

Project Dissertation Report on
LINKING CORPORATE GOVERNANCE ISSUES
TO THE SYSTEM FRAMEWORK

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DECLARATION

I Vishnu M., student of MBA 2016-18, of Delhi School of Management, Delhi Technological University, Bawana Road, Delhi-42, declare that the Project Dissertation Report on 'Linking Corporate Governance Issues To The System Framework', submitted in partial fulfilment of Degree of Masters of Business Administration, is the original work conducted by me.

The information and data given in the report is authentic to the best of my knowledge.

This report is not being submitted to any other University for award of any other Degree, Diploma and Fellowship.

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Place:

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CERTIFICATE FROM THE INSTITUTE

This is to certify that the Project Dissertation Report titled 'Linking Corporate Governance Issues To The System Framework', is a bona fide work carried out by Mr. Vishnu M., of MBA 2016-18 and submitted to Delhi School of Management, Delhi Technological University, Bawana Road, Delhi-42 in partial fulfilment of the requirement for the award of the Degree of Masters of Business Administration.

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EXECUTIVE SUMMARY

Each passing year, we find that the corporate governance issues has been increasing. The degree and severity of the crimes committed are also reaching new highs. So, the question arises what has changed that suddenly such incidents should rise. Surely, there must have been a big change in the business landscape. Since the beginning of the industrial age, ethics and mutual trust were highly valued. Fudging figures, making exaggerated claims were few and far between. Nowadays, business leaders who were considered as visionaries and thought leaders by the world are embroiled in the greatest scandals along with the organizations that they founded or were a part of.

This study endeavors to find out the root cause(s) behind such behaviors and crimes, also outline the common symptoms and their outcomes that happens during the downfall. A correct understanding of the present system and the system's framework is a necessity to find why these occur. First, we analyze the economic system in which the business operates and then we link how that system affects one's psychology. An effort is also made to identify the type of people that can succeed in the modern economic system. With this, we can say that the corporate governance issues we are facing today are an outcome of the system, i.e. it is a system result.

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1 INTRODUCTION

The focus of mankind shifted to science and new inventions since the Renaissance. Then, the question arose of how to exploit the resources for the benefit of fellow man. Around the same time mankind especially Europeans became adventurous and set on sail to map out and establish colonies across the world. Much of it was motivated by the devastating mini ice age preceded by the Great Plague. With the help of science, mankind could finally have answers to a lot of questions that troubled him and also invent new devices that will great enhance his earthly life.

For the first time in human history, mankind started using machines made of wood and metals to get the same work done quickly and efficiently with less cost. Soon mankind understood that they could attain better standards of living for themselves since the reductions were so significant that it had a dramatic effect on prices. A greater percentage of humans can now enjoy what was formerly reserved for a tiny percentage.

Around the same time great changes were happening in the world of finance and international trade. Gold and Silver were traditionally used as national currencies and for international trade. With the advent of printing presses came paper money. Bankers & aristocrats instinctively understood that a paper currency was a much better form of money than precious metals and more suitable for international trade.

Another seminal event was the rise of corporations which allowed those with lack of capital to fund their business with other's money. If a corporation succeeds both the inventor as well as the investors profits heavily. Other consequences were capital instead of lying around was now being used for productive purposes, economies of scale allowed goods to be produced cheaply and efficiently thus benefitting more people. The employment prospects resulted in the financial and social upliftment of many ushering in unheard of prosperity.

These events had some unforeseen consequences, the effects of which we are now witnessing. Bankers, aristocrats seeing the rapid growth around them felt that it will

continue forever. Hence they invented fractional reserve banking which requires perpetual growth or the system falters. Since most of the world was undeveloped the system worked beautifully. Another problem with the system was that it pushes everyone to work to meet the growth targets. It must be remembered that we live in a finite world, so infinite growth is not possible.

The monetary system hence can be compared to a Ponzi scheme as there is a disconnection between the resources that the system represents and the system itself. The system turns everyone greedy. During the same time, there was huge deforestation across the planet and natural flora and fauna were replaced with factories and buildings. The result of this global warming, pollution and climate change.

As the system reaches its limits i.e. the underlying resources are exhausted there will be more and more desperation at the top to maintain the façade of growth which is now impossible. Hence, there was a huge increase in corporate governance issues and all this can be tied back to the system itself.

The original designers never thought about these consequences else they would have corrected the system at the beginning itself. The growth and overall prosperity led them to believe they have done everything right. There were numerous opportunities to correct the system though no one took the initiative. At this point, maybe it is too late. The thought leaders and senior management executives have understood the mistakes of their predecessors and took small but correct steps to undo the problem.

They emphasized more focus on sustainability, corporate governance, corporate social responsibility and climate change. They also recognized how competition between individuals and teams can be ultimately harmful for the corporation thus focusing more on employee well-being and teamwork. Some organizations turned their offices into an informal place instead of the traditional cubicle design.

But the underlying issues still remain.

1.1 OBJECTIVES

There are multiple objectives with this study:

1. Elucidate and elaborate the System framework.
2. Understand the issues behind the rise of sustainability, corporate governance and corporate social responsibility.
3. Show that extinction is a system result.
4. Also show that Capitalism requires war.
5. Show that the increase in corporate governance issues since the beginning of this century is a result of the system framework.
6. Use popular corporate governance cases to confirm the hypothesis.
7. Link the issues in such cases to the system framework.

2 LITERATURE REVIEW

To conduct the research, an extensive review of existing literature was undertaken. It consisted of going over the writings of prominent intellectuals of the past and the modern time, studying economic and monetary history, studying academic research papers of world's leading economists, white papers and keynote speeches by important members of world's central banks, IMF, BIS & World Bank. Since Europe was where the Renaissance and as well as exploration began, an in-depth study of European history was undertaken with a special focus on the period from the Dark Ages to the present.

Since most of the ills of the present system can be traced back to the monetary system, it was a necessary to undertake a study of history of money. The review started with analysis of origins of money i.e. how the concept of money arose from barter and initial system of using money. Then to the Roman Empire where an extensive analysis of the complete history including the disintegration of Roman Empire was undertaken. Also, analysis of the coinage, subsequent debasing and taxation and the effect it had on the citizens of the Roman Empire.

Paper currency was invented in China. It was extremely important to analyze China's history and to come up with what lead to the widespread adoption of the paper currency and a transition away from Gold & Silver. Since, Renaissance Europe had taken the center stage and became the center of invention and innovation. Modern day central banking was established in Europe first as Bank of Amsterdam in 1601 followed by the most famous and still extremely important financial institution the Bank of England (BoE) in 1694.

From here on, the study of literature does not lead to straight answers but one has to analyze and contemplate over why a group of men chose to pursue the said path. This was also the period where various kingdoms started exploring the world and when the concept of reserve currency came into being. Also, at this we could witness the beginning of industrial revolution and capitalism.

Das Capital by Karl Marx & Wealth of Nations by Adam Smith offers an overview of the period and they try to reveal the mindsets of the prominent wealthy people and aristocrats of that time period. Still, the understanding of capitalism was not perfect. Considering the Occupy Wall Street movement at the beginning of this decade, a study of the French economic situation before the French Revolution was also undertaken. Various books were read on French foreign expeditions and conquests & its economic impact and its impact on the citizens of France to understand the reasons behind Occupy Wall Street movement.

Another problem was that from the Middle-Ages to the present, Europe had a tumultuous history. The same can be said for America since the American independence in 1776. All the nations of the West were involved in wars (domestic or foreign) or underwent revolutions. The impact this had on trade and the system level decisions will turn out to be very important. Most of the explorations and wars conducted since then was a way to either secure the empire or to ensure that collapse does not happen domestically i.e. the wars were actually fought for resources.

The key resource which radically changed the way I approached this research came from an unexpected place. A book by Matthew Simmons, "Twilight in the Desert" actually filled in the missing pieces and revealed the hidden disconnect which is fundamental in its effects it has on society.

Seeing the raft of scandals in the corporate world each one worse than the previous a study of corporate governance was undertaken. It involved going over the high profile scandals, what were the lessons learnt and what all laws were enacted to prevent similar such cases in the future. Key to this was the study of Sarbanes-Oxley Act, 2002 and Companies Act 2013 which is loosely based on the former.

Some of the high profiles cases that were studied included Enron, WorldCom, Parmalat, Rajat Gupta insider trading scandal, Ramalingam Raju and the downfall of Satyam and the recent ones Vijay Mallya Kingfisher case, Nirav Modi and Mehul Choksi case.

An in-depth study of these cases were undertaken and many conclusions were drawn from the same.

3 RESEARCH METHODOLOGY

The research methodology consisted of exploratory research and mainly relied on secondary research techniques. The research required that the entire system be clearly understood and modelled before proceeding further. To do this required extensive reading of the monetary system. There were many reasons for that chiefly being trade is fundamental to humans and can be seen as a part of transactions. Initially trade was conducted through barter and then we started using money which is a representation of our labor. A simple conclusion can be drawn that if we corrupt money, we can corrupt the society in unforeseen ways.

Secondly, a study of the history spanning across millennia was done. Only a specific area of the entire history was studied and it concerned the cultural, economic and political aspects. Conclusions were drawn which remain still valid to this day. An extensive and comprehensive study of the Middle Ages was also done this time focusing on everything instead of some aspects. The reason was all the modern systems are fundamentally connected to the Middle Ages and the events that happened around the same time period across the world.

Then a history of corporations and the modern international business was studied. The period consisted of from the beginning of Industrial Age to the present. The real importance of the industrial revolution lay in harnessing exogenous energy resources to apply vast leverage to the economy. Also, studied were the phenomena of globalization, offshoring and outsourcing and its short term and long term impacts on societies.

All along the resources which we must exploit and use and without which the whole system breaks down was not factored in. A study of resources and their present condition was undertaken. The study was concerned the amount of each critical resources used and remaining, historical and future cost of exploration and extraction of said resources and how the resources are linked to the system.

This lead to a startling conclusion. The economy is a surplus energy equation, not a monetary one, and growth in output (and in the global population) since the Industrial Revolution has resulted from the harnessing of ever-greater quantities of energy. But the critical relationship between energy production and the energy cost of extraction is now deteriorating so rapidly that the economy as we have known it for more than two centuries is beginning to unravel.

Then the recent corporate scandals were looked at and the corporate governance issues were identified and what remedies were undertaken (eg: laws) was also noted down.

Important findings from the corporate scandals as well as the system framework were made and startling correlations were observed. It turns out that the scandals were an outcome of the problems with the system not deliberately caused by the perpetrators.

In retrospect, it should have been obvious that such incidents would happen in the future and it is only going to increase as we approach more and more limits of the system.

Empirical research technique was used to draw the insights from the facts. The following corporate governance cases were considered: Satyam, Tata vs Cyrus Mistry, Siemens AG, Nirav Modi & 2008 Global Financial Crisis (GFC).

