

**GOVERN WELL FOR  
SUSTAINED WEALTH<sup>1</sup>**

by

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<sup>1</sup> Keynote Address at the Third World Conference on Corporate Governance, of the Institute of Directors, at New Delhi, September 27-29, 2002.

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## Govern Well for Sustained Wealth<sup>1</sup>

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One of the central lessons of the stock market boom of the 1990's and its crash in this century is that for corporations to create sustained wealth, good corporate governance (GCG) is an essential pre-requisite. Wealth itself has a cyclical tendency to rise and fall, like a *chakra*, a wheel, in a competitive market. The amplitudes can be reduced by GCG. Good governance is determined not only by competence, but by *dharma*, ethics. The practice of such ethics calls for different actions by regulators; boards; and management professionals. In this Keynote address, we deal with the *chakra*; the *dharma* and the actions for GCG.

### 1. Wealth *Chakra*, Cycles

The return of the whole world, to open economies, including the erstwhile centrally planned economies of the CIS, and mixed economies like India, has unleashed the competitive forces of an integrating single world market. We are back to the cyclical **Shiva** economics of creation and destruction, of Schumpeter, away from the mechanistic economics of Marx, and the inflationary economics of Keynes. The best of macroeconomic, fiscal and monetary policy instruments can help avoid the excesses of boom and bust, but not eliminate the cycle. In such a cyclical downturn, superficial wealth which rests on weak foundations of governance will erode very fast. Only the wealth created on the basis of good governance will be sustainable.

#### 1.1 Superficial Wealth

Some or more of the reported corporate income, and consequent wealth, as measured by market capitalisation, may be superficial for various reasons. If the profits are earned at the cost of quality, or by excessively squeezing vendors, dealers, and employees, or by ecological damage, the hidden costs will catch up, sooner or later. In the increasingly competitive world markets, the feedback will be faster; and, if not responded to, the retribution will be quick. If profits are reported quarter after quarter; year after year on the basis of window-dressed accounting of sales, costs, amortisation, provisions, off-balance sheet items etc, the investor confidence will be severely dented, and very difficult to regain.

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This is visible in the global capital markets. The Nikkei is at a 19 year low; Nasdaq at 30% of its peak; the Bombay Sensex at 50% of its all time high, etc.

At a macro level, part of the reported industrial growth, and consequent gap, may be illusory, if one factors in the opportunity cost of the ecological destruction. Both at corporate and at national levels, wealth creation can not be sustainable, if the environment is not sustained. The problem goes beyond even the nation state. One nation's pollution affects its neighbours. The Chernobyl nuclear accident was a spectacular case of fallouts on neighbours, especially Scandinavia. Another visible damage was the haze over Singapore and Malaysia, for several months, from raging forest fires in Indonesia. The bigger and richer the nation, the more dangerous a polluter it is for itself; neighbours; far off countries; and all of humanity, by eroding Mother Earth's ability to sustain life. It is inequitable in several ways. Two, in particular. First, emerging, populous countries can not sustain ecologically even a fraction of that consumption, even if they can afford it economically. Secondly, it erodes inter-generational equity, by lessening the chances of reasonable wealth and consumption for the future citizens of a shrinking and sick world.

## **1.2 Erosion**

Any wealth created through questionable values-led strategies, structures, systems, policies and processes, will evaporate rather fast. It was dramatically illustrated in the fall of Enron from a "model" growth company, to liquidation. Similar fate has befallen Worldcom, Xerox and many manufacturing companies. Among the professional service firms, the disappearance of Arthur Andersen, due to fraud, has been eerily fascinating. Even investment and merchant banks like Goldman Sachs and Merrill Lynch have been affected. At a personal level, corporate heroes have bitten the dust. Percy Barnevik of ABB felt obliged to return \$65 mn of excess pay. Jack Welch of GE has returned his expensive perks.

The erosion of corporate wealth occurs, under bad governance, in many ways. Customers desert the company due to poorer quality goods and services. Dealers and vendors try to protect not only their business, but also their reputation by switching to other business partners. Once bitten, twice shy, shareholders not only exit that company's shares; but that whole sector or region; and even the entire equity market, and put their money in debt, or keep it as cash. Young, new talent will be reluctant to join; and among the existing talent, there will be high turn over.

## **1.3 Sustainability**

Corporate wealth can be sustained only if, through good governance, the expectations of all the various stakeholders are met. Compliance with the laws and regulations, in all the territories of its operation is the minimum of good corporate citizenship. Much more is required. It is necessary to reward shareholders by dividend from truly earned income, and not by eroding future capital; and market capitalisation, arising from real earnings per share; and price-earnings ratio on sound rating and discounting. The stream of top line sales revenues have to come from viable operating businesses. This requires a balance between organic, internal growth and mergers. If it is necessary and opportune to acquire

businesses, the acquisition needs to be driven by the intent to create long-term wealth for shareholders, and not immediate executives' bonuses. A three phase model of M&A management needs to be patiently handled --- first, a thorough search for the right candidate, with a strategic fit; secondly, paying the right price, in a right manner, without using off-balance sheet hoodwinking; and, thirdly, integrating the two organisations, to ensure the anticipated synergy benefits.

