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VIEWPOINT

Are we ignoring the early warning signs in our corporate governance system?

Corporate governance system – revisited

Madhukar Angur
School of Management, University of Michigan, Flint, Michigan, USA and Alliance Business School, Bangalore, India

Abstract

Purpose – The purpose of this paper is to examine the aspects of the corporate governance system and suggest ways to foresee a corporate fraud in the offing. It aims to explore ways by which key stakeholders may view "early warning signs" in their assessments of an inefficient corporate governance system.

Design/methodology/approach – Secondary method was used to collect data from several corporations that failed or faltered over the past decade due to poor corporate governance.

Findings – Findings suggest that corporate governance system failures of most corporations could have been foreseen before they became public if the five key early warning signs described in the paper were closely monitored.

Practical implications – Paying closer attention to the early warning signs mentioned here may help identify lacunas in the corporate governance system and may avert corporate debacles.

Originality/value – The key early warning signs identified here appear to address most aspects of failure in corporate governance system.

Keywords Corporate governance, Ethics, India

Paper type Viewpoint

Corporate governance operates on the premise that it ensures the accountability of a firm's management through regulations that alleviate the principal-agent predicament. Another arena of corporate governance focuses on its impact in economic efficiency, primarily keeping in mind the shareholders' welfare. Corporate governance continues to be a key topic particularly due to the high-profile crumbling of a large number of firms such as Enron (2001), WorldCom (2002), Bristol-Myers Squibb (2002), Tyco International (2002), Parmalat (2003), HealthSouth Corporation (2003), Chiquita Brands International (2004), AIG (2004), China Aviation Oil (2005), UnitedHealth Group (2006) and the recent Satyam (2009) debacle. The US Federal Government passed the Sarbanes-Oxley Act in 2002, to reinforce the confidence of the masses in corporate governance, which had suffered a huge blow due to the accounting and corporate malpractices surrounding Enron Corporation, Tyco International, Adelphia, WorldCom, and Peregrine Systems.

It looks as if these episodes were not the eye-openers anticipated since the global economy faced yet another major scandal: the Satyam fiasco that tarnished the image of India Inc. and is being referred to as "India's Enron." It was expected that corporate surveillance would be strengthened and the past litigations would keep at bay scandals

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imposing billions of dollars of costs on millions of people and on the world economy. Yet systems seem to have failed miserably again. In such circumstances one is forced to ask: are we ignoring the early warning signs in our corporate governance system?

Relatively recently, the corporate world was shocked when B. Ramalinga Raju, the founder-chairman of the fourth largest information technology (IT) giant in India, confessed to years of fallacious profits and an audacious financial fraud of $1.6 billion. Price Waterhouse, the India-based statutory auditor of Satyam and a sister concern of Price Waterhouse Coopers International, is now under the scanner. A one-to-one comparison is being drawn between Price Waterhouse and Arthur Andersen, which lost its mark among the "big five" accounting firms once the loopholes in its Enron audits were exposed. Andersen's conviction also brought into light its faulty audits for other companies such as Waste Management, Sunbeam, and WorldCom.

Enron held the reputation of being "America's most innovative company" for six consecutive years until it came under the spotlight for carrying out accounting malpractice. The Enron scandal of October 2001, found the company had artificially boosted the profits and covered the debts totaling over $1 billion by improperly using off-the-books partnerships. Enron had also manipulated the Texas and California power markets and bribed foreign governments to win contracts abroad.

Satyam had also won awards and accolades for innovation in corporate governance. With the Satyam scandal coming to light, one has to face the stark reality that India's corporate governance system is in shambles and needs urgent reforms. In the current situation it would be extremely difficult, if not impossible, for Satyam to continue to exist. Should it survive, it will have challenges to face because, quite possibly, other companies will refrain from acquiring a tainted company. With this debacle all the competitors will smell an opportunity. It is to be seen whether India's top IT companies popularly called SWITCH (S-Satyam, W-Wipro, I-Infosys, T-TCS, C-Cognizant, H-HCL) will remain as is or be rechristened as WITCH (without Satyam)!

Such scams continue to tarnish world business practices and raise questions about the existing corporate governance system. Directors, managers, and other key stakeholders across the globe may want to assess the following "early warning signs" to gauge the overall corporate health and the effectiveness of the management team:

- *High earning expectation*. Is a potential "warning sign" as more often than not it leads to accounting irregularities that may result in "abusive earnings management." Revenues that consistently match or exceed the analysts' expectations should ring an alarm in the minds of the auditors and stakeholders. Enron held the reputation of being "America's most innovative company" for six consecutive years and consistently matched or exceeded analysts' expectations until it came into the spotlight for accounting malpractice. The Bernard Madoff scandal illustrates yet another aspect of this where the multi-billion dollar ponzi scheme seemed "too good to be true." Apparently, regulators were alerted many times over the years by several outsiders that Madoff's ability to deliver steady double-digit returns was Machiavellian.
- *Fraudulent accounting*. Cash flows that are not aligned with the earnings; receivables that are not parallel with the revenues; superfluous allowances for uncollectible accounts that are not connected with receivables; reserves that stand unparalleled with the balance sheet items; and questionable acquisition reserves should raise eyebrows. WorldCom overstated cash flow by booking

$3.8 billion in operating expenses as capital expenses and gave founder Bernard Ebbers $400 million in off-the-books loans. In no time, WorldCom surpassed Enron becoming the biggest bankruptcy in history and leading to a domino effect in corporate scandals.

- *Dormant or non-existence corporate governance committee.* Often in an attempt to mislead or deceive the financial community, the company either has a dormant corporate governance surveillance committee or does not have one; as such frauds cannot be easily detected by outsiders.