4 THE FRAMEWORK OF CAPITALISM

The framework was developed by me to understand the behavior of the market especially during the last ten years. It expands upon the definition of Capitalism & also brings to the surface the contradictions hidden in the system. The understanding will also lead to the conclusion that Capitalism cannot exist if the world understood the contradictions. Visionaries & intellectuals like Marx, Adam Smith understood these contradictions very well but never expounded upon them.

4.1 DEFINITION

Capitalism is one of the different types of economic systems and ideologies where the means of production is based on private ownership and the profits belong to them since they operate the said means. Characteristics that are inherent to this system are private property, capital accumulation, wage labor, voluntary exchange, a price system and competitive markets. In such a market economy, owners of the factors of production determine investment and decision-making in financial and capital markets and the prices and the distribution of goods are determined by the competition that is in the market.

It has often been criticized for concentrating power in the hands of a few called as minority capitalist which relies on the exploitation of majority which are the working classes; for prioritizing profit over social good, natural resources and the environment. Capitalism is also criticized for the resulting economic instabilities and inequalities that arose out of it. Those who support this system argue that it provides better products through competition, creates economic growth, yields productivity and prosperity which greatly benefits the world and society as a whole and it is the most efficient system among all when it comes to allocation of resources.

4.2 FINER ASPECTS

4.2.1 Importance of cheap energy & labor

The industrial revolution coincided with cheap energy i.e. with the initial discovery of coal and then later crude oil. It is a common observation that it is very easy to extract a resource at the top and extracting the last portions are always going to be extremely difficult. It was this discovery of cheap energy that allowed the machines to exceed the production of human labor i.e. coal and crude oil initially had a very high Energy Return on Energy Invested (EROEI). The resulting growth and value addition led to the betterment of every person from the lowly worker to the managing director not only in the standard of living but also in their earnings.

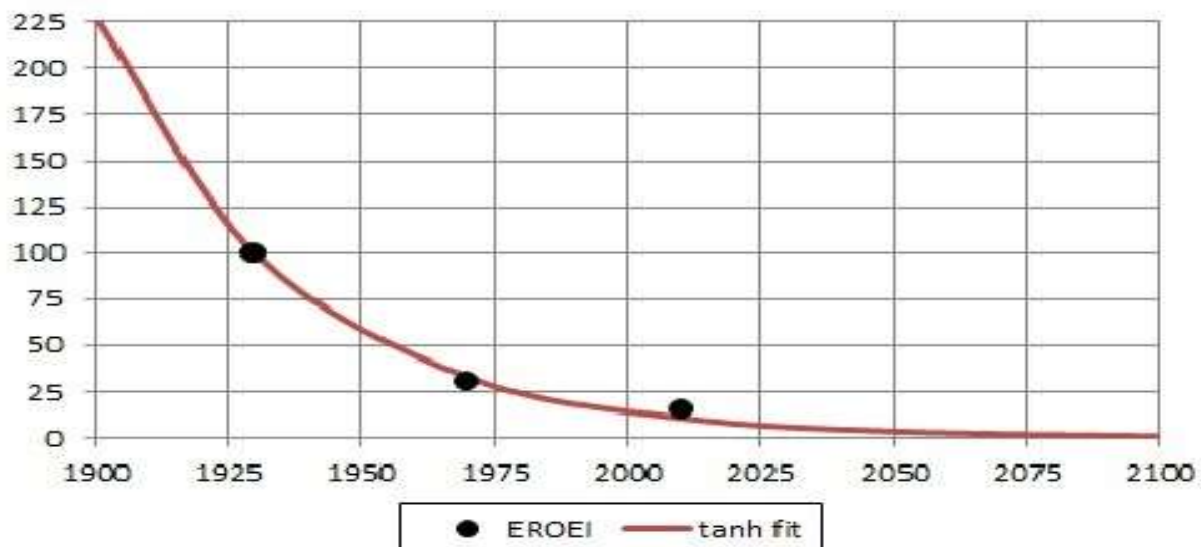


Figure 4.1 EROEI of crude oil.

From Fig 4.1 it can be inferred that prosperity was the result of cheap energy. Inequality started to rise when EROEI started to decline. The rise of globalization was also a result

of the same where the bankers and the industrialists were trying to continue the existing system with cheap labor.

4.2.2 Importance of productivity growth

Most of the business practices were highly inefficient compared to the modern practices yet there were plenty of jobs, wages and profits were very high. When energy was cheap businesses could continue with inefficient processes but energy i.e. net energy delivered to the economy becoming expensive, businesses had no choice but to increase productivity. This was more pronounced in the US since 1971 when US hit peak oil. Then businesses started employing Business Process Reengineering (BPR) & Enterprise Resource Planning (ERP) to boost their productivity. Further, internet and globalization has allowed to further increase productivity. Now, net energy is becoming scarce and the benefit provided by cheap labor has reduced, so businesses are now focusing on AI, Machine Learning (ML) & Robotics so as to completely remove labor and boost growth. BPR & ERP were first adopted by those countries who had to import most of their raw material.

4.2.3 Demonetization of Gold

Former US President Richard Nixon demonetized Gold on August 15, 1971 and the entire world economy transferred itself to a fiat currency system before transitioning to petrodollar system. The demonetization of Gold coincided exactly with the year US hit peak oil. From this, we can conclude that Money represents energy as well as value addition besides the usual representation of labor. Now, the entire world depends on oil due to the way currency system is structured.

4.2.4 Designers of Capitalism

Renaissance ushered in a host of new inventions which attracted the attention of wealthy individuals and aristocrats who generously contributed to the inventor. This marked the beginning of Capitalism. Towards 1700, world was moving towards central banking and fractional reserve system both of which was of immense benefit to the banks since they did not need to hold the entire deposit in their premises. So, the benefits of capitalism were taken mostly by the bankers, industrialists and aristocrats.

4.3 CONTRADICTIONS

4.3.1 Cost of currency & the free market paradox

One of the benefits that is attributed to Capitalism is free markets yet the cost of currency or the interest rate is set by a committee far removed from the ground realities. Euro can be considered as a perfect example, Germany has benefited the most from Euro while other members of the European Union has suffered declining growth ever since joining EU. In urban areas of India, one can obtain short term loans very quickly at a maximum of 17% interest rate while in rural parts the rate of interest for a similar loan goes up to 25%. Currency being an equally important component of a transaction, the cost of it must be decided locally for the prices of goods itself varies from place to place. For e.g.: a popular food available in every part of Delhi and the majority of the suppliers are street vendors. A plate of the same costs Rs.20/- in Dilshad Garden while it costs Rs.40/- in Munirka. If the same goods cost different in different places & cost difference of the raw material is marginal or negligible then this follows that the rate of interest should also be set or decided by the market as per its need or its ability to make payments.

4.3.2 Perpetual growth & limits to growth

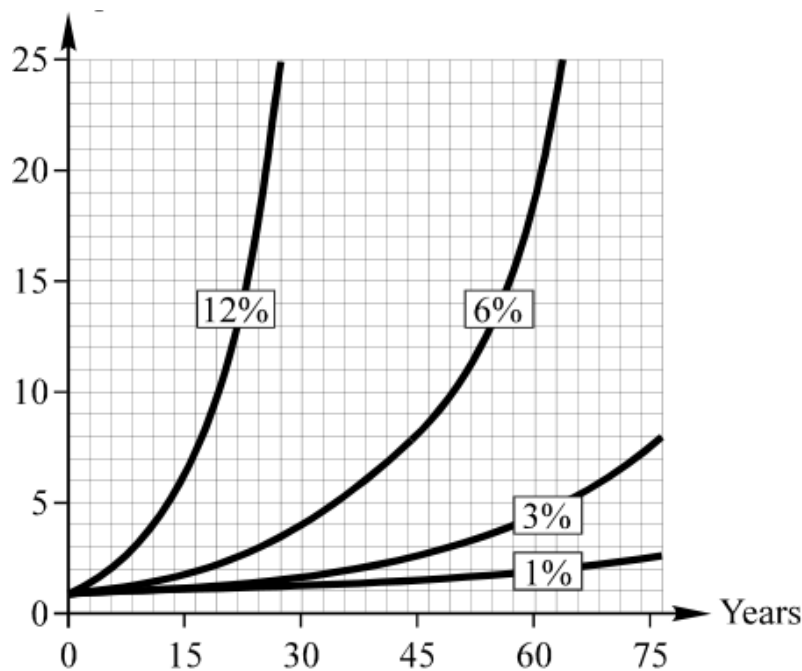


Figure 4.2 Exponential growth curves at various growth rates.

Capitalism requires that the future production or revenue be greater than the present. Most of the business were built on the back of loans taken out by the owners. Since compound interest was levied on the loans, it necessitated the requirement for growth. Fractional reserve banking always leads to inflation, so as to ensure that the purchasing power of the population remains stable, banks gave interest on the deposits and this necessitates that there must be wage growth. Such factors lead to the policy of perpetual growth which is unsustainable in the long run as the above figure illustrates.

Commercial banks can issue currency by creating loans which ends up as a deposit. Through misallocation of capital & malinvestment, they can create cycles of inflation & deflation. In the long run, this can lead to low confidence in the banking system, so a central bank was established who acts as lender of last resort. The system is very fragile. If the growth is not possible, then it must be financed with debt which is happening now due to lack of high quality raw materials.

This growth cannot be sustained in the long run since the Earth itself is finite & the raw materials we need are only available in the crust that too in the land which is only 40% of the total surface. This severely limits the amount of resources available to us. For the system uses resources as collateral to create new loans, leverage it and create more loans. This factor will play a major role in the coming crisis. For e.g.: we are running out of oil which can be verified by the fact that we need to drill holes 10km in the earth to get oil these days and a significant portion of the energy is waster in getting the oil out. Also, Ghawar has a water cut of 46%, so the system is going to be severely tested in the coming decades.

4.4 NEGATIVE INTEREST RATES

Negative interest rates in many parts of the world shows that the age of capitalism is over and the system is trying to extend itself by monetizing debt which will never be paid back. It also shows that capital can no longer be accumulated. Whatever anyone has accumulated till now is one's wealth, it is not possible to create new wealth.

4.5 SUMMARY

Capitalism in its modern form works beautifully as long as we have cheap energy and resources, the moment there is trouble in any of it, it can be hidden temporarily with monetization of debt and once that too runs out the system will collapse upon itself.

5 THE SYSTEM RESULTS

5.1 INTRODUCTION

Having understood the framework of Capitalism, it is now important to use this framework to formulate general outcomes or results which happens due to the nature of the system. This chapter will elaborate upon each of the outcomes.

5.2 EXTINCTION

The system requires perpetual growth while the world only has finite resources. Since the growth is compounded, the need for resources goes up tremendously every year. The system also requires an ever increasing population to maintain consumption growth since the consumption of a single human being is naturally as well as financially will be limited. This results in extinction. As every resource is consumed quickly, we will soon run out of these resources. To keep up with the population growth requires new land which results in deforestation and destruction of flora and fauna and ecological diversity.

