

Accounting Weakest Link, Says Uday Kotak In A Chat With Anand Mahindra, M Damodaran On Corporate Governance

BQ Desk
[@bloombergquint](#)

Published: Nov 29 2018, 3:53 PM
Last Updated: Nov 29 2018, 9:56 PM

In a year that has witnessed several board failures, from Fortis to IL&FS, noted banker Uday Kotak pointed to accounting as the weakest link.

"One of the weakest links in the fiduciary chain of governance is accounting," said Kotak in a discussion on corporate governance with former Securities and Exchange Board of India Chairman M Damodaran and Mahindra Group Chairman Anand Mahindra.

Kotak is the vice-chairman and managing director of Kotak Mahindra Bank Ltd., among India's top banks by market capitalisation. Recently he also chaired a corporate governance committee constituted by market regulator SEBI.



The discussion among the three, held at a conference hosted by Damodaran and titled *Gatekeepers of Governance*, touched upon critical issues of corporate governance, namely:

- Declining trust in business/companies
- Complying with both the letter and the spirit of the law
- The role of boards and independent directors
- Accounting practices and auditors
- Accountability of regulators



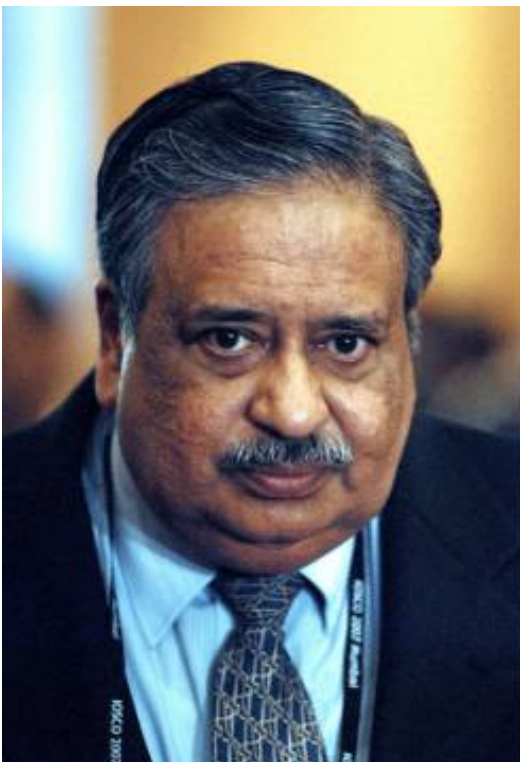
I will use a tennis analogy. In the early days of my career, I was very comfortable hitting the ball on the line. I've now come to the view that make sure you hit the ball inside the line because if it hits the line, you have an umpire who decides if it is inside or outside the line and god forbid, if the umpire decides its outside the line, then you're in trouble. Work towards following the rules, but hit the ball clearly inside the line and don't take the risk of even trying to hit on the line.

