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# Confounding corporate governance

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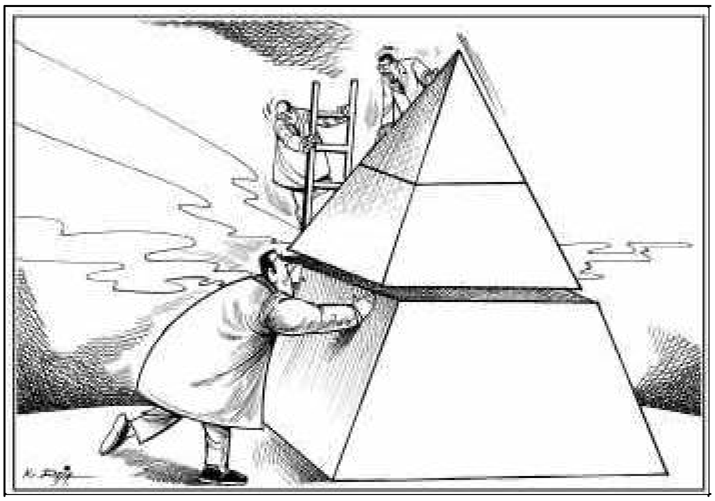

THE recent developments at the Reliance group highlight the opaqueness in Indian corporates. The allegations of movement of funds and a divergence between control and cash flow rights across group companies is at the heart of the corporate governance problem in many Indian business groups.

The pyramidal structure and cross shareholdings enable the promoter family to control firms within the group without necessarily having a significant equity stake. In pyramids, the company at the top, usually the family/founder company, controls companies lower down.

For instance, the company at the top, A, has a 50 per cent holding in subsidiary B. B has a 50 per cent holding in the subsidiary C; and so on.

Although A only has a 3.25 per cent stake in company E (the product of the ownership chain), A is in a position to exercise full control over E, through the vertical chain running through B, C and D.

Cross shareholdings are horizontal equity positions in firms within the group structure that reinforce the controlling shareholder's voting power.

Thus, if A and B are group companies and A takes a 25 per cent stake in B and B a similar stake in A, the control of the promoter is total and absolute.

The important point to note is that with group structures dominated by cross shareholdings and pyramidal structures, the threat of takeover, one of the most effective deterrents against poor corporate governance, is minimal. The promoter family can take decisions to suit its interests since it controls the board and voting rights.

The examples we have cited above are common in Indian business groups — controlling shareholders in Indian business groups typically have small equity investments (that is, cash flow rights).

However, the pyramidal structures and cross shareholdings give them disproportionately large control (that is, voting) rights.

There are both incentives and opportunities for controlling shareholders to expropriate wealth via the transfer of assets and earnings from minority shareholders of firms in which they have low cash flow rights to firms where they have higher cash flow rights.

Academic literature refers to this phenomenon as tunnelling. Thus, in the pyramidal structure discussed, A can transfer funds from E to B and be eligible for a 50 per cent share as against the 3.25 per cent share it would have received had the funds remained with E. A can engage in such activities with the knowledge that it will not be taken to task by the board as it has sufficient control rights and can steer the agenda the way it wants.

Considerable debate has taken place on reforming Indian corporate governance practices in recent times. Various committees have suggested Anglo-Saxon style corporate governance reforms. But such reforms are unlikely to improve the protection of minority shareholders. Despite legal protection, the poor enforcement of such rules ensures that minority shareholders cannot really take the offenders to task, even if they want to. Applying international accounting standards may also not enhance the quality of earnings. There is now considerable evidence that even within US GAAP, with disclosure norms far more stringent than those applicable in India, there are opportunities to manage earnings. When controlling shareholders have low cash flow rights relative to their control rights, the incentive to manage earnings and transfer wealth increases. Arguably, what is needed is a dismantling of pyramidal structures to promote effective governance and transparency of Indian companies.

If the holding company structure promotes ineffective corporate governance, why does it exist? The traditional argument in favour of a holding company structure in a country such as India is that it finances new growth, achieves diversification benefits, and internal monitoring and provides managerial expertise. Harvard Business School professors Krishna Palepu and Tarun Khanna have argued in a series of influential articles in reputed international journals that the holding company structure is effective in developing countries where many of the institutional mechanisms which facilitate market transactions are absent. These mechanisms have to be created internally within the group by vertical integration and diversification. This is easier with cross holdings than with standalone companies. Notwithstanding this argument and without any offence to these scholars, the fact is that instances of the structure being misused are widely reported in the media. Controlling shareholders are more likely than not, to give themselves lavish perquisites, transfer assets and profits on non-market terms across group companies and make sub-optimal investment decisions. Academic research published by Bertrand, Mehta and Mullainathan (2000) has documented that tunnelling does exist.

An even larger issue arising out of pyramidal structures is the difficulty ordinary investors face in distinguishing a good investment from a bad one. This is because the credibility of reported earnings is suspect, given the controlling shareholders' self-interest in the reporting process and their incentives and ability to manage earnings and transfer profits for private gain through related party transactions. Consequently, the reported earnings may be a poor guide to future performance.

To conclude, the complex organisation structures of many Indian business houses are a major impediment to good corporate governance. Mechanical measures such as increasing the number of independent directors on the board will do little to change the state of affairs unless cash flow and control rights are aligned. That calls for dismantling of pyramidal structures.

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