5.3 WAR

Art of War by Sun Tzu is a highly recommended book by Larry Ellison, CEO and founder of Oracle. It is a strange book in the corporate world where it is all about out doing the competition in terms of products and innovation, having the largest customer base, the best in terms of revenue and profit. A firm should be looking at these parameters but instead are taking a war approach. Of course this behavior can be extended to the nation state level where the lack of resources have always led to war. Capitalism only

exacerbates these tendencies due to the ever increasing pressure it places upon the resources. Hence, war is a natural outcome. UK can be used as one of the best examples, the country itself is an island nation and lacks any resources in significant quantities and all its wealth were an outcome of ruthless exploitation of other countries i.e. imperialism. And the industrial age began in the UK.

5.4 INEQUALITY

The owners of capital derive a tremendous advantage in this system versus those who lack the same. The owners can use the capital to fund new ventures which can generate exceedingly high returns multiplying their original wealth. Even if they put the money into stock market, they can get tremendous returns of up to 30% under an exceptional fund managers like Steven Cohen, David Tepper or Jim Simmons. Even a decent fund management can ensure good returns of 15%. Others lack such access and opportunities or they will not have any savings. Those who own the means of production especially in an automated world can quickly reap the profits sine the investment will pay for itself in a few years and the rest is profit. So, inequality is inherent to the system.

5.5 WELFARE SYSTEMS

The welfare systems that are in many nations of the world is a direct consequence of the system itself. For the system actively promotes inequality, a first world consumption oriented lifestyle requires such quantities of resources that is not available or will only last a decade at best, so such a lifestyle will be impossible for many. Some will be in so bad shape that they require government aid in the form of welfare. As inflation increases and wages won't keep up, many will become even more dependent on welfare or subsidies as they cannot keep up.

5.6 DIMINISHED PRODUCTIVITY

As the system approaches its limits productivity will be reduced due to the lack of cheap resources or due to rising inflation which is always succeeded by rise in unemployment. Also, wages have been stagnant for the past decade while there is inflation. This means that there will be marginal reduction in demand leading to oversupply and reduction in the industrial output. Europe can be used as an example where there is high unemployment, and zero percent or negative interest rates, the oil consumption has been flat since the debt crisis in 2011 which shows that demand has not picked up.

5.7 GREED

This is a psychological phenomenon but a consequence of the system itself. System requires perpetual growth and also places a heavy constraint on its stakeholders that is they must always make investments to try to stay ahead of inflation so that wealth in real terms increases. The long term effect of this is that the person as well as the society becomes greedy.

5.8 PROMOTES SHORT TERM THINKING

This is an extension of greed and is more applicable to the corporate world where there is relentless pressure on the top management and the board of directors to increase revenue as well as profits YoY and QoQ. Stock performance is directly tied to this. The consequence is that they start focusing on short term results to maximize the profits and revenues for the next quarter ignoring customer needs and expectations when they should be focusing on creating long term value and growth which now takes a backseat.

5.9 COMPETITION & PRESSURE

This is equally applicable to both corporates and the people. Since people spend a significant time of their life working, the work place behavior can influence them and can affect the society at large. The work place actively promotes short term thinking as described above since such behavior will definitely percolate to the lower levels. Further, the desire to obtain the largest raises and quick promotions have the net effect of competing with each other rather than fostering teamwork. Companies have unconsciously recognized since nowadays there is greater focus on employee health and there is a shift away from cubicles to informal work spaces.

5.10 CORRUPTION

Corruption is a made up of three factors and they are excessive greed, questionable ethics and morals and short term thinking. Corruption has become a major issue in the recent decades everywhere. Even German companies like Siemens, Volkswagen which are considered as the gold standard in terms of innovation and ethics have been caught in huge scandals and forced to pay record fines. Laws were designed by the governments primarily keeping the well-being of citizens in mind. The cost of compliance is often too high and cuts significantly into the profits and can cause problems with the shareholders. So, the easy route is to bribe some official and get the work done quickly. The cost is shoddy quality or other damages.

Officials are also eager to accept bribes since it is a fast way to wealth while at the same ignoring their responsibilities to the government, citizens and the nation. Both parties forgets about the purpose of the law, morality and ethical dealing and simply participates for gains.

5.11 ETHICS AND MORALS

This is another result of the system where the relentless drive to stay ahead and achieve objectives quickly can push someone or some entity to forego ethics and morals. If they get away with the crime without any jail or punishment, the severity of the crimes will only increase in the future. To show huge profits, companies stash away their profits in safe havens since repatriation can mean that 20% of the profits must be paid in taxes. This deprives the government of money that it needs but not paying taxes is necessary for the executives to show higher numbers. The long term effects on the society is the complete breakdown of the moral fabric.

5.12 BUREAUCRACY

When many countries were witnessing massive growth economically, the respective governments had no option but to expand quickly and do massive hiring. They needed all the new workers to look at the development activities being carried out, ensure that the businesses are complying with the law and for various other reasons. But when the growth stalled all these workers were made redundant. But the employment contracts were structured in such a way that they cannot be terminated or laid off and hence new jobs or responsibilities had to be given to them. This means that government remained bloated when it should not be leading to bureaucracy and red tape.

5.13 MONOPOLISTIC AND ANTI COMPETITION PRACTICES

The system requires perpetual growth but with limited access to resources i.e. resources are finite, this requires resource management. This also leads to many illegal practices.

Since the resources are finite and they are quickly exhausted due to perpetual growth, those who have complete access to the resources are better secured over those who do not have the same privilege.

The monopolistic behavior is a direct outcome of this where they can dictate the flow of resources as well as products and in some cases due to unfair pricing can walk away with large profits. Hence, anti-competition or predatory behaviors are also easily explainable.

5.14 PONZI SCHEME

Madoff, Enron are some of the biggest examples of Ponzi schemes in the recent past, at those time periods it can be argued that their behavior was highly unethical since there was global growth. But now, looking down from the system level, such behavior must be considered legal for there is no other choice than to extend and pretend. For there is no global growth or the growth is anemic yet many firms are showing YoY growth of up to 5%. How can this be possible if the global economy is growing at 1-2% annually? One method that firms employ is to resort to share buybacks to boost the EPS metrics, corporates debts are at record high and a significant portion of that was for funding dividends and buybacks.

The demand has been lackluster can be analyzed from the oil consumption figures and Baltic dry index figure. So, there was no need for new investment since existing infrastructure was enough to produce the same output. Money was cheap during the past decade due to negative interest rates or zero interest rate are at many places. When the interest rates finally normalize in the future, many companies will be forced to default causing immense pain.

Also, the European Central Bank (ECB) has corporate debt purchasing program (Corporate Sector Purchase Programme) which has kept many firms in the Eurozone alive and kept the yields suppressed.

5.15 SYSTEM ATTRACTS EVIL PEOPLE

As already described above, everyone is now forced to pretend that all is well with the system when actually it is not. Corporate ethics has hit a new low since 2000. In such a situation, you have to lie and work ruthlessly. This is an unfortunate consequence of the system. Those who have weak ethics and morals, psychopaths or sociopaths are the only ones who can succeed at this point. The very design of the system caused the stakeholders of the systems to become evil as the system approaches its limits.

5.16 AFFECTS MENTAL HEALTH

California is one of the biggest success stories and has been single handedly responsible for creating the largest group of billionaires on Earth. Through computers and IT most of which were designed and commercialized in the California, the world has changed. But the same California is now witness to the largest number of homeless people and used syringes are littered across the roads and the severity of the crisis has forced the government to take remedial action. Also, drug abuses and opioid overdoses have become a major problem in the USA in the past decade. The past decades was the same period which witnessed record layoffs, offshoring, stagnant wages and rising inequality across the USA. These issues and the mental health of the citizens appear to be linked.

5.17 SUMMARY

The system of Capitalism and the industrial age resulted in marvelous inventions and rising standard of living across the world. But a problem with the system i.e. perpetual growth in a finite world is a defect in the system that must be remedied quickly.

6 CORPORATE GOVERNANCE: AN OVERVIEW

6.1 INTRODUCTION

Corporate governance has started playing an important role in the corporate sector. It can also be said that there has been a renewed focus on sustainability. Corporate governance came to the front in the aftermath of Enron accounting scandal. Around the same time frame, there were many other scandals like Worldcom etc. Such scandals and fraud shook the world and led to radical rethinking.

On the law front, in the USA, congress immediately passed the Sarbanes-Oxley Act, 2002. And more than a decade later, India passed Companies Act, 2013 which was loosely based on Sarbanes-Oxley Act. The effect both these acts had on the corporate world was immediate. For example, Hammond Aerospace had a secret slush fund which was used for brokering billion dollar deals. When the new CEO, Ms. Cheryl Tobin stepped in she immediately started tackling this situation. The situation was given top priority.

Tata were always an example in philanthropy and doing good to the society. The name and the brand of Tata's were associated with that. They started focusing relentlessly on Corporate Social Responsibility (CSR) activities and can be said as one of the pioneers in this space in India.

There is more and more focus on ethics, morals, sustainability, social responsibility, good governance in the corporate sector. But the new laws and significant efforts by the corporate world to change themselves have not resulted in reduction of corporate governance cases but there has been an increase in such cases. Each new case was more complex and severe in terms of fraud.

Two important laws Sarbanes-Oxley Act, 2002 and Companies Act, 2013 will be briefly looked at.

6.2 SARBANES-OXLEY ACT, 2002

This act was passed by US Congress after the fraud at Enron came to light. The act had a heavy focus on strict financial disclosures and accountability of top management and Board of Directors to such fraud. The Enron fraud was of such epic proportions that it shook the world and had a significant impact in investor confidence especially in the US stock markets. A key change section 302 required that senior management must certify the accuracy of the financial statements reported. Section 404 another important part of the law forced management as well as the auditors to establish new reporting methods and internal controls to prevent the same frauds from occurring again. The act also assigns responsibility to the IT departments where they are responsible for safe storage of electronic records. Section 802 is concerned with maintaining records and specifies about retention periods for storage of records, the types of records that needs to be stored and finally about falsification and destruction of records.

6.3 COMPANIES ACT, 2013

This act was passed in 2013 and it brought significant changes to the way companies are operated in India. The Satyam scandal which happened in 2009 had a significant influence in the formation of this act. The act heavily borrows from Sarbanes-Oxley Act, 2002 but it was not designed with Indian corporate structure in mind. In India, most of the big corporates are promoter driven and this affects the structure of senior management and Board of Directors. Some of the most important aspects of the law are regarding the formation of Corporate Social Responsibility Committee, mandating internal audits and the establishment internal audit committees, changing the laws for the better concerning independent directors, mandating at least one woman director in every board and having uniform accounting year for all companies.

