Spillover Effects of Crises in the Independent Director Market

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Independent directorship is an important institution to ensure unbiased decision making and uphold the standards of corporate governance in any jurisdiction. Apart from the limited pecuniary benefits, it also gives an opportunity to independent directors (IDs) to observe functioning of any business at close quarters. In India, some of the corporate scandals in recent years have not only raised the question on the role of independent directors but have also resulted in IDs leaving boards in large numbers, especially after such scandals comes into light.

Since IDs are not privy to the day to day functioning of the company, they rely on the information shared by the promoters and the KMPs which might not be complete or true. Historically there have been instances where IDs were imprisoned or even have to leave the country to evade arrests due to corporate scandals which they were not aware of and leading to reputational risk and making the situation quite scary. This has been addressed to some extent in the Companies Act 2013, which states that IDs cannot be held liable for any violations that the company may have done unless proved that they were party to it or were informed beforehand. This clarification was overdue for quite some time.

The question that arises is; can IDs trust the promoters and the management of the company in sharing material information regarding the functioning of the company in the board room? This is not a simple question as it might not be possible to understand what an ID might be thinking or the intent of various discussions in the boardroom which might not get captured in the minutes in complete and fair manner. Overall, there are lots of unknowns in the board process and the concerns that IDs may have. To analyse this, the author has conducted a study using 'natural experiment' technique[1]. A natural experiment is defined as a natural occurrence that helps to tease out certain unobservable characteristics by observing the effects of that particular occurrence.

The study conducted is based on the well know event of Satyam collapse which was discovered in 2008. Satyam was the 4th largest and well known software company and was also awarded the golden peacock award for its corporate governance. It collapsed overnight when the promoter confessed to huge accounting fraud in the company. The study is an attempt to assess the impact of this event on the IDs of other companies in India. The study also tries to find the risks that IDs run being part of the companies and not absolutely sure that they are getting all the material information on the affairs of the company.

[1] In 2021 the Nobel Prize in Economics was given to David Card, Joshua Angrist and Guido Imbens for using 'natural experiments' to study labour markets

The findings show that the average number of IDs exit (resignations) from July 2007 to Dec 2008 was around 35. There was a massive spike in Jan 2009 and figure jumps to 102 which was the time when the Satyam scandal was discovered. The figure dropped but settles down at a significantly higher level averaging around 70 for Jan 2009 to July 2010 time period. Hence, one major incident makes a whole lot of IDs around the country very uneasy and they start exiting boards. Why was this happening? Were people not aware that accounting scandals can happen? That certainly is not the reason. The Satyam event doesn't mean that accounting scandals have become widespread in the country. This was purely one company event. Why did it led to rise in resignations of IDs? The risks had not gone up, it was always there, but the people's perception of such risks changed as suddenly they were made more aware about them. This change in perception made many IDs to reassess the risks vis-a-vis the benefits and those who were not confident about the promoters intentions decided to resign resulting in the spike in resignations.

The phenomenon is well captured by Nassim Nicholas Taleb in his famous book 'The Black Swan' which says "we learn from repetitions – at the expense of events that have not happened before. Events that are non-repeatable are ignored before their occurrence and overestimated after (for a while). After a Black Swan, people expect it to recur when the odds of that happening have arguably been lowered".

The Satyam scandal was a Black Swan event -unheard of and ignored earlier and hence the immediate and disproportionate reaction even though the probability of similar event was very low. This is how human beings perceive risk; they might not look at it in a statistical manner and just react (most of the times disproportionately).

Literature on accounting failures can be broadly classified into two categories: i. Determinants of accounting failures; managerial incentives, auditors, board composition, detection etc. ii. Outcomes of accounting failures for involved parties; effects on managers, labour market effects for involved directors, stock market reactions etc. The spillover effects on uninvolved parties include effect on financial reporting of other firms, peer firms' investments and most importantly Boards of other firms, which is the subject of the study in this discussion and by far the only study being undertaken in this area for an emerging economy. In an emerging economy, the general impression is that the risk as an independent director is greater compared to developed economies as the other pillars of corporate governance might not be strong enough. In this backdrop, the authors conducted the study to analyse the behaviour of the IDs after the major crisis of Satyam.

According to literature, one of the indicators for probable accounting fraud is higher share of discretionary earnings. The study attempted to find how an ID would react if he is serving in such a company (treatment group) compared to those serving other companies (control group) where discretionary earnings are not as high.

The analysis looked at five features to capture how engaged are the IDs and their reaction around the Satyam collapse; i. ID exits ii. % of IDs in the board iii. % of expert IDs iv. Board meetings held v. Board meeting attendance.

Findings show that after the Satyam collapse, IDs who were engaged in companies with greater risk of accounting manipulations had higher exit rate compared to other companies. IDs in such companies perceived that there is a fair chance that what happened at Satyam could happen in their companies as well and hence they took the decision to exit the board. This exit also resulted in fall in the proportion of IDs in the board of such companies. The study also shows that expert IDs were more likely to leave such firms after the Satyam like event. Two good things that happened after the Satyam event were number of Board meetings went up across boards and the attendance of IDs in board meetings also went up. However, this improvement was only for few months as both the indicators saw downward shift and reverting back after a couple of years. This shows that people walk out of the fear zone after immediate jitters of such events. The other possible reasons for the reversal could be the talks around the amendments in the Companies Act and also the fact that none of the IDs on the Satyam board had to go to prison, which was a strong possibility when the crisis happened.

In nutshell, the study, which is due for publication in an International Journal, is an attempt to answer how much Ids trust the promoters of the companies they are associated with? Do they get more scared when bad news makes headline? Using one indicator, the findings shows that companies with higher probability of such frauds can see IDs leaving boards in such times. However, such events also bring in more discipline in holding board meetings and the attendance.

(The note is based on the talk by the author under the Power Talk series at the Centre for Independent Directors, Indian Institute of Corporate Affairs, on 28th Jan 2022. The findings are based on the study titled "Systemic Impact of Accounting Scandals on Corporate Governance in Emerging Markets: Evidence from India" by KV Subramanian and Rajesh Chakrabarti, which will be published soon)