Uday Kotak
CEO, Kotak Mahindra Bank



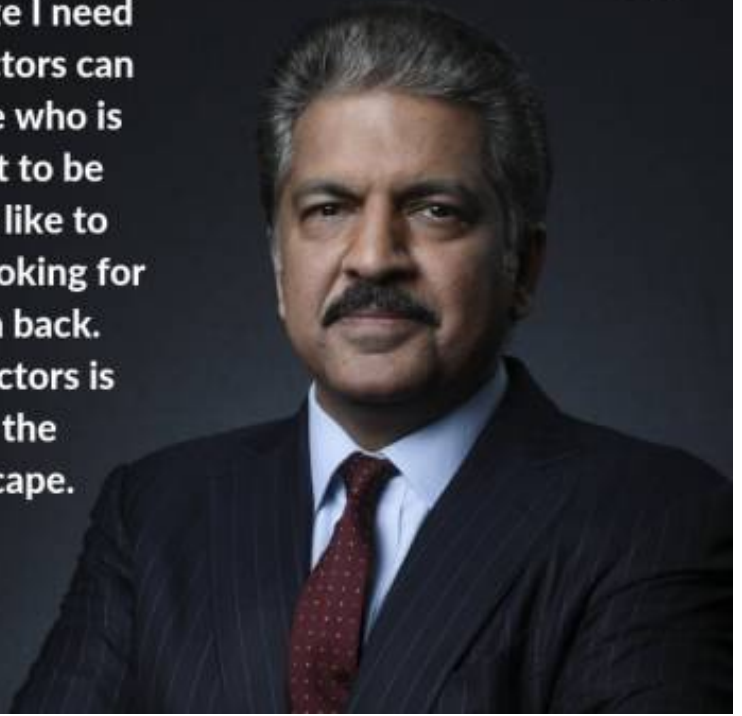
- **How are regulators appointed? You find someone who seems to be doing nothing much that somebody else cannot do, so put him/her as a regulator.**
- **Regulators are not directly accountable to the parliament' they're accountable through a ministry which takes the slack if something goes wrong.**
- **In occasional appearances before parliamentary committees, you can manage by being articulate and running out the clock.**

M Damodaran
Former Chairman, SEBI



I tend to be adventurous. I recognize I need curbing and only independent directors can do that. I don't want to be someone who is so balanced internally that I turn out to be boring and don't take risks. I would like to keep taking risks. I'd like to keep looking for things to do and I'd like you to push back. The institution of independent directors is probably the strongest keystone in the whole corporate governance landscape.

Anand Mahindra
Chairman, Mahindra & Mahindra



Watch the full discussion here.

Uday Kotak In A Chat With Anand Mahindra, M Damodaran On Corporate ...



Read the edited transcript of the conversation here.

Damodaran: Is life getting increasingly prescriptive in corporate space?

Anand Mahindra: I was a little concerned when you described me as people for whom there was very little disconnect between thought and word. I was trying to

imagine that could also describe the current President of U.S. So, I am not sure this is a compliment at all. I make sure that there is good disconnect at least in time between thought and word.

There used to be an old saying in License Raj that for every action, there is equal and opposite government program. Some time you wake up and get that sense. Are people forgetting that what you are trying to regulate is business? One of the most articulate practitioner of business George Dorio who invented American venture capitalism. He used to say that your job is not to eliminate risk but to eliminate unwarranted risk. The more risk you take the more reward you get. Risk is a very integral element of entire capitalist system. It is not the prescriptiveness, the sheer proliferation of regulations that almost seem to be designed to eliminate risk. The fine line we have to walk is to ensure that everything we are doing, and I don't mind being prescriptive, regulations are meant to be prescriptive. Just the question of plethora of regulations. How do we decide that we are getting to a point where we are creating bureaucrats and process followers and eliminating risk and therefore eliminating vital ingredient of what constitutes business enterprise? Forget India, we have seen drama in U.S. with Elon Musk. It was prescriptive, something which reined in him. Most people agreed that he needed to be reined in. Smoking pot in a radio show and talking policy after it does sound excessive. Musk represents the vibrancy of capitalism, vibrancy of vision of taking risk. His persona is based on taking risk. How do you measure when the risk has been eliminated and capitalism has been quelled as oppose to being regulated and curbed? For it, we don't have an answer yet.

Damodaran: Did you get sense of discomfort when you lead the company that the entire committee system was trying to create a narrow path in which you cannot tell people to take risks?

Uday Kotak: I want to start with something which I was told as a grandchild by my grandfather. He said that in life there are two kinds of rules—God made rules and man-made rules. Never break the god made rules. Be ready to question man-made rules. This is the philosophy at the heart of the issue between form and

substance. We are dealing with a society which with an intent to control or manage substance has moved significantly in direction of rules versus principles.