6.4 IMPACT OF THE LAWS AND THE FUTURE

The passage of such laws had a significant impact in the corporate world which ultimately benefitted the society. Now corporates are not only focused on profits but also ensuring that environment is minimally harmed. This has led to changes in packaging, supply chains and other areas. The changes in the accounting laws and the adoption of international financial reporting standards (IFRS) have made it very easy for the regulators, researchers and analysts to compare companies and their true state. Top management and the board of directors are now serious about governance issues and abiding by the law.

Yet, we are seeing a rise in corporate governance cases. For eg.: the Tata and Cyrus Mistry case should not have happened if the policy makers had looked at corporate structure or if they had made laws more stricter and specific. Bernie Madoff happened in 2008 causing losses above \$50 Billion to many wealthy investors and it was 6 years after the passage of Sarbanes-Oxley Act. The situation was even direr if we looked at the financial world in 2008 where we saw the downfall of Lehman brothers, Bear Stearns, AIG and Goldman Sachs being accused of selling fraud instruments to its clients and betting against it.

Ramalingam Raju and Satyam Computer Services were at the forefront of adopting corporate governance and corporate social responsibility policies at least it appeared to the world before the company collapsed. Recently, the world became aware of the scam perpetrated by jeweler Nirav Modi and his uncle Mehul Choksi. Punjab National Bank was the victim in this case and the whole scandal revealed poor internal controls and corruption at the bank even after following the prescribed rules in Companies Act, 2013.

The analysis in the coming pages will reveal that such scandals will only increase going forward.

7 THE ROLE OF GLOBALIZATION

7.1 INTRODUCTION

Globalization is the increasing linkage of economies of various nations that has possible thanks to advancement in telecommunication technology, new knowledge gained through management research, liberalization that happened across many countries and other factors. It resulted in the establishment of global value chain (GVC) and also the movement of goods and services across the borders. We also started witnessing the flow of capital and technology through many trade agreements. NAFTA was one of the key trade agreements that can be considered as the beginning of globalization. Globalization gathered pace when China was given WTO membership in 2001.

7.2 ROLE OF GLOBALIZATION AT THE SYSTEM LEVEL

Karl Marx argued that capitalism is not inherently stable - and Globalization proved him right. Capitalism over many decades have significantly reduced the middle class especially in many western countries as can be seen from the wealth inequality.

If we carefully analyze what Marx had to say, it can be concluded that crises or depressions are due to the fact that the exploited masses cannot buy that the ever-expanding apparatus of production turns out or stands ready to turn out, and that for this and other reasons the rate of profits drops to bankruptcy level. Another way to look at this would be for the past decade most companies have spent significant amount of their profits to keep up the stock price and manipulate EPS targets and they have not invested into machines or other productive investments, the only explanation can be due to the lack of increasing demand.

According to Marx, the concentration of wealth (capital) commodifies labor, deflates wages and generates an output gap, all of which leads to economic depression. Capitalists first feed on the labor pool but then feed on each other, causing profits to collapse, leading to corporate bankruptcy. All of which leads to political revolution. The corporate bankruptcy as argued by Marx has not materialized yet but we can already see political revolutions in the form of a shift towards nationalism, focusing on local manufacturing etc. Unfortunately, 35 years of trade deficits have created the exact conditions that make collapse wholly unavoidable. From basic macroeconomics, it can be easily asserted that no country can run secular trade deficits without incurring inexorable debt. The output gap, commodification of labor, mass real unemployment, imported poverty, and now secular non-stop asinine abuse of Keynesian Monetary and Fiscal policy as a means to paper over the damage wrought by all of the above.

Globalization was less about raising standards of living and was more about corporate arbitrage via demand displacement. Wherein lies the problem because displacing real demand with debt creates a long-term reduction in real demand. It must be understood that demand displacement is temporary and wholly dependent upon marginal borrowing which in turn is dependent upon interest rates and the Minsky cycle. By amplifying corporate profits at the expense of wages, corporations permanently reduced demand, since robots and third World factory workers do not have the same reckless consumption as the West. Each time due to a crisis profits collapsed and the Fed lowered rates further to sponsor demand displacement. It apparently never occurred that if millions of people were laid off in say early 2000s and 2008, how did corporate profits rebound so quickly and so strongly to new all-time highs? In each successive round, the increase in profit margins came at the expense of long-term revenue. Because in the long-term demand is revenue and revenue is profit. Hence rising interest rates will now collapse profits.

The increasing severity as well as the rise in numbers of corporate governance appears to be mainly a system result besides other factors from the above analysis.

8 WHY THERE WILL BE A RISE IN SUCH CASES

8.1 INTRODUCTION

From the analysis presented below, it can be easily said that such cases are only going to increase in the future in the severity as well as the numbers. A look at the state of consumer, the corporate sector and the global economic condition shall be considered.

8.2 ANALYSIS OF CONSUMER CONDITIONS

The following graphs will be used to analyze the consumer conditions followed by a brief analysis.

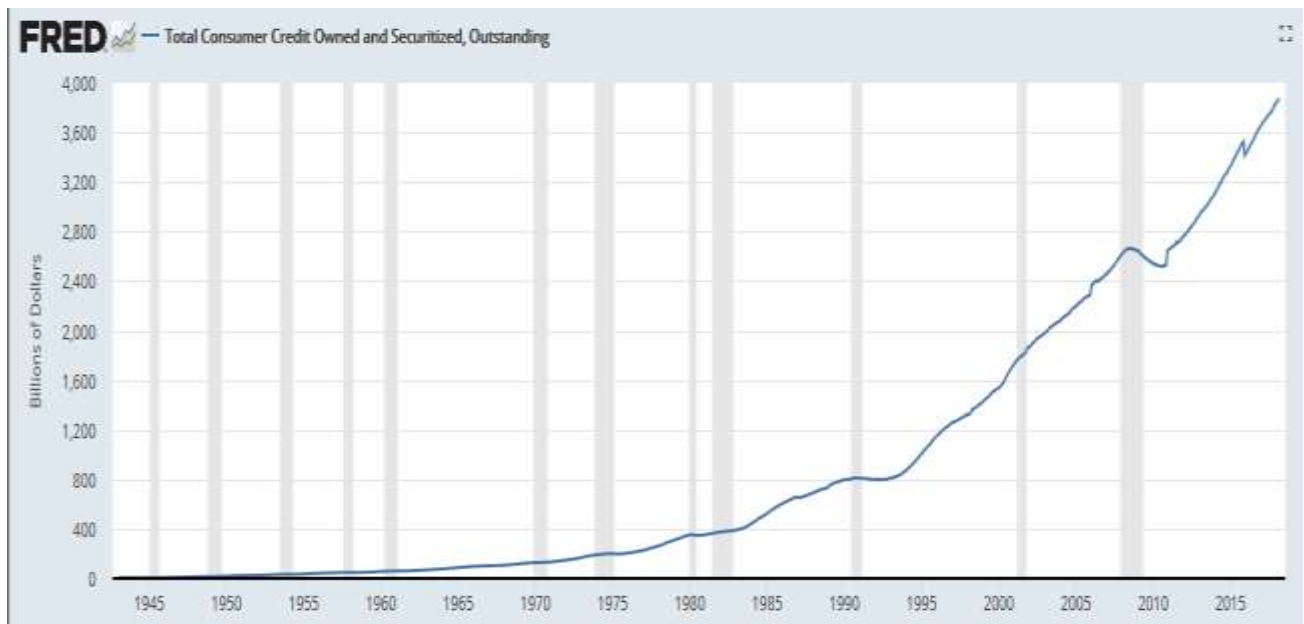


Figure 8.1 Total consumer credit in the USA.

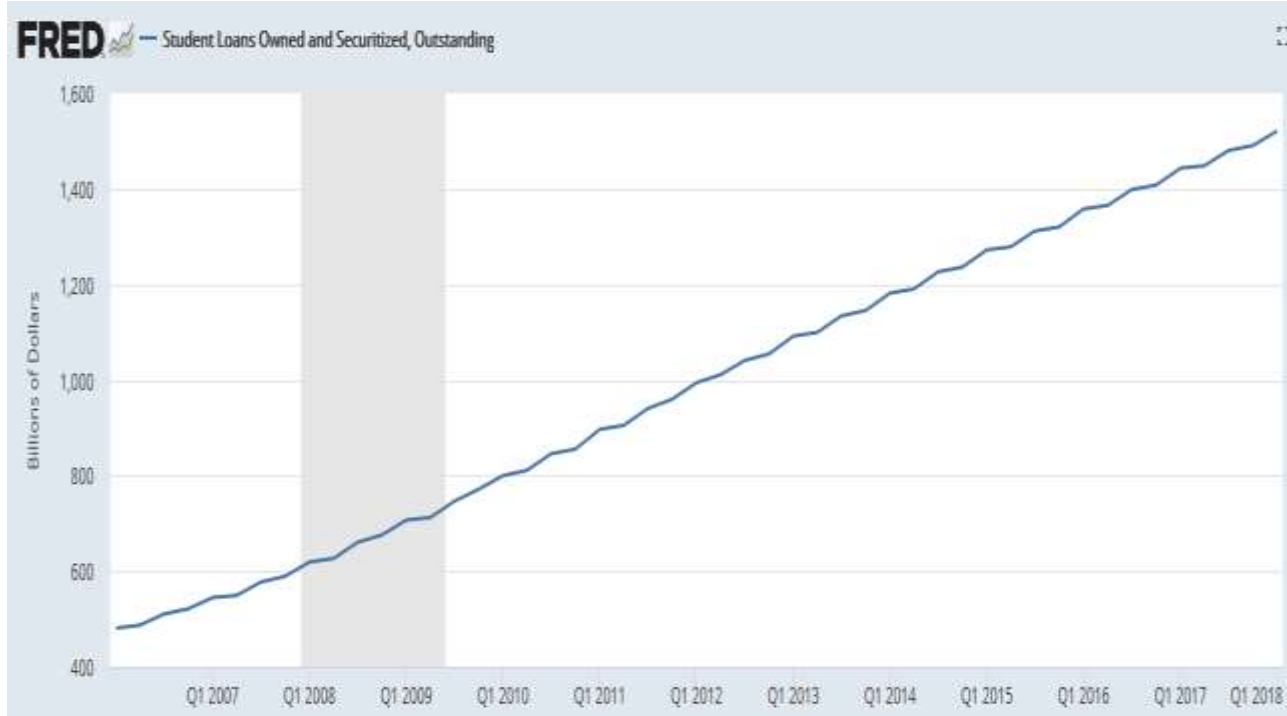


Figure 8.2 Total student loans in the USA.

