CORPORATE GOVERNANCE IN FAMILY CONTROLLED BUSINESS AND THE NEED FOR FORENSIC ACCOUNTING

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Abstract

In India, family business has a very important role to play in growth of the country's GDP, employment generation, building of the nation and creation of wealth. Growth of such family businesses in the last decade has been very significant as well as commendable. Family businesses has a deep understanding of the national scenario of our country and can easily tap into the vacant spaces where business opportunities exists and thus they become successful over the years. Most family businesses are started by fathers and grandfathers and they have expanded into new businesses in various sectors and beyond geographical boundaries. While many such businesses have gone on to be the pillars of the Indian Economy, there are also instances where such corporate houses engaged in manipulations and malpractices to fulfil their own gains and maximise their own profits without having any benevolent concern for the society at large. To prevent such practices Forensic Accounting comes in as a tool which applies investigative analytical measures to identify frauds. Thus this paper is an effort, to analyse whether family businesses in India are operation in a sound and ethical manner, by fulfilling social obligations as well as following corporate governance principals. Various case studies have been used to study the fraud cases in family controlled businesses and it highlights why Forensic Accounting is necessary as ordinary measures were unable to tackle such problems.

Key Words: *Ethics, Forensic Accounting, Moral and Stakeholders.*

1. Introduction

We already are very accustomed with the fact that the shareholders are the owners of companies and the management of the companies are the responsibility of the board of directors. The Board are also responsible for proper governance of their companies. Corporate Governance refers to a concept that Board of Directors should manage the company in a effective, efficient and transparent manner for the benefit of the stakeholders and board should also be accountable to the stakeholders. Stakeholders refer to the persons who are interested in the performance of the company (Example-Employees, Trade Unions, Suppliers, Government and Competitors etc.).

The concept of Corporate Governance is always closely associated with the words Ethics and Moral. So, understanding the difference between Ethics and Moral is equally important before getting into Corporate Governance. The words Ethics and moral are close but different and Ethics being much wider and brooder in terms of scope. Ethics may be defined as a way of being human and it is considered as the standard of moral conduct which is to be followed by all business enterprise for longevity of any business. The word Ethics is derived from the "Greek word 'Ethikos', meaning character" and "the word moral is originated from the Latin word 'Mos' meaning custom", thus the two words are similar yet different.

The term Corporate Social Responsibility first came into picture in India in early 1960s profit maximization objectives of corporate was first challenged by activists. The renowned German philosopher Karl Marx once commented on business objectives saying “Business is all green, only philosophy is grey”. The inner meaning of the comment was that business only tries to maximise its profits by exploiting the society, therefore business always remains green (meaning happy and profitable) whereas society remains grey(meaning exploited and sad). However, this statement of Karl Marx does not hold true in today’s world because if business tries to exploit the society for maximising the profits, then society will make sure that such business is not allowed to exist with the help of Corporate Governance principals. Corporate Governance concept thus encourage corporate justice, promotes transparency and accountability.

In the second half of post liberalization in around 1996 Corporate Governance saw a presence in the Indian scenario. The term or concept of Corporate Governance was introduced in the year 2000 on the recommendations made by Kumar Mangalam Birla (Chairman of Aditya Birla Group) by way of Clause 49 of Listing Agreement. It again got revised in the year 2006 after following the recommendation of Mr. Narayan Murti (Co-founder of Infosys). Enron scandal which occurred in USA around 2001 and bankruptcy of WorldCom in 2002 caused worldwide turmoil and tension which ushered a new phase where Corporate Governance became a must in almost all countries. Proper Corporate Governance is not possible with regular statutory audits. The companies are also required to obtain certificates relating to the condition of corporate governance and social responsibility from the auditors who are considered as an independent body. For implementation and to oversee Corporate Governance Forensic Audit principals must be applied to regular statutory audits. Integrating accounting, auditing and research skills offers the discipline known as Forensic Accounting. It is the study and interpretation of evidence for the accounting. It is the application of accounting methods to forensic evidence monitoring and processing, typically for investigating and prosecuting criminal acts such as embezzlement or fraud. The history of forensic accounting in the Indian sense goes back to the period of the Mauryas. Kautilya was the first person in his famous work Kautilya Arthashastra to have listed the famous forty forms of fraud or embezzlement.

