THIRD EDITION

Corporate Governance

Principles, Polices and Practices



A. C. Fernando
K. P. Muraleedharan
E. K. Satheesh

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Corporate Governance

Principles, Policies and Practices

Third Edition

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To
Rex and Reshama
for their constant support and encouragement

— A. C. Fernando

Dedicated to our parents

— K. P. Muraleedharan
— E. K. Satheesh

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Contents

Abbreviations *xv*
Foreword *xxi*
Preface to the Third Edition *xxii*
Preface *xxiv*
About the Author *xxv*
About the Contributors *xxvi*

PART ONE UNDERSTANDING OF CORPORATE HISTORY AND GOVERNANCE

1. Corporate History, Structure and Ownership Pattern **3**
- Introduction 4
- Characteristics of a Company 5
- Types of Company 6
- Shareholding Categories 27

Conclusion *33*
Keywords *34*
Discussion Questions *34*
References *34*
Suggested Readings *35*

2. Corporate Governance: An Overview **36**
- Introduction 37
- What is Corporate Governance? 37
- Governance is More Than Just Board Processes and Procedures 46
- A Historical Perspective of Corporate Governance 48
- Issues in Corporate Governance 53

Conclusion *60*
Keywords *61*
Discussion Questions *61*
References *61*
Suggested Readings *62*

3. Theories and Models of Corporate Governance **63**
- Introduction 64
- Corporate Governance Mechanisms 73
- Models of Corporate Governance 74
- What is "Good" Corporate Governance? 85
- Obligation to Society at Large 85
- Obligation to Investors 89
- Obligation to Employees 90
- Obligation to Customers 92
- Managerial Obligation 92

Conclusion *94*
Keywords *95*
Discussion Questions *96*
References *96*
Suggested Readings *96*

4. Initiatives in Corporate Governance: Global and National **97**
- Introduction 98
- Corporate Governance Committees 99
- World Bank on Corporate Governance 111
- OECD Principles 111
- McKinsey Survey on Corporate Governance 113
- Sarbanes–Oxley Act, 2002 114
- Indian Committees and Guidelines 118
- Working Group on the Companies Act, 1996 119
- The Confederation of Indian Industry's Initiative 121
- SEBI's Initiatives 124
- The Naresh Chandra Committee Report, 2002 128
- The Narayana Murthy Committee Report, 2003 130
- Dr. J. J. Irani Committee Report on Company Law, 2005 133
- Uday Kotak Report on Corporate Governance 2017 136

Conclusion *140*
Keywords *140*
Discussion Questions *140*
References *141*
Suggested Readings *141*

PART TWO LEGAL FRAMEWORK AND AGENTS IN CORPORATE GOVERNANCE

5. Legal and Regulatory Aspects of Corporate Governance **145**
- Introduction 146
- Legal Frame-work of the Corporate Governance in India 146
- The Indian Companies Act 2013 146
- Investor Protection under the Companies Act 2013 160
- Relationship Between Investor Protection and Corporate Governance 161
- India Companies Act 2013 and New Investor Protection Measures 163
- SEBI's Poor Performance—Suggestions for Improvement 169
- Auditor's Responsibilities under Companies Act 2013 170
- Securities and Exchange Board of India Act, 1992 176
- National Depositaries Act 1996 186

Conclusion *196*
Keywords *196*
Discussion Questions *196*
References *197*
Suggested Readings *197*

6. Share Holders—The Prime Stake Holders **198**
- Introduction 199
- Corporate Stake Holders 199
- Rights of Shareholders 202
- Views of Various Committees on the Issue 203
- Grievance Redressal Process 209

Conclusion *212*
Keywords *212*
Discussion Questions *212*
References *213*
Suggested Readings *213*

7. Other Stake Holders of the Company **214**
- Introduction 215
- Corporate Governance and Employees 215
- Corporate Governance and Customers 218
- Corporate Governance and Institutional Investors 219
- Corporate Governance and Creditors 223
- The Corporate Governance and the Community 226
- Corporate Governance and the Government 228

Conclusion *229*
Keywords *230*
Discussion Questions *230*
References *230*
Suggested Readings *230*

8. The Role of Board of Directors in Corporate Governance **231**
- Corporate Governance Framework 232
- Introduction 232
- Board in Ensuring Corporate Governance 247
- Governance Issues Relating to the Board 249
- The Role of Directors 250
- Directors' Remuneration 253
- The Indian Companies Act 2013 and Corporate Governance 253
- Role of Board of Directors in Family-owned Businesses 256
- Some Pioneering Indian Boards 259

Conclusion *261*
Keywords *261*
Discussion Questions *261*
References *262*
Suggested Readings *262*

9. The Role of Auditors in Corporate Governance **263**
- Introduction 264
- Types of Auditors 265
- Corporate Governance and Internal Auditors 271
- Cost Audit Methodology 272
- Quality Audit 273

Conclusion *274*
Keywords *274*
Discussion Questions *274*
References *274*
Suggested Readings *275*