The sales growth from either or both of the above strategies has to be accompanied by productivity and cost control. While growth firms are given a high P-e ratio for some time, as for AoL, the investors expect profits, sooner or later. Investors go further, and expect cash eps, and not just eps on accrual basis. But, the cost control should not go to the extent of shortchanging the customer in terms of value for money or any other expectation and promise.

The other imperatives for sustainable wealth are to be a good employer to attract, retain, develop, excite and utilise talent; and to earn the goodwill and respect of all the local communities, country-wide, and world-wide, if relevant, where the company operates.

## 2. Governance *Dharma*

As in management, so in governance, as well, a global concensus is emerging on the core elements of a *dharma*, code of governance. The earlier codes based on reports like Cadbury and Birla need to be tightened. The key elements are --- the constitution of the Board; its main committees; their functioning; guiding the management; holding it accountable; and enforcing sanctions, including replacement, where necessary.

### 2.1 Indifferent Governance

The recent big, shattering scams seem to have woken up many boards. Till then, it appears that quite a percentage of boards were exhibiting indifferent governance. They were doing so, in most cases, not consciously, but by default. Relatively few may have colluded with the management to defraud the other stakeholders. But, in the majority of cases they may have committed more errors of omission than commission, such as the following. The non-executive directors may have left it mostly to the Chairman. Even if he were highly committed and industrious, the total burden of governance is too much for one person. The governance is even more indifferent, if the Chairman relies overly on the management, including the executive directors. The Chairman and the NED's may also have winked at some lapses and disturbing signals, hoping that these are passing aberrations.

There are many such possible deviances. Legal violations and payment of penalties should have rung a bell. The management may report unfailing quarterly and annual growth in profits, and beating the budget. This should raise some doubts and queries, at least for classification and confirmation. The management may have created a culture of compliance and fear, eliminating possible whistle blowers.

## 2.2 Poor Governance

This is one or more shades worse than indifferent governance. Here the whole Board, especially the so-called “independent” directors, or a majority of them, or even a few directors in key Committees, collude with the top executives in the reporting of illusory performance and profits; and hype up the market perception, for a high price-earnings ratio, leading to bloated paper wealth. The gap is not so much in the board’s and management’s competence, but in their values and ethics. They are often aided and abetted by compliant auditors and conspiratorial financial analysts, who share the loot, with the board and management.

All the formal structures mandated for CG may be in place, but more in form than in spirit. The independent directors may have been chosen to be “yes-men” to the full time Chairman and Ceo. In case of a non-executive Chairman, he and all NED’s may be there because of their pliability to the MD and Ceo. The various committees --- Audit, Finance, Appointments, Compensation etc may meet, receive papers, keep minutes, and go through such motions, without real probing. If the insiders themselves are impervious to GCG, there is not much that the external stakeholders can do.

## 2.3 Good Governance

Whether at national or corporate level, good governance is first about values, and then about structures, systems and processes. The values are embedded in Mahatma Gandhi's famous guidelines –

No politics without principle;  
no wealth without work;  
no commerce without morality;  
no education without character;  
no pleasure without conscience;  
no science without humanity; and  
no worship without sacrifice.

An important element of GCG is to earn and retain the trust of customers, by consistently delivering on the professed customer value proposition. This includes not trying to build and exploit monopoly or oligopoly power, but to earn the profits through efficiency. Even the film makers of Bollywood, Mumbai, part of the world's largest Indian film industry, known for extravagant blockbusters, are keen on cutting costs, according to FICCI and IMPPA. The average cost has been brought down to Rs. 5 crs (1 mn dollars). The film Devadas is an exception, at 10 mn dollars.

The best of products from leading, research oriented firms can also develop defects. Microsoft has just admitted critical security flaws in the Internet Explorer. It has issued a jumbo-sized patch for correction.

## 3. Global Action

Sustained wealth is the legitimate aspiration of all stakeholders, all over the world. Like peace, GCG is also indivisible. Unless consistent actions are taken across national and regional borders, erring companies will find safe havens to escape into. Such actions are required by several constituents, including, in particular, regulators, boards and professionals.

### 3.1 Regulators

The circle of responsibility for GCG begins with the Regulators, such as the SEC in US; the FSA in the UK; and SEBI in India. They have to create, review and strengthen the regulatory framework for GCG. The circle also ends with them, in those cases where Managements first, and Boards later, fail in their responsibilities.