2. Importance of Corporate Governance and Need for Forensic Accounting:

A good system of corporate governance is important on account of the following:

a) In a company investors and other stakeholders require safety and security from unjust malpractices in terms of corporate reporting and accountability. It has been observed that many companies improper projections, valuations and forecasts to create a profitable picture of the company’s future performance. Thus they raise finances such false projections. Corporate Governance will help to protect investor’s interests and thus install their confidence on the market.
b) Proper Corporate Governance results in timely and adequate solution of investors grievances. Many measures have been taken by RBI and SEBI in this regard but more is needed in the years to come.
c) It will help to set up a standard for Corporate Governance where investors will be gaining confidence in making their investment decisions. Investors prefer to invest in Companies where proper internal controls prevail along with excellent history of Corporate Governance.
d) Countries having strong Corporate Governance principals will be having a more Global Value in terms of attraction foreign investments. It will create a direct relationship between corporate governance and flows of foreign investment which in long run will help in economic development of the country.

e) Countries having strong Corporate Governance such as USA and European countries use Forensic Accounting which ensures a healthy stock market. Activities such as insider trading are also curtailed to ensure true and fair transactions in the market. It will increase the shareholders confidence and protect them from unjust practices. For tackling the problem of insider trading stronger penalties and fines needs to be imposed. Stronger stock market will result in overall growth and prosperity of the country at large in the global ranking and ratings of the countries.

f) Frauds occur when a misstatement is made knowingly by management with the intention to deceive others. Such practice can be made by one or few directors and because of such practice the entire Corporate Governance structure is blamed. Times like this the auditors are blamed as they do not identify the culprits and segregation is not made. This gives rise to the need for Forensic Accounting as a tool to detect the actual culprits in the management and bring justice to the company.

3. What is family controlled business?

A family controlled business generally means a business owned and managed by one or more families. In case of a joint stock company; it refers to a company where majority of the shares are owned by members of a particular family or the Board of Directors comprises mostly of close family members. Thus both the ownership and control both rests with family members. Normally these businesses are formed by private group of people or family members and over time or generations they become one of the giants in the country. Such businesses are found around the world like:

a) LG- which is in its fourth generation of family ownership,
b) NIKE famous sports brand controlled by Knight family,
c) Walmart which started around 1960s controlled by the Walton family
d) DELL IT-company started by Micheal Dell in 1984, etc.
e) In our Indian context also if we count, the list will go on and on; ranging from the Ambani's Reliance Group, Tata Group, Birla Group etc. Family groups in India as well as around the world have always found success because of the fact that they work with certain principals and values, which considers what is better for everyone and not judge things from individual perspectives. They make sure that family ways and dynamics play an important role in molding the ways of the operations of the business, by giving prominence to 'WE' rather than 'ME'.

4. Cases of Corporate Scandals and Frauds in Family Controlled Business:

a) <u>Health South Corporation Scandal (2003)</u>

HealthSouth was an American Company which was incorporated in Birmingham Alabama, in the USA in 22.2.1984. It started as a family private business called AMCARE, INC. founded by Richard M. Scrushy. The new company started its operations with an initial capital between $50,000-$70,000, which very soon transformed to Health South Corporation, later went public. Before the scandal, it was one of the largest publicly traded healthcare company in the USA.