The reason for it goes back, in financial sector, to global financial crises which happened in 2007-08. If you see the whole area of evolution of regulation and supervision pre-2008, it was on principles. What we saw on 2008 in financial markets is a race to the bottom. Inevitably, bank A versus bank B. Bank A which followed principles and bank B saying let me push the envelope on principles. Bank A lost out and you saw an inevitable race to bottom leading to the global financial crises. There has been shift in the whole journey of regulation, more towards rule-based philosophy than just the principle-based philosophy. This is a fundamental shift we are seeing in last decade. In U.K., the FSA was separated from Bank of England. The whole pre-2008 narrative was very different from what we are seeing today.

That brings us to heart of issue of letter versus spirit. We are finding today in world of regulation is when one takes a view that let's follow spirit and the letter is not clear. Therefore you go with spirit and inevitably you get a push back. 'Don't give me this spirit business, this is the rule, have you followed it or not and you get a slap back'. If you take a view based on spirit, you run into problem.

Therefore, even if spirit is a question mark on a particular rule, you then say I have no ability to question spirit and let me at least follow the rule. We are living in the world which is going through transition in a way from principles to rules. There may be spirit behind the letter, but people forget the spirit and letter remains. And we have to deal with this.

In the world of corporate governance, the challenge which we face is measurement of rules. In tennis analogy, in the early days of my career I was very comfortable hitting the ball on the line which means it is still inside and valid. I have come to view that make sure you hit the ball inside the line. Because if it hits the line, then you have an umpire who decides whether it is outside or inside. God forbid, if the umpire says it is outside then you are in deep trouble. The fundamental philosophic change which I have moved towards is make sure t



come what may but make sure to follow the rules but hit the ball clearly inside the line and don't take risk of even trying to hit on the line.

Mahindra: Do you think that by hitting inside the line you would have taken less risk than you would have and gone some opportunities to grow?

Damodaran: The increasing margin of safety leads to sub-optimal results.

Kotak: It is debatable question. The risk of umpire saying you hit outside the line are much greater including the reputational risk than hitting inside the line. When you are looking at risk, there is reputational risk. In a 24/7 media, you are first hung in the court of media well before you go out into real world.

Mahindra: Unfortunately, like John McEnroe, you can't beat up the umpire either.

Damodaran: You can't even abuse your racket, forget abusing the umpire.

Damodaran: Post 2008, our regulators worldwide, in order to prove that they belong they are relevant and what they do is legitimate are pushing the envelope?

Kotak: The regulators are also grappling with this. For every good story, there are half a dozen stories which are a problem. I can relate to current financial sector in India. You ask where the system draws the line. If you see six layers of checks, the first layer is management. The second layer is board. Third layer is shareholders, particularly the institutional shareholders. Fourth layers are auditors. Fifth layer for leverage financial institutions are rating agencies. Sixth layer is regulator and supervisor. We are seeing a number of situations where in world of markets where there are minority shareholders, these six layers of checks and balances need to be working. We are finding situations where you question whether some or all these layers are not doing their fiduciary job. How do you work to a situation where finally the blame comes on policy makers when all 5-6 layers fail? And the reaction of public where money is at risk. It is a backlash. There is societal backlash. Social media has changed the parameters of B2B and B2C communication where B2C has very little understanding of reality. You can see things getting out of control. Regulators therefore had to meet this challenge being responsible.

Mahindra: We have seen failure of many of these layers, whether it is rating agency in 2008 and recently rating agency in case of IL&FS. Do you think the regulators are overreaching right now?

Damodaran: Let me address two other issues. One is how are regulators appointed? You find someone that is available who seems to be doing nothing much that somebody else cannot do and put him/her as a regulator. The regulator is not directly accountable to Parliament. They are accountable through a ministry which takes the flak if regulation goes wrong. Occasionally, we appear before a parliamentary committee and if you are sufficiently articulate you can put across worst of cases and keep looking at the clock and saying its lunch time. There are friendly parliamentarians in committees who have to take their diabetes shots in time before lunch and therefore the meeting comes to an end. I've tried this successfully.

Two is you question why are regulators being increasingly prescriptive? Regulators always play black pieces. You don't have which like in the real world who runs ahead of thief. You wait for something to go wrong and then respond. Unfortunately, instead of looking at rules and laws available to you, your first instinct is trying to write a new regulation thinking that no existing regulation addresses it. You have whole body of regulation. Some of it is restating some of the existing regulation.

