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A Case Study on Accounting Window Dressing and Template Regulation

ORIGINAL ARTICLE

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Abstract

Financial reporting by way of EVA has the merit of structuring transactions without deluding the stakeholders about the underlying economic performance of the company or influence contractual outcomes that depend on reported accounting numbers. The present paper shall find out how the linkages between the corporate governance and EVA as an regulation, could curb the tradition of putting forward the practice of creative accounting into the positive accounting theory and make the users aware of such a scope is the need of the hour. This study broadly aims at looking out for solutions in bridging the gap in existing knowledge of value based relationship between corporate governance and the wealth measure performance paving the way to mainstream of thinking on ethics without misuse of accounting standards. The study has also contributed to identify the scandals of corporate governance recoiled due to creative accounting by exploring various national and international relevant case studies that have precipitated significant implications on the Indian corporate sector.

Key Words

Corporate Governance, Economic Value Added, Ethics, Creative Accounting.

Introduction

The saga of Corporate Governance has engrossed unequivocal awareness since the late 1990s with the dismantling of the protectionist and socialist regimes and the opening up of the industrial sector to international competition and private ownership. Lack of adequate governance of Indian corporate leading to creative accounting has been cited in the popular press, academic debates and some committee reports as one of the primary reasons for underperformance of companies and the growing apathy of the investors in corporate financing. However, increased shareholder activism, regulatory vigilance and discerning compliance procedures are playing a prominent role in improving and strengthening corporate governance mechanisms and thereby avoid creative accounting practices in India.

Corporate performance and good governance are very much intertwined with each other in measuring excellence in all productive, economic and social pursuits. In the changed scenario, as the essence of corporate governance lies in the valuation reporting, the enthused investors are no longer satisfied with bland accounting figures but need to know how much value has been created by the company in terms of true economic profit i.e. through the path of revolutionary EVA (Economic Value Added). Although the traditional measures of performance are still in vogue, it has led to value destroying actions with the false notion of creating shareholders' wealth without considering the concept of cost of capital. In the era of globalisation, to achieve the best corporate performance, the corporates in their commitment to all stakeholders and shareholders' relationship, has focussed on EVA, a superior performance measure for corporate reporting and internal governance. Thereupon this focuses on the cohesive management values in harmony with the companies and engrossed by the quantum of economic value generated by them in excess of its cost of capital. In other words, a company creates value only if it is able to generate returns higher than its cost of capital and causes the objective of management suitable with the stakeholders' interest.

The creation of value, as understood by the Global ethical business people is in regard to create value through integrated and sustainable relationships with the primary corporate constituencies of shareholders, lenders, customers, employees, suppliers and the communities in which the firm does business. The value created many not always reflect in financial statements, as they may also be from the non-financial assets and it is to be realized by the companies as an integral part of fully understanding the performance of their business. Companies are under pressure from the investors to report all the value drivers of their performances which includes the various intangibles too, such as the intellectual capital, requiring transparency in their measuring and reporting also. Much of the discussions about tackling creative accounting procedures through already existing corporate governance standards with well-developed regulatory and financial reporting framework couldn't hold back the American and London corporate by an unprecedented string of corporate collapses from early to recent times – Maxwell, BCCI and Polypeck in UK and followed after 20 years are Worldcom, Xerox, Enron, Satyam, to name a few.

Modulations of Corporate Governance Resolving Creative Accounting

Corporate Governance is the framework for the policies and procedures which govern a business corporation with artificial transactions invoking the concept of substance over form, whereby the economic substance rather than the legal form of determines their accounting substance. It is the essential part of business ethics since the morality of the Board and its individual directors underlie these policies and procedures and remain at the discretion of the management. The ethics of Corporate Governance is therefore the determination of what is right, fair, proper and just in accounting decisions and actions that affect other people at the level of individual, organization and society. In other words, it focuses on the relationships that ought to be with the employees, customers, stockholders, creditors, suppliers, distributors and the other members of the community in which the corporates exist.

Corporate Governance is not only an issue of compliance and disclosures but a powerful instrument for national economic and social transformation. The corporates should realize that improving corporate governance by strengthening board expertise, board oversight and exercise of better internal controls to manage risks, [illegible] [3]. Therefore the compliance can result in enhanced reputation, increased operational effectiveness, higher employee morale, improved customer loyalty and more transparent engagement with civil society. In the era of globalization, there are enormous opportunities for proactive businesses with infinite field for innovation and creativity. However, innovation requires transparency in the architecture which is imbedded in improving company's credibility and access to global capital. The real management challenge for global companies thus, lies in creating systems for global governance that comply with stakeholder expectations right across their global operations and helping them build new markets and increasing effectiveness.