Summary of the Case:

- The CEO of the company Richard M. Scrushy inflated the earnings of the company by $ 1.4 billion to meet the stockholders expectations. He allegedly told accountants to present false transactions to enhance earnings.
- The scandal came into light when the CEO of the company made a huge sale of $ 75 million in the company's stake in a day just before the business announced huge losses, thus the fraud or scandal came under the radar of US Securities and Exchange Commission (SEC).
- The CEO was charged with 36 counts of accounting frauds and sentenced to 7 years imprisonment.

b) Satyam Scandal (2009)

Satyam Computer Services Ltd. was also a family business started by Satyanarayan Raju, father of Ramalinga Raju (main player in scandal), who first began growing grapes on an industrial scale in the region of Hyderabad. By the 1970s, the family's riches allowed it to launch the younger Ramalinga Raju to the United States, where he earned an M.B.A. Coming back to India, Ramalinga Raju took over the leadership of the family business, starting cotton mills and construction business. Then Ramalinga Raju started the information technology business Satyam Computer Services in 1987. The company was a listed public company operating in Indian IT servicdes and back office accounting firm. Corporate governance and fraudulent auditing practices were used by the company to misinterpret the books of accounts and thus the scam or scandal occurred.

Summary of the Case:

- The company misleadingly enhanced the revenue of the corporate by $ 1.5 billion, thus it falsified revenues, revenue and profits margins, cash balances of the company to the extent of 50 billion rupees.
- The fraud was discovered when the founder/ chairman Ramalinga Raju admitted to the fraud by issuing a letter to the company’s board of directors in which details of how the fraud was conducted was mentioned.
- Being a family owned business Ramalinga Raju along with his brother were booked by the court of law by means of breach of trust, plotting or preparing conspiracy plans, cheating and manipulating the books of accounts along with the auditors of the company. However, after initial imprisonment they were released after the CBI was not able to file charges on time.

c) Lehman Brothers Holdings Inc. Scandal (2008)

Lehman was one of the largest global financial services firm or investment banking company. It was founded by ‘German immigrant Henry Lehman in Montgomery, Alabama in 1844’ where the founder started a small general store. Later in 1850, Henry Lehman along with his brothers who were close to him, Emanuel and Mayer, founded Lehman Brothers. Over the years the corporation survived many hardships like the Great Depression in 1930s and the two world wars, Long Term Capital Management collapse and Russian debt default in 1998. Before the collapse of Lehman in 2008, it was a success story for 158 years starting from 1850.in the year 20017 Lehman Brothers was ranked as No.1 in “Most Admired Securities Firm” by Fortune Magazine. With the bankruptcy of Lahman the global markets crashed and Wall Street was in serious crisis. This was considered the largest case of bankruptcy case because as it surpassed previous bankrupt giants such as WorldCom and Enron.

Summary of the Case:

- The company was alleged that it had suppressed $ 50 billion in loans and disguised them as sales.
- The matter came to light when Lehman Brothers allegedly put up for sale bad loans to Cayman Island’s Banks with proper agreement with the bank that such bad loans would be bought back ultimately at some later date. It shaped or created a impression that Lehman Brothers had with it a sum of $50 billion more as liquid cash and $ 50 Billion less in bad assets than what it really had in actual.
- Reports suggest that the suppression was done with the prior knowledge of the executives or board along with the company’s auditors.
- Dow recorded its major one day point loss instantaneously after the news became public, however eventually a $700bn bailout assistance package called “Troubled Asset Relief Program” was prepared by Henry Paulson, 74th US Secretary of the Treasury, and it was approved by Congress after much debate. Ever since the announcement in September 2008, Dow ultimately closed at a new six-year low of 7,552.29 on 20.11.2008, followed by a further drop to 6626 by March of the next year.