For example, whenever the murder takes place no one says amend the IPC. Go after the guy, collect evidence and hang him. But when Satyam happened, even corporate India said we need to amend the laws. Satyam didn't need any amendment of laws. The existing laws were enough to deal with it.

My worry, as somebody who is being three years in regulation, is that regulator should not have a disconnect with regulated universe. Anyone who has been regulated is better candidate. You know what is practical, pragmatic and what needs to be done. You don't need a sledge hammer to go after a fly because people notice sledge hammers and say this guy is very active. You guy after a fly, you don't need a sledgehammer. Regulators need to step back, look at regulatory assessment which is critical, and we all talk about it. Before you write a new

regulation, you look what the impact is, do you need it? All regulation comes at a cost. It is the beneficiary of regulator who picks up the tab at the end of day. So, you need to see the cost benefit analysis for that person before you write a fresh regulation. I think a philosophical problem is that All of this is based on distress of business. You believe that if there was no regulator, the businessman will do something wrong to enrich himself unjustly. Unfortunately, it is starting point of all of this. So, we set up the six layers. Will we ever get to a situation of trust but verify instead of distrust and crucify? We are in distress and crucify. When we will move to trust but verify?

Mahindra: You put a finger on point which is not only a corporate problem but a problem of mindset for Indian society. We grew up at a time when there was enormous mistrust of business not simply by governance or regulators but by society in general. The names of three largest industrial houses was synonymous to kind of abuse. Or to call someone a baniya was an insult in the old days. Then of course, people wanted their daughters to marry an IAS or IPS and not businessmen.

Post the IT boom that refreshingly started changing and we started getting iconic heroes from business and liberalisation came along is improved during the dot-com boom. So, people wanted to marry their children to marry someone who had created a unicorn. Even around world and India, there are spectacular business failures and due to ethical reasons, it set the clock back.

I don't have an answer to this. As businesses, we have to be vocal. We have to come out and showcase success stories where people have done business right way. Uday's market cap overtook Maruti's and I tweeted that I am proud of you because you achieved it in the right way. I did it because I don't think there are enough stories which are role models because it is not about changing government perception but societal perception where in India we have slipped back. Businessmen have come down few notches. We need to work back on it and then we will take time. There is no quick fix to this. I do believe that there is this problem. There has to be constructive sense of dissatisfaction between the executive and board of independent shareholders. Constructive sense of

dissatisfaction is not constructive sense of distrust. Constructive dissatisfaction as opposed to distrust is what we should try to engineer at board level. The societal change will take a longer time.

Kotak: I believe the society has gone the other way and become even more intrusive than the past. I was recently wanting to have a confidential discussion with a friend. I asked him why you don't come to office. He said that I won't come as from your lobby upwards there will be cameras. Why don't we have them? There is intrusion, privacy, we need to record everything, something funny will happen. We have created a mindset which has become less trustful of the societal aspect. We are not comfortable talking freely on mobile phone and we switch to WhatsApp. Why is that? There is something which has fundamentally changed in society. The informal contact as how we communicate, deal with each other has undergone a structural change. Maybe digital age and number of other aspects are responsible. Maybe liberal civil society is giving broader needs of economy and country where a little bit of intrusion into what we call as old fashion way of doing things is undergoing a fundamental change. We have to ask ourselves where do we want to be.

Damodaran: One of the instrumentality for businessmen to behave was the independent director. You have a lot of people who supposedly were the good guys and girls who came into the boardroom and ensured everyone else stayed on course. Asked the right questions and tried to instill a sense of justice. Over time it has been found, they were found to be reportedly sleeping on the job. Other cases they were awake but were unaware of the things happening around them. Therefore, some have described the institution of the independent directors, especially the sub-component of retired civil servants, as their only skill they bring is the ability to open doors in Delhi. We have been equated to be doorman. It is better to be doorman than doormat. Do you find any justification in having this institution of independent directors, attaching so much importance to it, having such great expectations from people who come in for board meetings and disappear from there and only to resurface after one quarter?