The SEC in the US, shocked by the scandals in the supposedly best regulated economy, has now required Ceo's and Cfo's to personally certify their accounts. The vaunted US GAAP, generally accepted accounting principles, has been found to be inadequate. The self-regulation by the Institute of CPAs is being supplemented (superseded?) by a National Accounting Board.

There is a similar ferment in India, to prevent similar huge and devious scandals. The Department of Company Affairs has set up a new Committee on Corporate Governance, chaired by Prof. J K Varma, to take the requirements beyond those of the earlier Birla, CII and other reports. The Accounting Standards Committee of Sebi has suggested **audited** half yearly results from fiscal 2004-05. They want the SE's to be more involved. The Audit Committee of the parent company should review of accounts of the subsidiaries.

Sustainable wealth creation by industry, requires not only GCG, but also good governance in the public domain, not only by nation states, but by increasingly powerful regional structures like the EU, Asean, Nafta etc, as some serious issues transcend national sovereignty. At the national level, there is a need to reduce controls, corruption, delays, and transaction costs. Globally, ecology, trade, employment, food security etc. have to be fostered. According to the WSSCC, Water Supply and Sanitation Council, based in Switzerland a billion people lack clean water; and two billion more lack sanitation. It has launched a "WASH" campaign.

The task of regulation is even more difficult in Russia. According to Brunswick UBS Warburg, only eight Russian tycoons control 85% of the top firms. Capital flight continues at \$115 bn p.a., as in the 1990's. President Putin is determined to restructure, but has a long way to go.

### **3.2 Boards**

The board of directors are the last hope of the various stakeholders, failing which, they will explore and take the exit options. In a competitive global market, customers, investors, talent and business partners have other options. The battle for their attraction and retention has to begin with GCG.

Through their Committees and board meetings they can guide, direct and control the management. They first need to be a role model of working hard to earn their own income and wealth, including sitting fees and commissions. They would have earned the right to demand the same from their top and senior executives, including, especially, their stock options.

The Audit Committee can no longer take the external auditors' certification, at face value; at least, not till the new regulatory disciplines, such as separation of auditing and other services, are fully internalised and implemented. The Committee should call for a strengthening of Internal Audit, receive copies of its reports, routinely for information, and act on exception items. It should call for audit peer review, once in a while, with a surprise element thrown in.

The Appointments-HR Committee should stress character as much as education, training and current performance in the appraisal, compensation, promotion, career paths and succession planning processes.

Another aspect of GCG is CSR, corporate social responsibility. Creation of wealth and jobs through efficient provision of quality goods and services is, of course, the first

requirement of CSR. But, it goes beyond that. Sustainable wealth requires a harmonious relationship between Business, on the one hand, and the Civil Society, on the other. Glaring and rising inequalities in income and wealth are not conducive to the acceptance and support of Business by Society. Corporates have to practice philanthropy, and share part of their wealth with the communities in their areas of operation. They can do this in many ways --- both directly, and through effective Ngo's. These can vary all the way from micro, local causes, to macro, global issues, such as before the RIO + 10 Earth Summit at Johannesburg, and subsequent action programmes.

### 3.3 Professionals

A great deal of the responsibility for sustainable wealth creation, through GCG, rests with the professionals --- directors, executives, technologists, auditors, analysts and others involved in the setting up, running and growth of enterprises. The biggest gap they have to plug is not in knowledge, but in their values. In the Indian tradition, those few or more, who are manipulative, highly qualified professionals are known as *gyaan paapis*, knowing sinners, less deserving of our *kshamaa*, forgiveness. One can not really say, of them, as the Bible does --- "For, they know not what they do".

Professionals, whether working in regulatory bodies, boards or management, need to get in touch with the basic definition of a profession in sociology. It has three key characteristics. The first is expertise in a recognised body of knowledge --- in this case Management, Accounting, Law, Economics etc. Directors and top managers should be in those positions primarily because they have acquired such knowledge, and are constantly updating themselves. The second aspect is a set of competencies, including the attitudes, skills and habits, to apply that knowledge, in practice, as emerging, real-life situations demand. The third element is a deep commitment to the values of using the above repertoire of expertise and competencies for institutional and public good, putting both of them above personal interest and convenience.

### Conclusion

The credibility of the business system, world trade, globalisation and the new emerging international economic order, depends on GCG. The two most serious dangers are --- consumers losing the nerve to spend; and equity and debt investors losing faith in the capital markets. A deflationary depression of the 1930's kind is not an impossibility. It will be a disaster. GCG and GG are potent instruments to prevent it. The hour is late, but not past. Let us hasten.

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