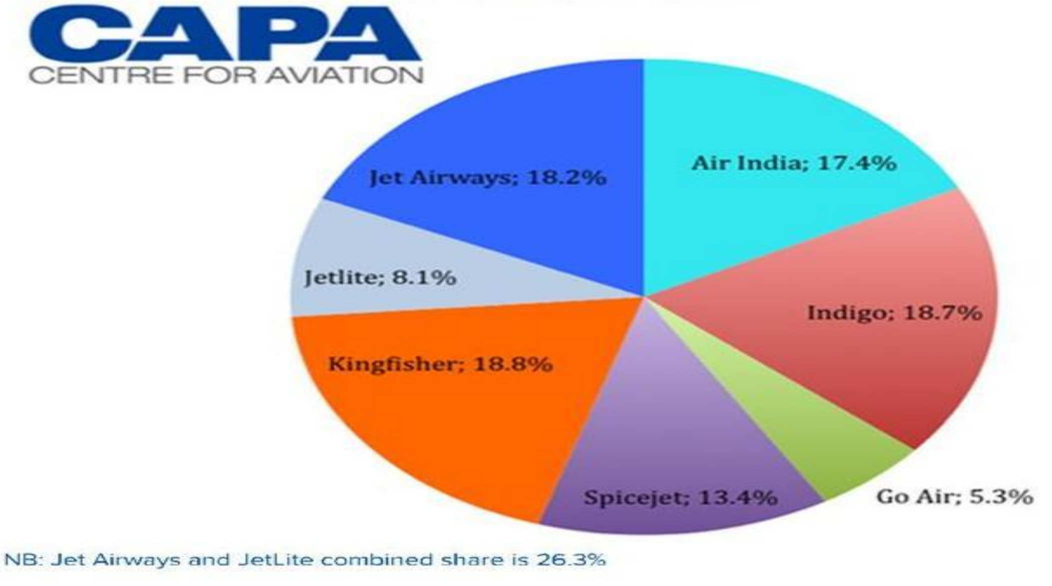
d) Kingfisher Airlines Limited Scandal (2011)

Kingfisher Airlines Limited can be considered as a family controlled because it was promoted by United Breweries Ltd., Vijay Mallya (the chairman), Kingfisher Finvest India Ltd.etc which are all part of Vijay Mallya and his group of Companies. The father of Vijay Mallya i.e. Vittal Mallya can be considered as a pioneer entrepreneur in Indian history. Vittal Mallya started purchasing shares of United Breweries Ltd. in 1946 to 1947 and very soon in 1947 he became the first director of United Breweries Ltd. The business grew over the years in various sectors such as beverages; aviation, investment etc. and his son later took over the reins of the business. Kingfisher Airlines Limited started its operations in India in 2005. Due to various problems in management and improper governance, the company became bankrupt in February, 2011 after incurring huge losses. The summery of the promoter’s shareholding in the company were as follows:

Sl. No.	Name of the Shareholder	Shares held in numbers	Shares held as % of total
1.	United Breweries (Holdings) Ltd.	400,000	0.05
2.	UB International Trading Ltd.	40,000,000	4.95
3.	Vijay Mallya	15,117,321	1.87
4.	UB Overseas Ltd.	13,563,180	1.68
5.	Kingfisher Finvest India Ltd.	2,231	0
Total		**69,082,732**	**8.54**

Source: Author's Compilation (Annual Reports, www.moneycontrol.com)

Indian Airlines domestic market share in August, 2011 before bankruptcy of Kingfisher Airlines was as follows:



Source: CAPA – Centre for Aviation and Indian Ministry of Civil Aviations (www.centreforaviation.com)

Summary of the Case:

- Poor Governance, deficiency of professional management and individual decision making especially by Chairman Vijay Mallya are some of the causes of the company being bankrupt.
- Following the acquisition of Air Deccan, Kingfisher both the company endured a loss of over 1,000 Crore for three successive years. India is a country where people of the country are very sensitive regarding prices of products and services, kingfisher owner Vijay Mallya maintained lofty fares for the airlines and advertisement expenses sky-rocketed. This was the beginning of the end for the company.