The diverse stages of development of a country and its legal, regulatory, educational and religious systems have a bearing on standards of conduct, nonetheless there appears to be no particular pattern of ethical or unethical corporate behavior. In recent years, there has been a growth globally in establishing stricter corporate governance procedures which are introduced as remedies to encourage higher ethical conduct in business corporations and to prevent unscrupulous conduct. Many different Codes of Ethics and Governance has come into existence ranging from those issued by international bodies for multinational enterprises[4] to individual Codes adopted by different countries and business corporations around the world. Nevertheless, a number of high profile corporate scandals have also occurred manifesting poor corporate governance standards and other lapses in business ethics, including greed, treachery, breaches of trust, conflicts of interest, lack of transparency, insider dealings and fraud by directors and others. Corporate scandals are not restricted to any one country, or any particular business sector. They have arisen in the United States of America, the United Kingdom, Italy and India, to name a few. The corporate sectors involved in the breakdowns in corporate governance due to unethical practices, include telecommunications, energy, home furnishing, dairy foods, life insurance, car manufacturing and others.

In the following lines, many good and bad practices of corporate governance ensuing in success and failures in the corporate sector in India and abroad have been discussed. The various cases have been compiled from different sources of literature on corporate governance.

The Cases of Corporate Fall-outs due to Creative Accounting

Indian Tobacco Company (ITC) Classic Finance (India)

In late 1996, almost half of the executives on board of the tobacco to hotels major ITC Ltd. were in jail on charges of FERA and excise violations. It was at this point that the downfall of ITC Classic Finance (Classic), ITC's flagship financial services 49% subsidiary, began. The scandals in ITC had a massive damaging effect on the ITC brand and corporate image. The impact got reflected on Classic too and it was inundated with desperate fixed deposit holders wanting to withdraw their funds. Funds worth over Rs50crore were withdrawn within a few days after the crisis broke out. The continuing uncertainty on fund flows into the company and the eroded value of its portfolios began scaring off potential investors and foreign partners as well. International Finance Corporation (IFC), which was to provide a credit of $45 million to Classic, also held back the offer till 'things cleared up'[5].

Classic's negative cash flows, its huge asset liability mismatch and the slow process of divestment of stakes held by Classic in the ITC group companies finally, made it declare a loss of Rs 285 crores June 1997, which almost wiped out its entire net worth. Meanwhile, troubles mounted as redemptions kept increasing, from Rs 750 crores in mid 1996, deposits came down to Rs 550 crores in May 1997[6]. From a peak level of one million depositors, Classic was left with just six lakhs. ITC gave Classic Rs 75 crores credit line to maintain cash flow to meet the redemption pressure. At this juncture, Classic had to take inter-corporate deposits to fund the outflow. The sustained downturn in the capital markets during 1995-96 added to the company's woes and soon, key personnel began leaving the company. Already neck-deep in legal troubles, ITC realized that it would be better off without Classic to add to its problems. ITC then initiated discussions with Daiwa Securities of Japan and a few Korean, British and American investment banks for a possible tie-up.

ITC was desperate not to let Classic go for liquidation, as that would have reflected badly on its brand power. ITC announced that it was even willing to infuse more funds to keep Classic afloat. Both GE Capital and the Hinduja Group evinced interest in Classic. Since they laid down very stiff terms for the buy-out and valued Classic much below ITC's expectations, talks did not proceed further. Nothing seemed to be working out in favor of Classic as there were no takers for a company with non-performing assets of over Rs350 crore and an investment portfolio having an extremely poor executed standard.