The Maytas deal (where the Satyam chairman attempted to acquire two companies controlled by his sons – Maytas Properties and Maytas Infra – for $1.6 billion to cover-up for the lacunae in his books of accounts) acted as a red flag for the corporate world. There was outright disapproval by the investors claiming that it was an irresponsible misuse of funds and act of nepotism. Later the travesty of inflating the company's profitability by more than $1.6 billion in cash and assets on its books came out in the open. Satyam's factitious accounts had been audited by Price Waterhouse since the financial year 2000-2001. It is interesting that in seven years Price Waterhouse could not detect a problem, yet Merrill Lynch sensed the deceit in just ten days!

The department of company affairs in India reportedly revisited norms regarding corporate governance after the Arthur Andersen-Enron scandal and later when WorldCom came to light in early 2000s. Former cabinet secretary Naresh Chandra and his committee proposed a tighter regulation of the auditing and accounting practices of corporations in India and recommended that:

- a compulsory rotation of audit partners every five years; and
- submission of an annual report by the audit firm to the board of directors and the auditing committee.

These suggestions were generally overlooked not only in the companies Amendment Bill of 2003, but also in the new companies Amendment Bill of 2008. Arguably, had the suggestions been adopted the Satyam debacle could have been averted or at least detected earlier:

- *Assessing the true nature of ethical and altruistic practices of the company.* Many businesses pay lip service to ethics and corporate philanthropy and as a result their practices still fall short relative to its importance. Businesses ought to think deeply about corporate social responsibility and appropriate standards of conduct in society. Corporate philanthropy and ethical practices might have double-edged motives. This dovetails nicely with the notion of corporate social responsibility. Many citizen groups have argued for companies to be socially responsible corporate citizens from a normative and ethical perspective. Economists have generally tended to focus on whether it is profitable to be socially responsible and the possibility of realigning incentives to make corporate social responsibility a profitable, and even necessary, venture. Milton Friedman's contention that "the business of business is business," and the slavish dedication of many businesses to focus on increasing short-term shareholder value and rewarding managers accordingly borders on myopia and may have long-term negative implications.

Companies claiming to be overly ethical and those excessively publicizing philanthropy need to be closely monitored. It might be interesting to note that certain companies spend a small fraction of their sales on philanthropy and a much larger share on publicizing such contributions! Matching donors to their respective recipients one-on-one will allow for a closer study of the extent to which altruistic motives dominate and could serve as one of the early warning signs. Of course, in some cases unethical practices might be pretty obvious to detect. For instance, just as in Enron's scandal, debts in Satyam's case were hidden and bribes were allegedly offered to get World Bank business. The World Bank is now reported to have barred Satyam from bidding on its projects.

- *Lookout for The Big Lie Theory*. Although related to the ethical practices of a company, according to the proponents of "the big lie theory," after having established their credibility, certain firms may become excessively greedy and tend to get involved in "big lies," that is, they commit frauds of prodigious magnitudes. The infamous Enron-Arthur Andersen-WorldCom and Satyam-Price Waterhouse episodes hold testimony to the theory. Andersen's motto was "Think straight, talk straight." The firm's culture was believed to be ingrained with honesty and ethics. But this did not last. After having established a reputation for IT consultancy in the 1980s, the ethical standards of the firm went downhill as the accountancy firms in the USA were having a tough time maintaining commitment to the auditing arms. Commitment and honesty in audits were pitted against the desire to grow the consultancy practices, which were greater revenue generators from the existing audit clientele. Predictably, Andersen gave into the pressures of the client's desires to maximize profits and succumbed to fraudulent accounting and auditing practices in order to capitalize on the opportunities to increase consultancy fees.

The current mortgage problem and the resulting financial meltdown is nothing more than greed, self-deception and part of the "big lie theory." Over a period of several years, the reputed Wall Street experienced increasingly fewer losses from risky loans. The big investment banks became bolder since property values were increasing, the economy was good, and if they repossessed a property they could easily sell it for enough to cover their loan. As the good times continued, Wall Street figured out that the bolder the guidelines the higher the interest rate they could demand; so guidelines got even riskier. A borrower with poor credit could suddenly purchase a home without proving their income and with good credit the sky was the limit. And nobody, the borrower, the loan officer, or the financial institution cared a bit because the housing values continued to rise. In a way, very credible big investment banks reportedly looked the other way when it came to mortgage financing that is the genesis for our current global financial trepidation. In fact, the old adage "too good to be true," holds testimony even for the big lie theory. Reputation is not an end by itself, but an on-going effort that needs to be nurtured and enhanced. Some of the major blunders appear to have been committed by companies with some of the "best reputations." Hence, it becomes prudent to keep track of such aberrations as early warning signs of otherwise "reputed" companies.

Hopefully, paying closer attention to Enron-Arthur Andersen-WorldCom-AIG – UnitedHealth-Satyam episodes may help identify lacunas in the corporate governance

system. However, some questions remain unanswered: How many WorldComs, Enrons, and Satyams is it going to take for us to finally bring the systems in place? Will we keep ignoring the early warning signs of the corporate governance system? For how long?

About the author

Madhukar Angur is a David M. French Distinguished Professor at the University of Michigan Flint School of Management. He has worked in world-class companies in various capacities in engineering and management. He served as the Marketing Manager and General Manager of Vulcanizing Fiber Board and BDK Corporation. He serves on the board of companies in the manufacturing and service sectors, and is a consultant for many regional, national, and international companies. He has received many honors and recognitions. He is listed in *Who's Who among America's Teachers* and was nominated twice for the Carnegie Foundation Professor of the Year Award. He has published extensively in various business and marketing journals in many areas. Madhukar Angur can be contacted at: angur@umich.edu

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