- Kingfisher was warned and informed by an official notice from the Airports Authority of India (AAI) in February 2012 mentioning in the notice that total debts of Rs. 2,551 million(US$35 million) has accumulated. It had posted a loss of Rs. 444 Crores in 3 months ended December, 2011 quarter. The revenues took a huge hit, which were down by around 25 per cent and amount of such decline were Rs. 1,342 Crore from Rs. 1,790 Crore. The company had a huge debt of Rs. 6,000 Crore and on such debt huge interest charges were piled up to Rs. 350 Crore from Rs. 340 Crore the year earlier. So by the end of December, 2011 turn-around was out of the question.
- In 2011 December it was estimated that the debts and bank loans outstanding was over Rs. 280 Crores. Further it had huge outstanding taxes and MC Joshi, CBDT chairman broadcasted that legal action against Kingfisher is very much on the cards for outstanding tax dues of almost Rs. 600 Million.
- Outstanding Salaries of employees were enormous and scope of repayment was remote. So the creditors decided to file a petition in Bangalore High Court for winding up of the company. The shares of Kingfisher lost about 67% value in 2011 and the market value reached record low on 11.11.11 to around $213 Million.
- Since 2012 onwards Mallya and his companies one by one came surrounded by controversies and financial scams and Mallya decided to leave India in 2016 and went to UK when pressure from Indian Government to repay the debts started to catch up. All efforts are being made by the Indian Government for his extradition from UK to face charges of financial crimes. As per news network BusinessToday “The ED has said that Mallya is liable for three to seven years of rigorous imprisonment and up to Rs five lakh in fines for cheating over Rs 9,990 crore and laundering the proceeds of crime”.

5. Measures by Indian Government to incorporate Corporate Governance in Family Controlled Business and Forensic Accounting:

In India for the purpose of maintaining a proper Corporate Governance practices in Family Controlled Companies, the Companies Act, 2013 brought in the following provisions:

a) Independent Directors and Women Directors: 'The Act now necessitates at least 1/3rd of the total directors of a listed company to be Independent Directors and have no substantive or pecuniary relationship with the company or related persons. Public companies with paid up share capital exceeding Rs. 10 Crores or turnover exceeding Rs. 100 Crores are statutorily required to have at least 2 directors as Independent Directors’.

b) Corporate Social Responsibility: ‘Every company having net worth of Rs. 500 Crores or more, turnover exceeding Rs. 1000 Crores or net profit of more than Rs. 5 Crores is required to constitute a Corporate Social Responsibility Committee under Section 135 of the Companies Act, 2013 constituting 3 or more directors with at least 1 Independent Director. The committee will be responsible for CSR activities relating to promotion of education, gender equality, health, poverty eradication, environment, employment etc’.

c) Audit Committee: The Act provides for the setting up of an Audit Committee and the members of such a committee must be persons with ability of reading and understanding financial statements and the committee will play a vital role in recommending remuneration and engagement of auditors and reviewing their independence. Apart from creating Audit Committee, it is also mandatory to create Nomination and Remuneration Committee.

d) Serious Fraud Investigation Office: Section 211 of the Act presents that a Serious Fraud Investigation Office (SFIO) is required to be set up, to keep a watch on the affairs of the company and examine incidences of fraud once reports are received from Registrar or Inspector or from any Department of Central or State Government. (Bob Tricker, 2017) mentioned that with these new regulations imposed by Companies Act, many companies are found to be guilty of malpractices or fraud, therefore on such companies Forensic Audit investigations are ordered by the court.

The Companies Act, 2013 measures the following other measures are also to be considered:

a) SEBI Guidelines: The Securities and Exchange Board of India (SEBI) too put forward certain standards on corporate governance including focus to conduct special audit or Forensic Audit, that are binding on all listed companies and those must be adhered by Family Controlled Business.

b) Bifurcation between Business and Family Practices: For the smooth running of the business it is essential to clarify properly the roles of various family members in the business. The objective of the business should be to compete and maximize the wealth on a Global scale and not to have internal fights among members.

c) Leadership: The leadership of the family business should be clearly mentioned and it cannot be challenged on small issues. Further, clear inheritance of the business as well as leadership should be clarified well in advance to all members concerned.

d) Board of Directors: The Board of Directors in a family controlled business should be elected on democratic principles on the basis of qualities and favoritism should not prevail in such appointment.

6. Conclusion

The business and governance of family business needs to evolve with the new generations coming in to take forward the business. Each generation must understand the surrounding society and culture and work accordingly for the welfare of the business as well as the society at large. The future is about smart work, making a right balance between progress of the world and innovation to make the world a better place. Family business should find the right balance to operate in a manner that will use innovation and technology in a sustainable manner for the betterment of the world and thus fulfilling the needs of the society. So if they can find the right balance and proper governance then the possibilities are endless.

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