The Ketan Parekh Scam (India)

The sudden crash in the stock markets on March 1, 2001, came as a major shock for the Government of India, the stock markets and the investors alike, prompted the Securities Exchange Board of India (SEBI) to launch immediate investigations into the volatility of stock markets. SEBI also decided to inspect the books of several brokers who were suspected of triggering the crash. Meanwhile, the Reserve Bank of India (RBI) ordered some banks to furnish data related to their capital market exposure. This was after Global Trust Bank, a private sector bank having exceeded its prudential norms of capital exposure, contributed to the stock market volatility. This scam shook the investor's confidence in the overall functioning of the stock markets. By the end of March 2001, at least eight people were reported to have committed suicide and hundreds of investors were driven to the brink of bankruptcy[7]. The scam opened up the debate over banks funding capital market operations and lending funds against collateral security. It also raised questions about the validity of dual control of co-operative banks. The first arrest in the scam was of the noted bull, Ketan Parekh (KP), on March 30, 2001, by the Central Bureau of Investigation (CBI), who had single handedly caused one of the biggest scams in the history of Indian financial markets. He was charged with defrauding Bank of India (BOI) of about $30 million among other charges[8].

The JVG Scandal (India)

In October 1997, the Reserve Bank of India (RBI) banned all Non-Banking Financial Companies (NBFCs) of the JVG Group of companies - JVG Finance, JVG Leasing and JVG Securities - from accepting deposits from the public. This was revealed after an investigation which showed that, these companies had been accepting deposits in excess of their stipulated limits.

Soon after, JVG downed the shutters of several of its offices in small towns of Maharashtra, Uttar Pradesh and Bihar, claiming that, it had detected huge irregularities in the operations. The closing of the offices created a panic among the depositors and strong voices were raised against the group. In November 1997, JVG hurriedly rented an office in Gurgaon (Haryana) to accommodate irate investors. Hundreds of investors and agents camped on the grounds of the office[9]. The agents (or the field-workers), who raised deposits from investors on behalf of JVG, were extremely worried. They said they could not go back to their local offices without collecting the dues fearing the wrath of the investors. More and more depositors and field workers teemed over the next few days with hopes of getting their money back. At this juncture, frightened by the dire reputation, the JVG Chairman claimed that a majority of the certificates were forged and hence they would not be paid back. Many of the depositors, who had invested as little as Rs.500 could not even, imagine of taking the dispute to the court[10]. The Company's allegation that its agents had issued fake certificates to depositors for more than Rs.100 crores was seen as a strategy to cleanse its responsibility in paying the investors.

They were sure to apprehend the agents for issuing fake certificates. Then, in June 1999, after 16 months in jail, the Chairman was granted bail on a personal bond of Rs1lakh with a surety of a similar amount and was directed not to leave the country without the court's permission and not to tamper with evidence[11]. The JVG companies were de-listed and barred permanently from indulging in NBFC activities in the future. However, JVG's demise and the Chairman's turn in jail would perhaps never replace the dreams and hopes of the investors whose hard-earned money had vanished forever.

The US-64 Controversy (India)

UTI was established through a Parliament Act in 1964, to control the nation's savings through the mutual fund schemes. By February 2001, UTI was managing funds worth Rs64250crores through over 92 saving schemes such as US-64, Unit Linked Insurance Plan, and Monthly Income Plan etc. UTI's distribution network was well spread out with 54 branch offices, 295 district representatives and about 75,000 agents across the country[12]. The first scheme introduced by UTI was the Unit Scheme-1964, popularly known as

US-64. The fund's initial capital of Rs5crore was contributed by Reserve Bank of India (RBI), Financial Institutions, Life Insurance Corporation (LIC), State Bank of India (SBI) and other scheduled banks including few foreign banks. It was an open-ended scheme, promising an attractive income, ready liquidity and tax benefits. In the first year of its launch, US-64 mobilized Rs19 crore and offered a 6.1% dividend as compared to the prevailing bank deposit interest rates of 3.75 - 6%. This impressed the average Indian investor who until then considered bank deposits to be the safest and best investment opportunity. By October 2000, US-64 increased its capital base to Rs15993 crore, spread over 2 crore unit holders all over the world[13].