Mahindra: The value of independent directors cannot be overstated. You said regulators should be practitioners. I fear if you get business people to be regulators then they come with a lot of baggage. They come with their own biases, failures, experience of obstacles they had and sometimes it leads to agendas as opposed to somebody who has had distance from it. You have to have somebody who is familiar with the field and studied it, who have intelligent enough to be objective and have wide perspective. I am not sure you want somebody who is a practitioner bringing the baggage of their experience.

In independent directors, there is value from a spectrum of people. Even who are not business people, somebody who is in public policy has had huge input on our board talking about risk of taking business into a country. We are getting into a country in Europe with a political risk and that person was very uncomfortable and brought a view about leader of that country and risk that it entails which pushed us back rightfully.

I tend to be adventurous. I tend to be on a track that hasn't been on before. I recognise I need curbing and to question and challenge. Only independent directors do that. You have to be willing to be challenged, curbed but I don't see it as negative. I want to remain somebody who takes risk. I don't want to be so balanced internally that I turn out to be boring and don't take risk. Institutional independent directors is the strongest keystone in corporate governance landscape.

Damodaran: We are being told that there are directors on bank boards that cannot read balance sheets.

Kotak: I would like to add that in some cases, there are managements who cannot read balance sheets. There are three categories on a board. One is whole-time directors which by very nature are non-independent. Second is non-executive directors who may not be independent. Third is non-executive directors who is independent. Board will have, in some shape or form, all these categories.

The role of management is to run and execute and come out with a whole business strategy and everything else. The role of board is to challenge it and govern it.

There are time when there can be potential issues between management position

in their capacity as management and role as a board. There is fundamental risk in that situation. That is the reason why you have non-executive directors. Technically under law, everybody has fiduciary responsibility. It is the same responsibility across the board. The knowledge, ability to add value would be a non-executive director whether independent or non-independent. Non-independent is linked to some peculiarly or other relationship which make them non-executive and non-independent. They could be adding as much or more value inputs from the point of view of knowledge and skill. They need to be aware of their potential conflicts. So, the institution of independent directors is to be aware of and protect the minority shareholder community which has no say, especially in Indian society today, from the potential conflicts from one management versus governance, second is conflict between non-executive director non-independent versus independent. Therefore, many independent directors have a role of knowledge, scale, input. Second, like a check that should there be a conflict. Are the non-independents ensuring that the minority shareholder interests are taken care of?

We are seeing as an evolution is a dangerous potentially, coming from a regulatory mindset, of creating almost a combative position between independents or non-independents. While we recognise the role of independent directors as an institution, we have to be careful where we don't push it to level where it is two sides of battle zone. That is where the regulatory framework should be careful of not pushing it above and over that edge.

Damodaran: Independent directors gang up and become the opposition party in board room. Is that a fear you have?

Kotak: It is a risk. Companies Act 2013 is often referred to as the Satyam Law as it is a new law came after Satyam. The new law protected independent directors and gave more immunity to matters which had not come up to board, which was not available earlier to independent directors. In Satyam, independent directors said that this never came up before and then how are we supposed to know. So, the law has given greater protection for independent directors compared to non-independent directors' post-2013. If you take spirit of law and if they have been

given more protection by very logic it should reduce the combativeness between independents and non-independents. There is a sense of better immunity which has not come up. However, the moment you have a problem which is potential fraud or a scam, the kind of public layer which is there today requires the regulator and enforcement agencies to show some action. I believe that we must give a lot more support to regulators. Their job is extremely tough, it is relatively easy for us but speed at which media and social media is happening and the accountability which is expected from regulatory class of not having acted. And then you see this whole new trend which is also leading to extreme positions, where about how the safest heaven is now being London. It is deeper society question. Why do people not want to be prosecuted for action against in India? The belief is that the law may not be fair, then you get back deeper into society which is leading to this opposite position.