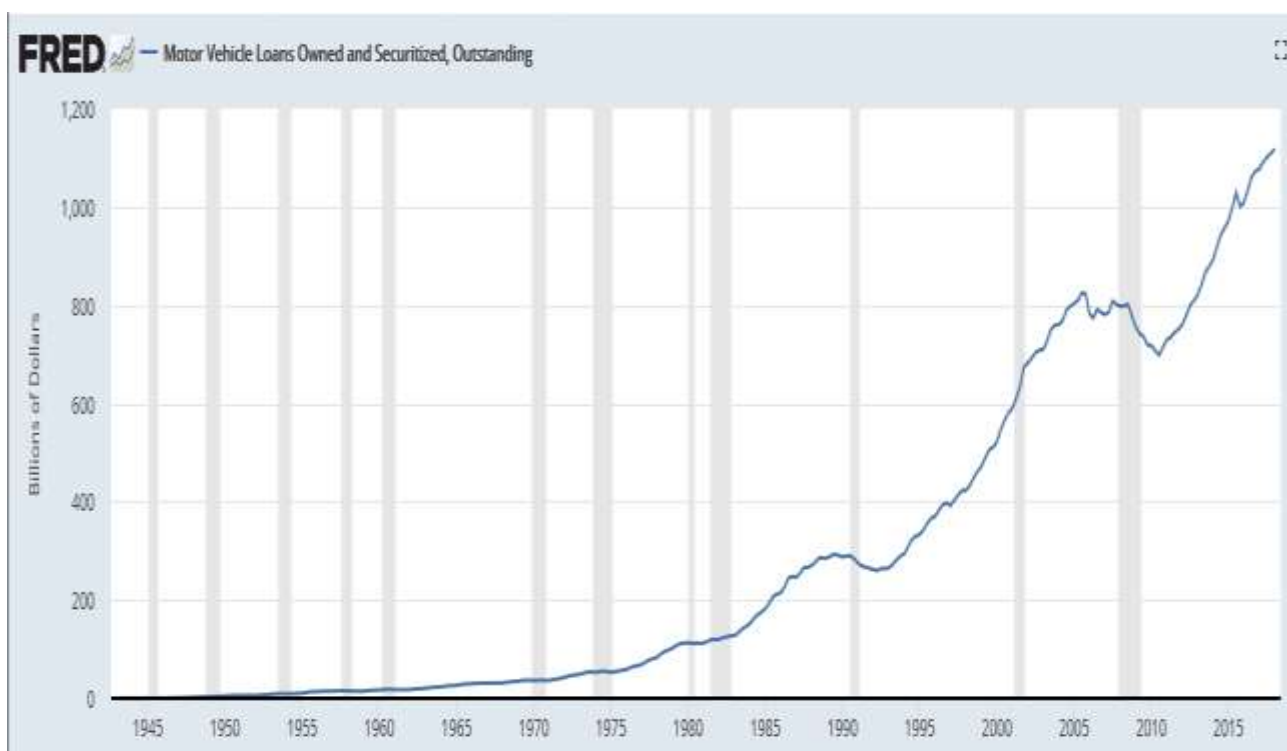


Figure 8.3 Total motor vehicle loans in the USA.

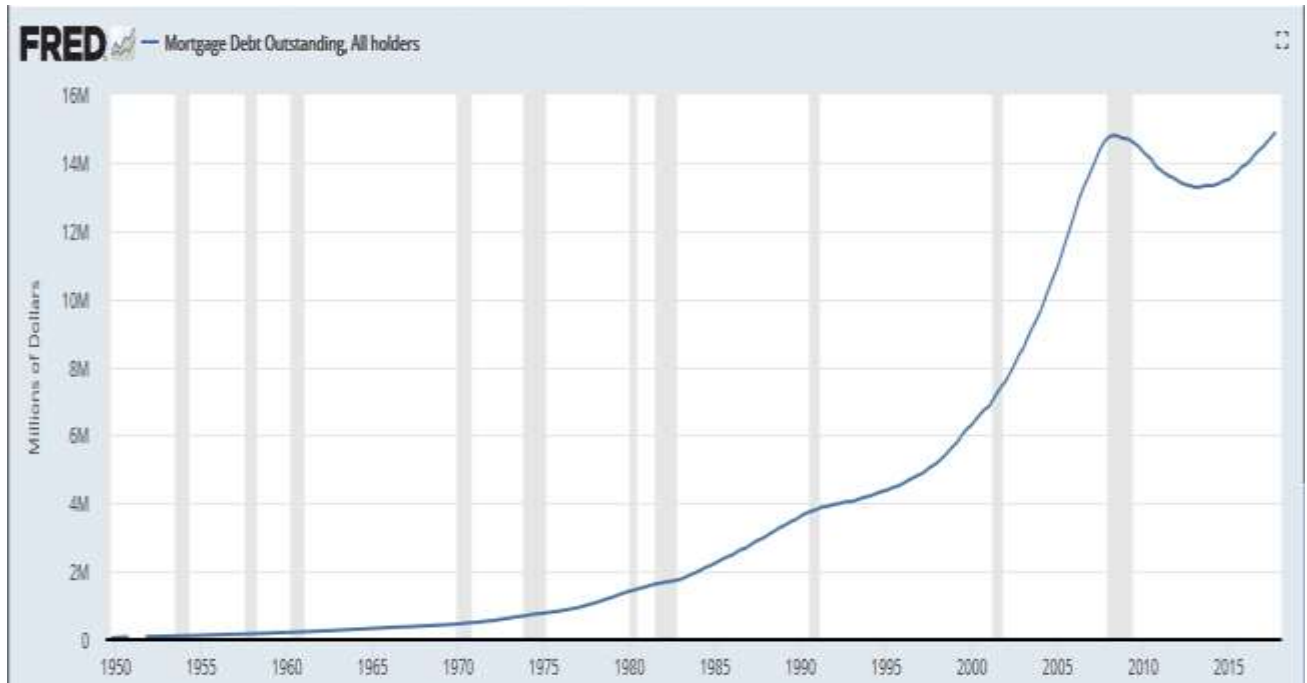


Figure 8.4 Total mortgage debt of all holders in the USA.



Figure 8.5 USA civilian labor force participation rate.

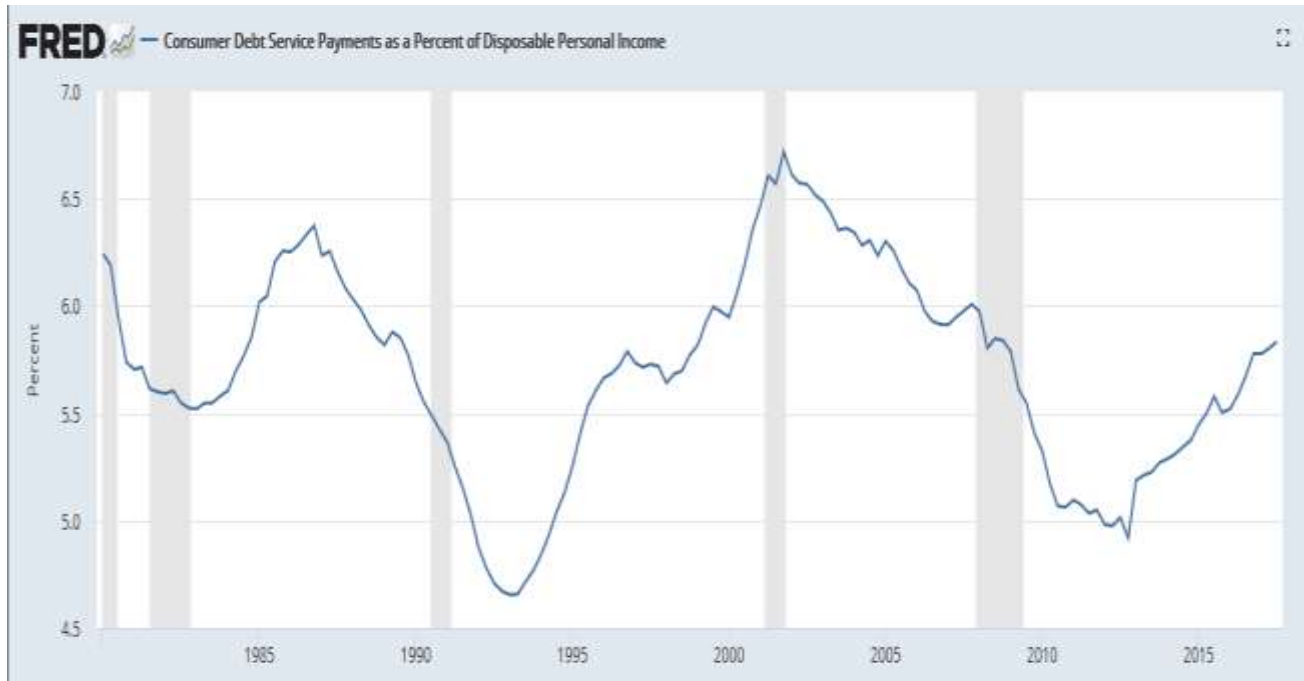


Figure 8.6 Consumer debt service payments as a percentage of disposable personal income of all holders in the USA.

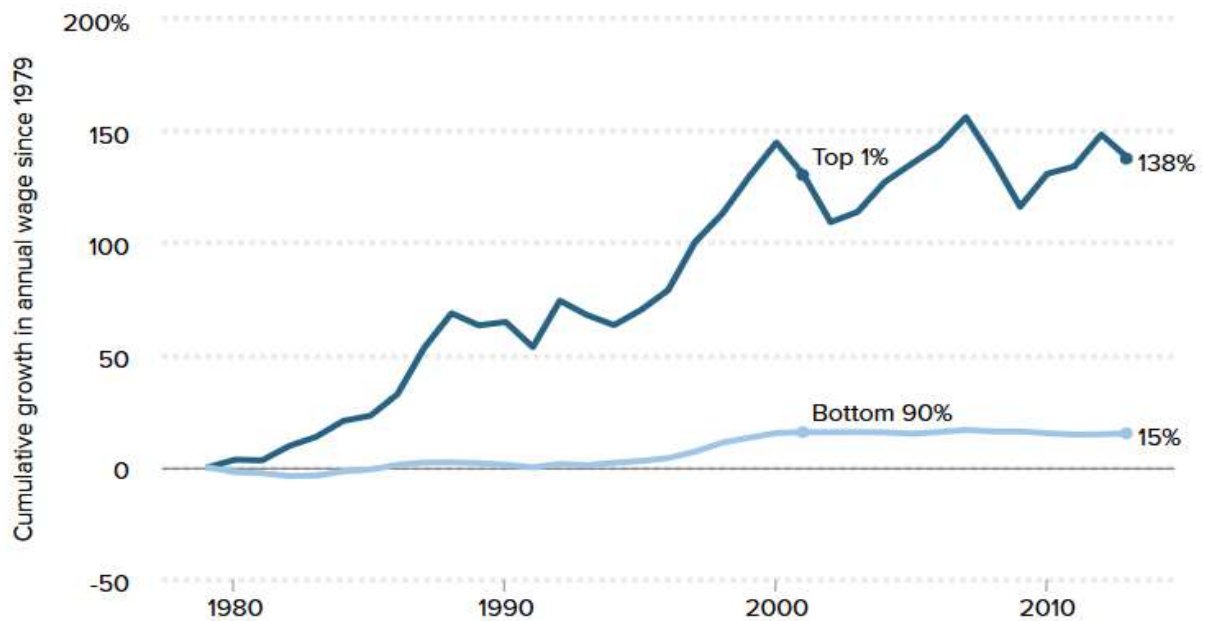


Figure 8.7 Cumulative growth in annual wages since 1979 in the USA.

