Stakeholder Corporation” published in 1997, Wheeler and Seelampa established that stakeholder focused corporations outperformed shareholder focused corporations. The principal purpose of publicly traded corporations was to maximise value of their shares on the stock market and not the bottom line results. Rewards to the directors and management began to be determined not by the quality of a company's products or services, but by the performance of company shares.

The acceptance of this concept has been catastrophic, particularly for institutions in the financial sector. With the ever-greater complexity of the financial needs of companies and their clients, investment banks started using "financial engineering" to manufacture an array of complex financial products that have no intrinsic economic value, but which when properly (or improperly) manipulated can generate fees and profits . This is deception and is precisely what made subprime mortgage lending calamity -- the genesis for the current man-made economic meltdown--possible. Changing the structure of boards won't make any difference . What will is a transformation in corporate culture that values dissent in the boardroom and encourages free and frank dialogue.

This calls for a shift in the way we view corporate governance. Is it a set of rules, paradigms or principles? Regulators like us to perceive corporate governance as a set of rules. Rules trigger defiance. Deep down each one of us there is a desire to beat the system, transcend the rules and become a master. Why not turn corporate governance into principles?

Why do we need independent directors after the frauds of ENRON and Satyam both of whom had outstanding boards. Chairman of the audit committee of ENRON was dean of Stanford Business School. Professor Palepu the head of Harvard Business School's Corporate Governance programme sat on Satyam board. Why do regulators focus so much on independent directors when they know their presence did not prevent scores of frauds of the genre already mentioned? Frankly we do not need independent directors when they have so little impact on the company and spend that less than two days a year. We should expect institutional investors to perform that role meritoriously.

With the escalation of fees, stock options and share of profit, the job of a 14 hours a year independent director , can be very lucrative specially when you can hold 15 such directorships concurrently and remunerations are edging fast to the level of executives. You get a syndrome where it becomes difficult for people to understand something when their salary comes from not understanding it.

What companies need is directors of independent mind. This again is a training and development issue. Yet there is little talk of beefing up training for directors. Directors think they have done all the training required before they joined as a director. This attitude is catastrophic in a business which is changing by the hour and where whatever made you successful earlier wont now.

The true purpose of corporate governance is to get rid of the groupthink and cosiness by disrupting the status quo. This is also a starting point for companies to be more competitive. It is so simple to achieve if we underpin corporate governance with a set of principles such as dispersal of central authority achieved by separation of roles at the top, diversity in the boardroom, encouragement of dialogue by valuing dissent and moving towards greater transparency and disclosure to win trust and confidence. The focus should be on developing and delivering training programmes for directors that enable them to use their minds independently, question board agenda, learn the art of dissent, encourage dialogue, and structure board meetings in away that permits no hold barred discussions.

The way diversity and disclosures drive value in today's world could not be imagined by a native of industrial society. In today's interconnected economy knowledge is capital. Diversity enhances capital between the engaging parties. It is the font head of all innovation. Sharing of knowledge between diverse parties increases knowledge of both parties. The degree of increase depends on the degree of diversity.

It is a shame that even in this day and age gender balance is treated as a favour to "weaker sex" instead of value enhancer in its own right . This fortunately is not true of the really innovative and visionary companies. Xerox has women as CEO and chairmen women. Ann Mulcahy, the chairman is also black.

Gender imbalance is an important area for correction. 20%f FTSE100 is all male. There is no Black British female director in FTSE 100 companies. There are only 8 ethnic minority women directors in FTSE 100 companies.

Britain today has just 11.7% women on its boards. During the past 10 years UK's record of women in boardrooms has improved merely by 5%.to 11.7%. Meanwhile women's representation as leaders of Norwegian business has risen from 6% to 44%. Rest of the Europe is moving equally fast in the same direction. .

With the current rate of change in composition UK Boardrooms will take 73 years to correct gender balance despite increasing evidence that women at the top are outperforming men from companies. Indra Nooyi, Chairman, PepsiCo, Betsy Holden, Co-CEO, Kraft Foods; Meg Whitman, President and CEO, eBay; and Andrea Jung, Chairman and CEO, Avon Products, Chanda Kochhar of ICICI and Kalpana Morparia of J P Morgan are shining examples of what gender diversity can do to companies in both West and in India.

Because of the possible embarrassment, awkwardness and bewilderment resulting from transparency, the transformational potential of unleashing the power of transparency has been grossly underestimated. Apart from helping to access capital, transparency improves decision making, drops transaction costs, evaporates boundaries of class, caste or creed, builds employee morale, inspires commitment, confidence, courage, collaboration, creativity, competence & improves competitiveness by building market goodwill.

With such formidable promise delivered by transparency, it is time we stitched programmes to introduce companywide transparency, learn the art of handling failures and wearing our embarrassments in full view of public like badges of honour.

Tragically corporate governance still surrounds in myths. Few realise that in today's multi-reality world of wrenching change and surprise, the collective wisdom of the board is the only way to lead business. Because of its focus on transparency, accountability, responsibility, inclusivity and equitable growth, corporate governance is a real engine for both social and economic transformation for emerging economies like India and China. Yet its practitioners continue to limit independent's role to merely being minority shareholder's watchdog. Shareholder interests cannot be served without directors engaging extensively with the whole body of stakeholders.

Financial meltdown that shook the world was a direct outcome of the mismanagement of risk. Managing risk is the collective responsibility of the board. Director's primary job is to secure companies against financial and non financial risks. It is this area of risk management which has been completely ignored by boards. Boards did not even constitute risk committees and expected inexperienced Audit committees to handle risk. SECURE is an acronym that spells the risks- social, economic, climate change, unforeseeable, reputational and ethical.

The area of non financials is getting increasingly extended as the value of natural and social capital widens and gets integrated into the balance sheets to create triple bottom line results. In the ultimate analysis, the value of the company lies in the brand. The ESG (environment, social, governance) are opening up new and unfathomable opportunities for innovative companies who love to play and would engage with these issues extensively to enhance the brand. The collective wisdom of the board provides a bedrock that can help nurture and embed these issues in the organisational DNA in a holistic and integrated way. Getting real with corporate governance is the only way we can confront the issues that matter in our quest to get directors perform their true role - to build the company's brand.

It is well known that the truth that makes men and women free is for the most part the truth which they prefer not to hear. But as Martin Luther King Jr. said, "Our lives begin to end the day we become silent about things that matter".

Our upcoming two conferences – one in Hyderabad (India) , the abode of Satyam, from 21-22 August 2009 and later with a bigger cross section of practitioners in London on 8 and 9 October 2009 aim to generate a free and frank, no hold barred debate on these issues because getting real with corporate governance impinges not only the future of our markets but also the future and security of our children.

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