Damodaran: The regulators have one advantage—in the afterlife when you're trying to get to heaven there are two queues there. The longer queue says you have to go to hell first qualify there and then come here. The other is for regulators and vice chancellors. Because they've seen hell already.

Mahindra: The combativeness has become an axiomatic thing. People assume independent directors as watchdogs. So, they ask what you were doing when this happened. The perception is that they have been put there for oversight over the non-independent directors and executives. What about if we say that is fine. They are there to challenge back but the ultimate goal of board is to build a business. Why can't independent directors be held accountable for a business not working? I am not talking failure or fraud. I am talking about if the business is not performing, why should only I be held accountable? Independent directors completely go out of the line of fire when performance is being demanded or we are held accountable. The moment we say that they are there to challenge but they are there to challenge constructively to help build a business, but we will have to hold them accountable if company doesn't grow. That might bring people from one side of table to another and say we are all in this together. Our first goal is to make this business grow. Process of constructive dissatisfaction has one goal

—not to check each other but make the business grow in right way. If we can bring that mindset then it will be very healthy.

Kotak: It is one big debate which is not taking place in India which is very different practice from globally is skin in game for independent directors. Globally, it is an accepted practice that independent directors can be eligible for ESOPs and stock options. Indian mindset has gone to a different level and I don't think it is easy to change it where the feeling is that there will be collusiveness if things like this are allowed. Part of combativeness is that the system and macro-system is ready to allow alignment of interest between non-executive and independent directors versus so called promoters and management.

Mahindra: Lot of our independent directors had ESOPs. Was that under your purview of committee?

Kotak: It was clear from a regulatory framework point of view that this is the area that we should not be seriously tread on. Under Companies Act too, independent directors are not allowed to.

Damodaran: The Parliamentary committee, they persuaded that this will lead to short termism, even though they forgot that there was a way to address it which is that you don't trade the stocks till you left the board. May keeps a cooling off period after you leave. Then alone you can operate but until then you block it. To the protection for independent directors, the Section 149 (12) doesn't travel far enough. Everybody is responsible for business. In this big act, there is only one subsection which says that all directors are responsible for the interest of company. You will not find any article in media discussing it. You have otherwise well-informed people saying that independent directors exist for minority shareholders and they don't have to do anything with rest of business which is the wrong way to go.

Damodaran: Are auditors doing enough?

Mahindra: We have been very fortunate in the Mahindra group to have not only good firms as auditors over the years. Even in continuing basis, not just the but partners who have been handling the Mahindra account have been

exceptional individuals. That has helped a lot. The person who was the partner at M&M, I use to understand the arcane elements of accounting and auditing from that person. When you have mutual respect with an auditor as opposed to combativeness, I think it is very potent combination. It helped tremendously. It educated me and made me understand what degrees of freedom we had in terms of accounting and results. Of course, if the auditor comes in initially with distrust of that group or the person leading the board then that is recipe for disaster. It is not recipe of constructive learning on both sides.

Kotak: I'll take a different view. One of the weakest links in fiduciary chain of governance is accounting. We are finding that this situation is leading significant issues for many listed companies in equity and debt markets. The question you ask is how do you address this fundamental conflict of interest? I think it is being addressed now by the government between the auditing profession being under ICAI and also regulating itself. There is an inherent conflict of interest which is now being addressed by the new body which is NFRA which will be independent regulator of accounting fraternity. As the PM has said, the signature of auditor is so important especially for entire body of markets and minority shareholders. As we in financial sector deal with markets and if we want to move much more market-based, we have to rely on that signature. There have been significant questions on that reliability of that signature.

BloombergQuint

Stay Updated With [Law & Policy News On BloombergQuint](#)

More On This Topic



Accounting Weakest Link, Says Uday Kotak In A Chat With Anand Mahindra, M Damodaran On Corporate Governance

November 29 2018, 3:53 PM



Call For A Paradigm Shift

October 08 2018, 5:40 PM