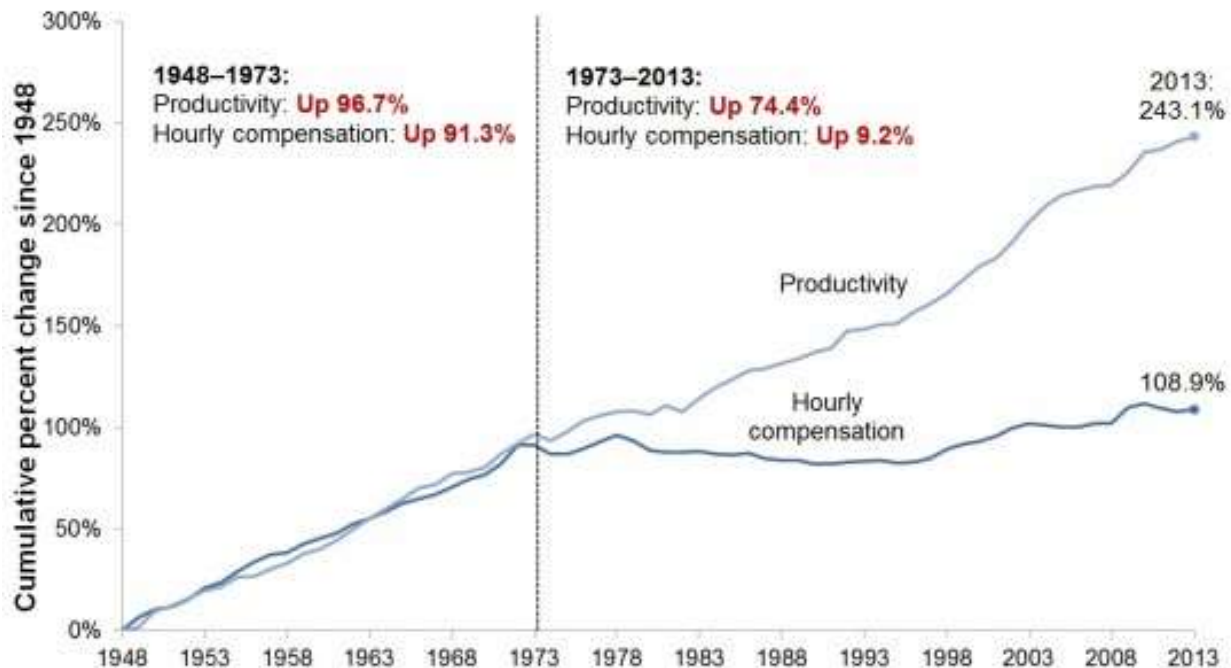


Figure 8.8 Disconnect between productivity and hourly compensation since 1973 in the USA.

From the above figures we can conclude that consumer is appearing to be tapped out since he does not have the wage growth to keep up with the inflation and the savers have been in a poor state due to zero or negative interest rates in the West.

Consumers across the West which consists of developed economies and are the biggest contributors to World GDP are facing the biggest problem. Since consumer debt across all categories are at an all-time high, the ability of service the debt will keep on reducing since there has been stagnant wage growth. Disposable income will also keep on decreasing which will have a negative effect on the corporate sector.

The past decade have also seen many startups coming up and offering huge discounts and free offers to attract consumers to their platform. This must have had a significant impact on consumer behavior since they are now addicted to freebies or discounts. This can be a problem for the corporate sector since they too will be forced to give discounts affecting their revenues and profits.

8.3 ANALYSIS OF CORPORATE SECTOR

The following graphs will be used to analyze the corporate sector conditions followed by a brief analysis.



Figure 8.9 Total debt of non-financial corporate sector in the USA.

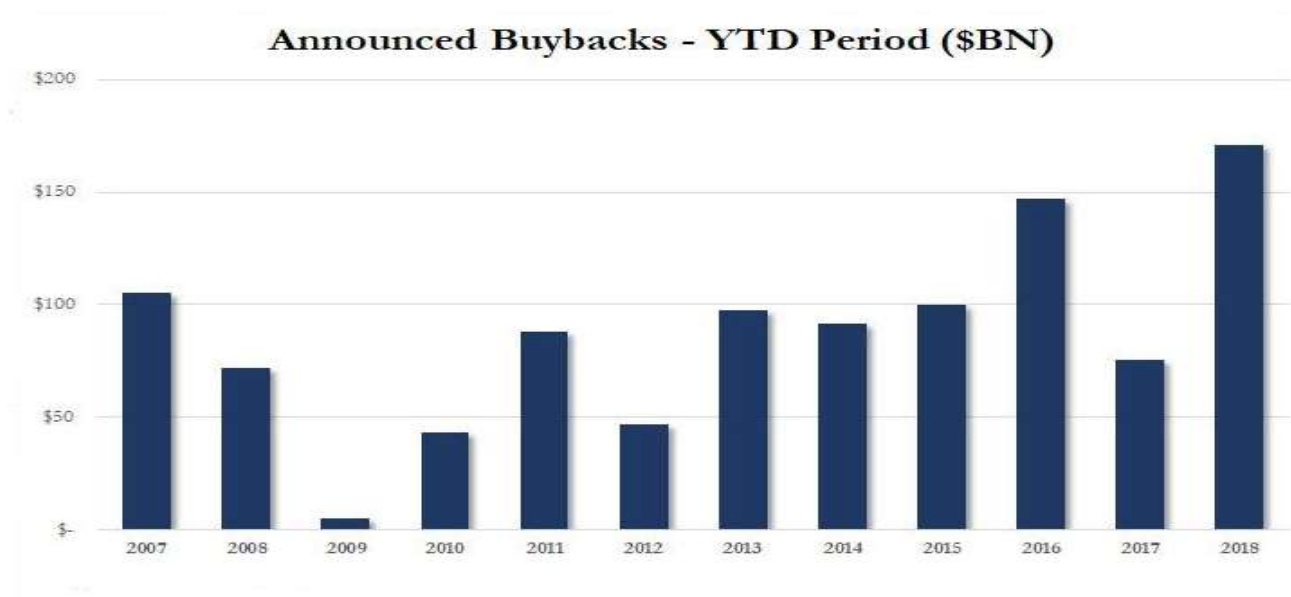


Figure 8.10 Announced buybacks in the corporate sector in the USA.

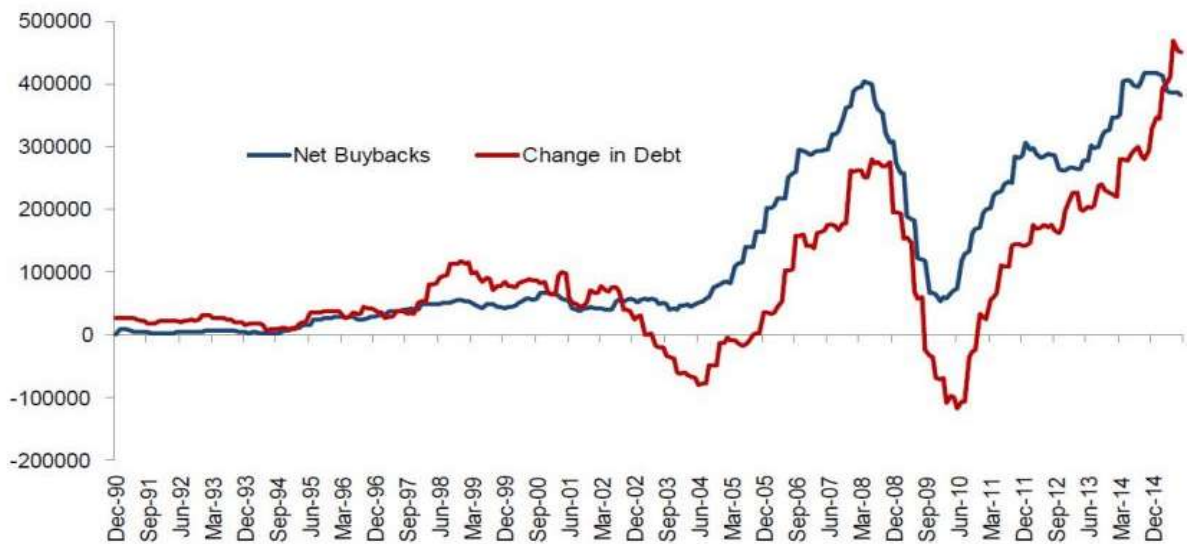


Figure 8.11 Most buybacks are funded by debt in the USA.

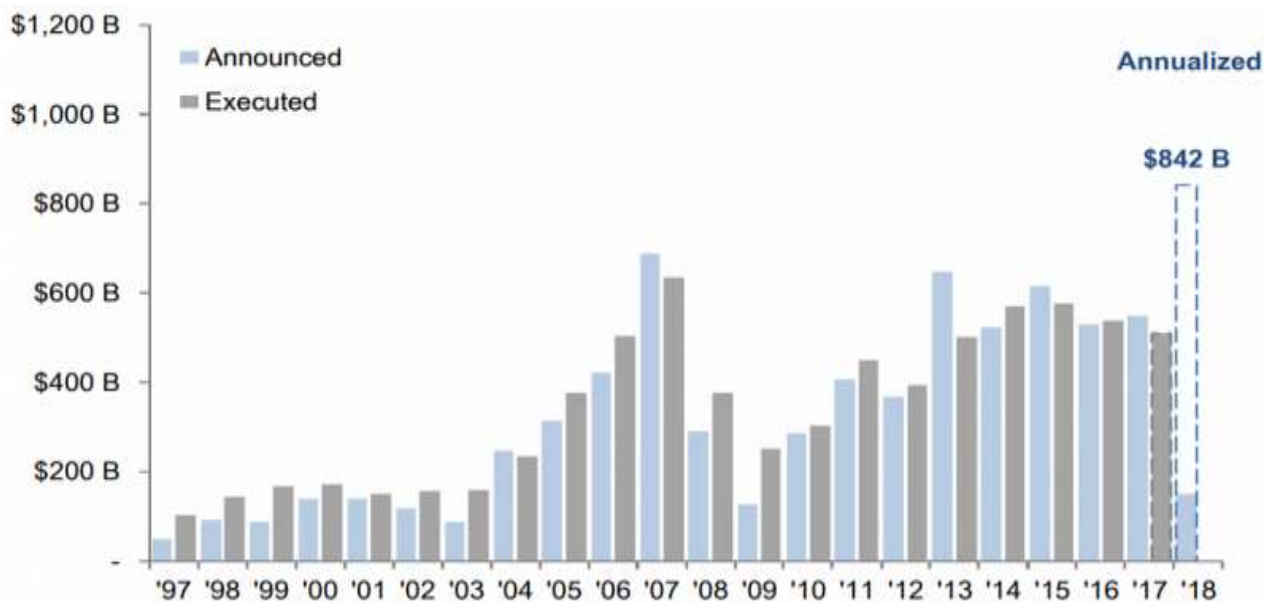


Figure 8.12 Announced and executed buybacks of S&P 500 companies in the USA.