However by the late 1990s, US-64 had emerged as an example for portfolio mismanagement[14]. In 1998, the UTI chairman revealed that the reserves of US-64 had turned negative by Rs1098 crore. Immediately after the announcement, the Sensex fell by 224 points. A few days later, the Sensex went down further by 40 points, reaching a 22-month low under selling pressure by Foreign Institutional Investors (FIIs). This was widely believed to have reflected the adverse market sentiments about US-64. Nervous investors soon redeemed US- 64 units worth Rs580 crore[15]. There was widespread panic across the country, as the investors of Unit Trust of India's (UTI) Unit Scheme-1964 (US-64) were shaken[16]. For the first time in its 32 years of existence, US-64 faced depleting funds and redemptions exceeding the sales. Between July 1995 and March 1996, funds declined by Rs3104crore. The depleting corpus coupled with the redemptions resulted in a liquidity crisis because of the lack of proper fund management and internal control systems at UTI adding to the growing investor agitation[17]. By October 1998, US-64's equity component's market value had come down to Rs4200crore from its acquisition price of Rs8200crore[18]. The net asset value (NAV) of US-64 also declined significantly during 1993-1996 due to turbulent stock market conditions. Unlike the usual practice for mutual funds, UTI never declared the NAV of US-64 - only the purchase and sale prices for the units were announced. The practice of not declaring US-64's NAV in the initial years was followed due to the heavy stock market fluctuations resulting in low NAV figures, which would have discouraged the investors. But this seemed to have led to a mistaken feeling that the UTI and US-64 were somehow immune to the volatility of the Sensex[19]. Following the heavy redemption wave, it soon became public knowledge that the erosion of US-64's reserves was gradual. Internal audit reports of SEBI regarding US-64 established that there were serious flaws in the management of funds. While the equity investments increased by 40%, UTI seemed to have ignored the risk factor involved with it. Most of the above investments fared very badly on the bourses, causing huge losses to US-64. The management failed to offload the equities when the market started declining[20].

Satyam (India)

At the end of the 2008 Satyam Computer Services was one of the darlings of India's IT outsourcing sector. It was the country's fourth largest IT service company, with annual revenues of well over $1bn. It clients were spread across the globe and included a healthy swathe of Fortune 500 companies. The firm was winner of the world council for corporate governance's golden peacock Award and a few year earlier Ernst & young had named satyam's founder and chairman B Rambling Raju, entrepreneur of the year that all changed on 7January 2009 when Raju resigned, confessing to hiding about $1bn in cash shortfalls. In a letter made public, Raju admitted that he had been fixing the books for seven years. When a deal to buy his son's development companies Fell through , the effort was no longer tenable He wrote: 'it was like riding a tiger , not knowing how to get off without being eaten.'

In the immediate aftermath, Raju his brother and the company's chife financial officer were jailed on change related to the fraud. The company was sold to tech Mahindra in public tender and its name changed to Mahindra satyam. A Satyam computer service was no more.

The balance sheet carries as of September 30, 2008

A inflated (nonexistent) cash and bank balance or Rs 5040 Crore (as against Rs 5361 Crore reflected

in the books):

- An accrued interest of Rs 376 crore which is non existent.
- An understand hability of Rs 1230 Crore on account of funds arranged by me.
- An overstated debtors position of Rs 490 crore (as against Rs 2651 reflected in the books) 30.
- The holes in the balance sheet were due to inflated profits recognized in the past several years.

What began as small gap between actual and reported performance soon swelled in size, and each failed attempt to cover up the scam resulted in a larger gap 'the Satyam Fiasco , although very painful has resulted in a actions to improve the corporate governance in India , but there remain much more to be done'.

Conclusion

Corporate crimes injure investors, employees, and the capital markets that fund the needs of existing firms and promote new businesses[21]. The recent revelations of corporate fraud through creative accounting have increased the need to investigate and prosecute criminal activity conducted by corporate officials and associated professionals, who have abused their positions to enrich themselves while breaching the trust of investors, employees, financial institutions, and the capital marketplace. These revelations of a corporate culture of corruption and deception in a number of very prominent companies have threatened to undermine the public's confidence in companies, the financial markets and the economy. They also have magnified the need for a renewed emphasis on effective corporate governance through the value based management system

Regulators world-wide are focusing on an increasing level of communication with stakeholders, making them aware of risks inherent in businesses and ensuring top management oversight of creative accounting. In order to restore full public confidence in the financial markets, continued strong enforcement would be necessary to increase the level of transparency of corporate conduct and of financial reporting thereby strengthening the accountability of corporate officials. The adherence to corporate governance norms is vital for integrity and efficiency of the financial markets, while poor practices of corporate governance deteriorate a company's prospective future and consequently can pave the way for frauds and even financial difficulties. However, companies with well governance structures by way of EVA reporting usually outshine other companies and have been able to attract investors and stakeholders, whose support have helped in fostering growth and development.

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