Corporates are more focusing on share buybacks since 2004 and it has only accelerated since then. Most of the buybacks are funded with debt which will leads to problems in the future when interest rates rise. If there was growth, there is no reason for a buyback rather all the money will be spent on investments. The fact that this is not happening shows that corporates have enough capacity to meet existing and future demand & they do not have the need to make investments. This also shows why there are layoffs happening since many are being made redundant.

8.4 ANALYSIS OF GLOBAL ECONOMY

The following graphs will be used to analyze the global economic conditions followed by a brief analysis.

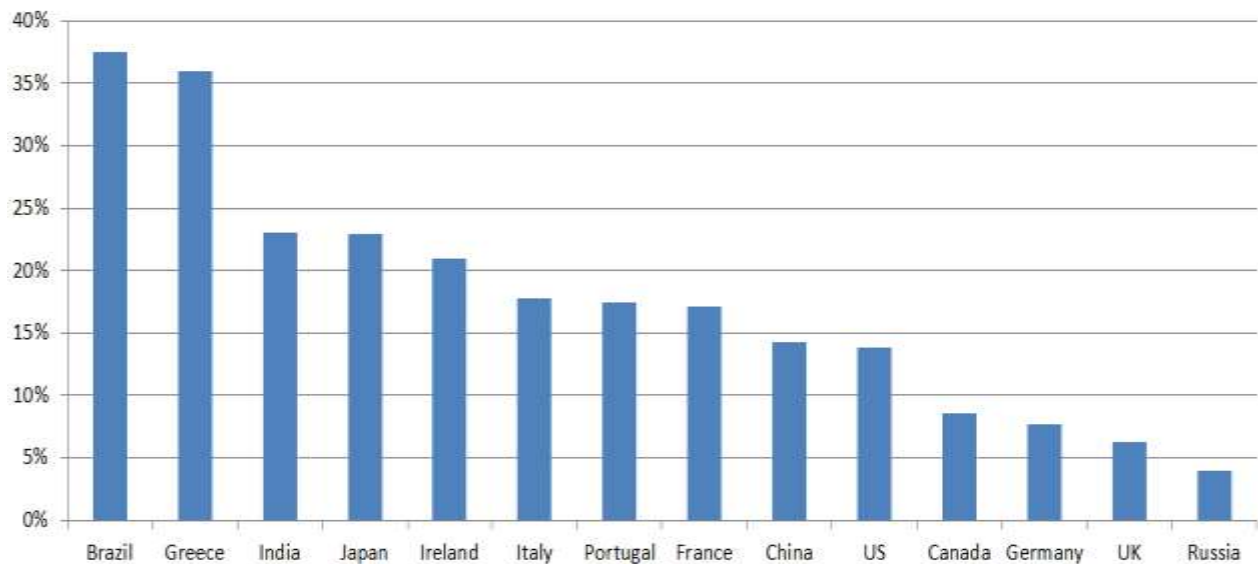


Figure 8.13 Central government debt expense as a percentage of tax revenue.

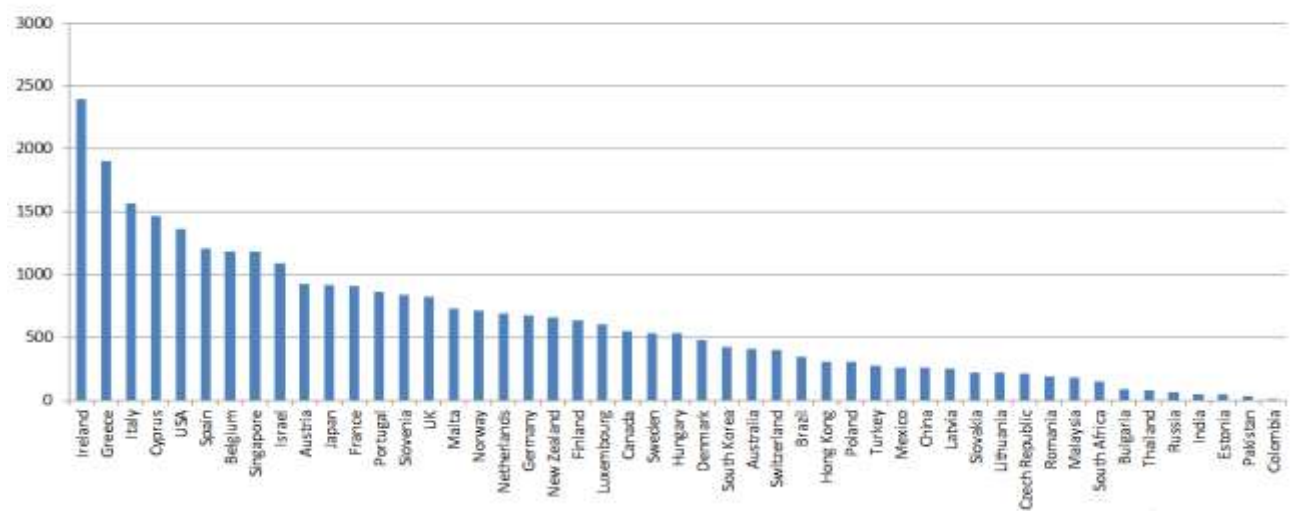


Figure 8.14 National debt interest expense per year per capita.

Portfolio Name		SWISS NATIONAL BANK		ID	H211384-1		Currency USD		
Holder		SWISS NATL BANK		Filing Date		06/30/2017			
Date		08/22/17				Display Currency USD			
Rebalanced		08/17/17		Short Margin		0		Futures Margin	0
						Current			
Security		ID	Position	Price	PCS	FX Rate	Principal	Accrued	
<Search>									
Totals							85,002,032,797.41	0.00	
Cash			0.0000						
11)	AAPL	AAPL	19,169,416.0000	159.86	EXCH	1.00000	3,064,422,841.76		
12)	MSFT	MSFT	27,045,170.0000	73.22	EXCH	1.00000	1,980,112,121.55		
13)	FB	FB	8,760,000.0000	169.67	EXCH	1.00000	1,486,265,400.00		
14)	JNJ	JNJ	10,738,464.0000	134.70	EXCH	1.00000	1,446,417,408.48		
15)	AMZN	AMZN	1,481,841.0000	967.45	EXCH	1.00000	1,433,607,075.45		
16)	XOM	XOM	16,024,636.0000	76.72	EXCH	1.00000	1,229,329,950.74		
17)	GOOG	GOOG	1,140,966.0000	925.01	EXCH	1.00000	1,055,404,959.66		
18)	GOOGL	GOOGL	1,103,089.0000	940.92	EXCH	1.00000	1,037,918,501.88		
19)	T	T	25,261,658.0000	37.97	EXCH	1.00000	959,248,308.41		
20)	PG	PG	10,252,888.0000	92.76	EXCH	1.00000	951,057,890.88		
21)	VZ	VZ	16,739,530.0000	48.40	EXCH	1.00000	810,193,252.00		
22)	GE	GE	31,877,861.0000	24.62	EXCH	1.00000	784,832,937.82		
23)	V	V	7,535,228.0000	104.11	EXCH	1.00000	784,492,587.08		
24)	PFE	PFE	23,367,689.0000	33.15	EXCH	1.00000	774,638,890.35		
25)	UNH	UNH	3,845,088.0000	194.72	EXCH	1.00000	748,696,309.92		
26)	KO	KO	16,389,490.0000	45.60	EXCH	1.00000	747,278,796.55		
27)	CVX	CVX	6,953,823.0000	106.38	EXCH	1.00000	739,768,552.21		

Figure 8.15 Swiss National Bank speculating in the US stock market.

The bailouts that happened in 2008 followed by the negative or zero or low interest policies across the world has heavily indebted many nations across the world. Low interest rates allowed them to reduce their interest expense which still is a significant portion of tax revenue in many nations. The moment interest rates starts rising these nations will not be able to meet interest payments causing them to default.

Such high interest expenses have impaired the ability of nations to make productive investments to develop their respective nations. The West have stagnant wage growth which naturally limits the ability to collect tax which puts further pressure on the governments to make vital investments which can help the overall economy. Further, some central banks like SNB and Bank of Japan (BoJ) are speculating in the stock markets when their functions as per the charter is completely different. These distractions will prove costly in the long run and can affect the whole world. Many governments across the West are increasing the maximum working age to limit pension payouts, the governments themselves are in terrible shape and can be said that they may be understaffed in critical areas.

8.5 CRITICAL ROLE PLAYED BY OIL IN THE GLOBAL ECONOMY

Oil plays a fundamental role in the global economy. As per a study conducted by German military Bundeswehr, it was found that oil is used directly or indirectly in 90% of the industrial processes. The transportation of commodities and goods in the modern Just-in-Time (JIT) based supply chain relies on oil, hence oil becomes a critical input and its price can have significant impact in the world and everyone will be affected by it. As per a study conducted by Goldman Sachs, it was found that every 1 cent increase in gasoline price reduced the purchasing power of US households by 1 billion dollars.

Recently, oil price has been increasing rapidly and this will have a significant effect.

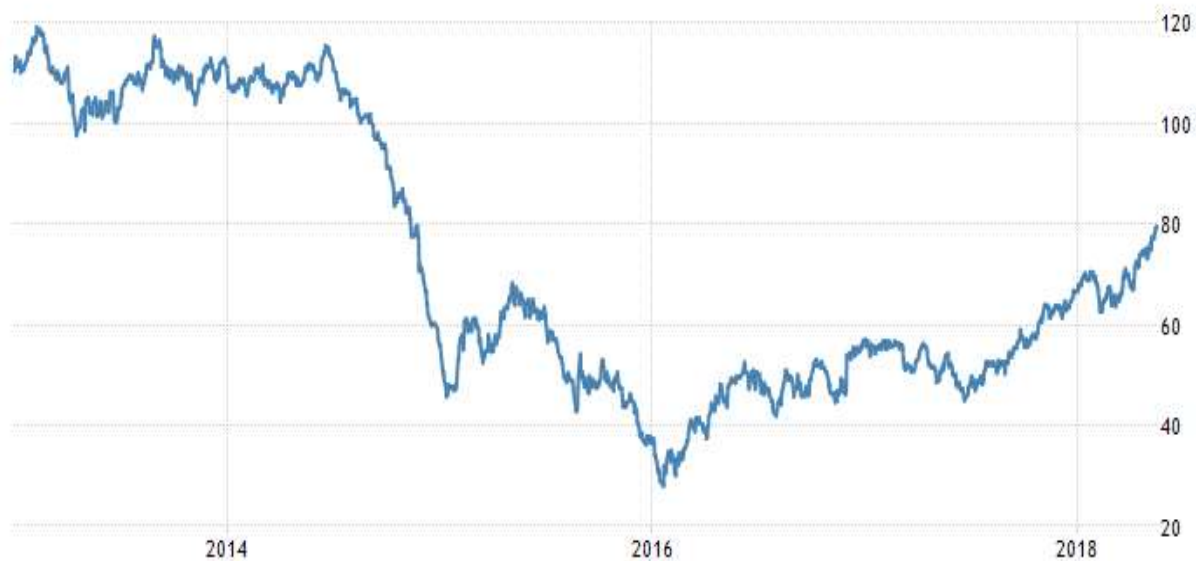


Figure 8.16 Brent crude oil price in US Dollars.

9 CASE STUDY 1: SATYAM COMPUTER SERVICES

9.1 INTRODUCTION

Satyam was a major player in the Indian IT industry and Ramalingam Raju was many considered one of the best entrepreneurs India has ever produced before his fall. The case will be analyzed in brief and then linked to the system framework

9.2 GOVERNANCE ISSUES & LINKING IT TO THE SYSTEM FRAMEWORK

Satyam expanded rapidly and the CEO was very ambitious compared to his peers and his speeches would lead one to believe that he wanted nothing but the best. But expansion can only occur by two means either profit or debt. Expansion like that of Satyam required a combination of both. This was the beginning of the end. Such pressure to outperform and expand led to strain in profit margins while his ambitious nature did not allow that. A Ponzi scheme had to be hatched up to pretend it was going very well. Secondly all the key stakeholders that would have stopped this illegal activity in their path were looking out for their own short term benefits. During mid-2000s, US and European IT was slowing down as confirmed by CEO himself in 2008 while Satyam was expanding. Also he wanted to ensure that Satyam performed extremely well in the stock market. All of this lead to faking and lying which is a symptom of psychopathic behavior. The auditors for Satyam PwC were paid twice as compared to industry standards and they abdicated their fiduciary responsibilities.

Hence, there was widescale corruption. Raju acted extremely greedy with questionable ethics and morals and behaved like a psychopath. Those who were supposed to prevent this looked at short term gains and remained silent.

10 CASE STUDY 2: TATA & CYRUS MISTRY

10.1 INTRODUCTION

Tata is one of the biggest conglomerates in India. Tata's are known for their philanthropy and helping the society. Historically, Chairman of Tata always belonged to Tata family but for the first time in 2012 an outsider was appointed. His abrupt removal in 2016 shook India and many previously unknown aspects about Tata conglomerate was revealed.

10.2 GOVERNANCE ISSUES & LINKING IT TO THE SYSTEM FRAMEWORK

During the reign of Ratan Tata, Tata expanded at a rapid pace and it was mostly funded by debt as will be later revealed. Out of all the companies under Tata, only TCS has been widely profitable rest are either loss making or barely profitable. A philosophy of Tata family is to be ingrained everywhere in the world by selling all sorts of goods and services hence Tata has major interests in many fields.

Global growth was slowing and many companies of Tata group had taken significant amount of debt and it was affecting their inability to sustain themselves. Mistry was mainly doing cleanup of the conglomerate by increasing cashflow and cutting loss making divisions. A complete cleanup of the Tata group would have led to the write down of over two-thirds of the total market cap which cannot be done. Hence, the decision to remove Mistry was necessitated. The BoD & AoA were in violation of the Companies Act. Nano project was kept alive despite causing heavy losses to the group.

We can clearly see that excessive greed, questionable ethics and morals, creation of a Ponzi scheme (funded via debt), short term thinking (writedowns) and lack of concern towards minority investors and the law can be seen here.

11 CASE STUDY 3: 2008 GFC

11.1 INTRODUCTION

The Great Financial Crisis (GFC) of 2008 had a significant role to play in the predicament we are facing but the event itself is important since it happened 6 years after the passage of Sarbanes-Oxley Act in 2002. Since all failures in 2008 happened due to the same reasons, the underlying causes must remain the same, hence collectively analyzed.

11.2 GOVERNANCE ISSUES & LINKING IT TO THE SYSTEM FRAMEWORK

Some of the most unethical practices imaginable happened in the run up to 2008. Banks sold worthless derivative instruments and took bet against their clients profiting in both ways i.e. in the sale of such instruments and profits made from the betting against them. Even among the agents responsible for selling the houses, there was complete breakdown of morals. Everyone was motivated by excessive greed and it quickly became a Ponzi scheme. Builders hoping to make a quick profit started building McMansions which is poorly constructed and is ostentatious. Unlike older houses such houses will face extreme maintenance during their life and will not last as much.

Government and Federal Reserve was aware of these issues yet did not do anything. Bernanke who was the Fed chairman during the crisis had written a research paper on this scenario a couple of years before and he clearly knew what was going to happen and how it will play out. After the crisis happened, instead of allowing the institutions to fail, the government bailed them out setting precedent and creating moral hazard. Government even bailed out automakers who were facing bankruptcy thus artificially suppressing the crisis. When the next crisis happens, the effects will be double since the previous crisis was only partially and set wrong precedents.

12 CASE STUDY 4: NIRAV MODI SCANDAL

12.1 INTRODUCTION

Nirav Modi is a billionaire jeweler and founder of the Nirav Modi jewellery chain and is responsible along with Punjab National Bank (PNB) and his uncle Mehul Choksi for one of the biggest frauds in the history of Indian corporate governance. This happened despite many audits that happens in Indian banks as per the regulations of RBI and after the passing of Companies Act, 2013.

12.2 GOVERNANCE ISSUES & LINKING IT TO THE SYSTEM FRAMEWORK

There are two aspects to consider in this case. The target segment of Nirav Modi has been witnessing tremendous wage growth while the bank employees without whom this would not succeeded have not had a wage hike since 2012 as well as there is immense pressure on them for cross selling. Banking was one of the most prestigious jobs in India and was paid more than Indian civil servants though now the opposite is true.

Nirav Modi acted like a typical psychopath i.e. not recognizing how his actions would affect his customers, investors and the Indian banking system. He went for short term profits ignoring sustainability of his own business, became incredibly greedy and started running a Ponzi scheme. Banks are subjected to more audits than typical firms and it is impossible that the scandal could not have come to light in one of those audits which means that higher ups were involved. RBI even issued a notification in 2016 of such a possibility yet never investigated whether such incidents were happening showing weak oversight. Government also did not force the bank to do such checks which could have prevented this or stopped this incident earlier. So, it can be said that the stakeholders abandoned their responsibilities and there was rampant corruption in the bank.

13 CASE STUDY 5: SIEMENS AG

13.1 INTRODUCTION

Siemens AG was considered as one of the best in its field, a highly ethical organization with sound business practices with a motivated, hardworking and talented workforce. All of that changed overnight when Siemens were asked to billion dollars fines to different governments. The amount totaled \$1.6 billion.

13.2 GOVERNANCE ISSUES & LINKING IT TO THE SYSTEM FRAMEWORK

Corruption was institutionalized in Siemens and everyone accepted it without any issue. The governments which accepted bribes were mostly emerging market ones and not developing ones. Despite Foreign Corrupt Practices Act (FCRA) in the USA and laws in the EU banning companies from bribing foreign officials, the company went ahead with it. Siemens had feared about growth since Marshall Plan since western companies were awarded contracts for rebuilding of Germany. This fear gave way to corrupt practices so as to sustain growth by any means.

Siemens had no respect for the laws of developed countries like USA and there was no effort from the side of top management or board of directors to reform the system before the scandal came out. Hence corruption percolated from the top. What it also reveals are the corruption of governments and their civil servants where they are abdicating their duties towards the citizen and nation. They take part in corrupt activities motivated by greed and desire for short term gains and quick riches. The consequences of such actions are borne by the public. Post scandal, Siemens restructured itself and created new processes and now only participates in ethical activities and as a result had to pull out of some countries.

14 CONCLUSION

The system has a disconnect that was not obvious to anyone and hence no remedial actions were taken. The disconnect is that the system requires perpetual growth to sustain itself while the Earth is finite so its resources must be finite. At some point, we will be facing resource constraints as we exhaust those resources which were cheaper to extract due to it being nearer to the crust.

Another aspect of the system is that it requires continuous growth in the amount of working population and this population growth leads to rampant deforestation and the consequence of the same is climate change and excessive pressure on the already scarce resources.

As we approach the resource limits both the population growth and resource extraction rate will stall and then fall. During the same time, the system must have constant growth and such growth can only be achieved using monetization which is what is happening. Corporates are trying to stay alive in this system by opting for stock buybacks to boost their EPS. If they spend the money on new machinery, it will lead to overcapacity as the demand is stagnant and yields are extremely low in the market forcing them to opt for dividends and buybacks. The troubling aspect is that it is funded with debt and not with profits and when interest rates normalize many corporations will suffer. As we automate more and more, we will need very less workers resulting in layoffs which are already happening. A quick look at the future can be obtained from the retail industry where there are a huge number of store closures as spending shifts to e-commerce.

Corporates have to now battle on many fronts and they are innovative products, research and development, after sales service, sales and marketing, climate change, corporate social responsibility, employee welfare while the demand side is stagnant. The only solution has been to merely pretend that all is well.

These factors discussed above explains why corporate governance cases are happening day after day. The stakeholders who are supposed to oversee the system and prevent

such abuses are helpless. Case in point is Ben Bernanke who knew exactly how the crisis will play out in 2004 and became Fed chair in 2006 yet did not do anything to check the behavior of the banks. Baltic Dry Index which is a very important indicator for global commerce have never attained its all-time highs since 2008 showing that trade never recovered.

Globalization and offshoring allowed firms to produced goods at cheaper cost but this resulted in job losses across the West. Now, citizens are demanding a return to nationalism as can be recognized from Brexit and Trump's victory. This will only put more pressure on the corporations in terms of product costs. Since, the consumer is already in a weaker position they will not be able to absorb the cost increases resulting in lower demand.

From the few case studies that have been covered here, some common themes emerge. There is abdication of responsibilities at the senior management and board level of the companies as well as at the regulators in the government. In most of the cases, there was either a Ponzi scheme or a semi Ponzi scheme. The system promotes unabated greed which can be seen in all the cases. This greed and a desire for quick riches resulted in many scandals. Everyone was concerned about the short term rather than thinking about long term and sustainability. The senior level mostly consisted of those people who lacked empathy and never cared about the consequences of their actions.

Since a large scale reform of the system is not possible at this stage for such action will require monumental efforts on all sides and simply passing more stringent laws will not work. A cultural change is necessary. New research must be conducted focused on sustainable development and a new market system must be established with sustainability as its foundation. Only then, will these issues go away.

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