PART THREE COMPONENTS AND FACILITATORS OF CORPORATE GOVERNANCE

10. Financial Reporting and Corporate Governance **279**
- Introduction 280
- Indian Accounting Standards (IAS or the Indian GAAP) 286
- IFRS (International Financial Reporting Standards) 286
- Convergence of Indian Accounting Standards with IFRS 288

Conclusion *304*
Keywords *304*
Discussion Questions *305*

References 305
Suggested Readings 306

11. Whistle Blowing Mechanism and Corporate Governance 307
- Introduction 308
- Why Whistle Blowing in the Corporate Governance? 308
- The Whistle Blower 309
- Whistleblowers and Informants 312
- The Factors Influencing the Whistleblower in Disclosing Wrongdoing 313
- The Whistleblowing Process 314
- Organisational Responses to Whistle Blowing 316
- Impact of Whistleblowing: Negative and Positive 317
- Whistle Blowing Policy of Organisations 318
- Elements of Whistleblowing Policy 318
- Benefits of Good Whistleblowing Policy 318
- Whistleblower Laws in India 320
- Role of Whistle Blower in Corporate Governance: Selected Cases 322
- The Citygroup Case 326

Conclusion 327
Keywords 327
Discussion Questions 327
References 328
Suggested Readings 328

12. Role of Government in Corporate Governance 329
- Introduction 330
- Different Roles of Government in the Economy 331
- State Intervention in a Developing Economy 333
- Public Governance and Corporate Governance 334
- Political Governance Requires Restraints of Power 334
- Public versus Corporate Governance—A Study of Comparison 342

Conclusion 346
Keywords 347
Discussion Questions 347
References 347

13. The Role of the Media in Ensuring Corporate Governance 348
- Introduction 349
- The Board of Directors 352
- Corporate Governance and the Press 354
- Ethics in Advertising 357
- Adverse Effects of Advertising 358

Conclusion 367
Keywords 367
Discussion Questions 368
References 368
Suggested Readings 368

PART FOUR ISSUES AND PROBLEMS OF CORPORATE GOVERNANCE IN DEVELOPED AND EMERGING ECONOMIES

14. Corporate Governance and Buisness Ethics 371
- Introduction 372
- Importance and Need for Business Ethics 373

- The Indian Context 374
- Roots of Unethical Behaviour 376
- Corporate Ethical Framework 378
- Some Unethical Issues 383
- Corporate Governance Ethics 386

Conclusion *392*
Keywords *392*
Discussion Questions *393*
References *393*
Suggested Readings *393*

15. Corporate Governance and CSR **394**

- Introduction 395
- Definitions of Corporate Social Responsibility (CSR) 396
- Justification of CSR 399
- The Scope of Social Responsibility 402
- Social Responsibility and Indian Corporations 413

Conclusion *416*
Keywords *416*
Discussion Questions *416*
References *417*
Suggested Readings *417*

16. Corporate Governance and Public Policy **418**

- Introduction 419
- Framing of Public Policy 425
- Involvement of Business in Public Policy Decision Making 425
- Public Policy and Business 427
- Economic Policy 428
- Monetary Policy 428
- Fiscal Policy 430
- Physical Controls 432
- Government Regulations in Business 433
- Public Policies and Government Regulations in India 434
- Workplace Safety and Health 436
- Functional Regulations 439
- Goods and Service Tax (GST) 440
- Consumer Protection Act 444
- The Insolvency and Bankruptcy Code, 2016 446
- The Competition Act 2002 449
- Public Policies for the Global Village 453

Conclusion *454*
Keywords *455*
Discussion Questions *455*
References *456*
Suggested Readings *456*

17. Corporate Governance in the Developed and Emerging Economies **457**

- Introduction 458
- Corporate Governance Issues in the Developed Countries 459
- Problems Faced by the Developing and Transition the Economies 466
- Defining Corporate Governance 469
- Corporate Governance Models 469
- The Institutional Framework for Effective Corporate Governance 472

- Corporate Governance Challenges in Developing, Emerging and Transition Economies 477
- Current Corporate Governance Settings in Transition Economies 478
- Corporate Governance in South Africa 489
- Corporate Governance in New Zealand 491
- Corporate Governance in Indonesia 491
- Corporate Governance in Israel 492

Conclusion *493*
Keywords *493*
Discussion Questions *494*
References *494*
Suggested Readings *494*

18. Corporate Governance in the Public Sector and the Family Owned Companies: The Indian Scenario 495

- Corporate Governance in the Public Sector Companies 496
- Public Sector Governance in India 496
- Forms of CPSUs 498
- Generation of Income 498
- Strong Industrial Base 499
- Public Sector Governance 503
- Compliance of the Guidelines 514
- Family-Run Business and Corporate Governance 516

Conclusion *528*
Keywords *529*
Discussion Questions *529*
Suggested Readings *529*

19. Banks and Corporate Governance Online

- Banks and Corporates
- Why Corporate Governance in Banks?
- Corporate Governance and the World Bank
- Basel Committee on Corporate Governance
- Sound Corporate Governance Practices for Banks
- Corporate Governance in Indian Banks
- Review of Indian Experience in Corporate Governance
- Ganguly Committee's Recommendations

Conclusion
Keywords
Discussion Questions
Notes
Suggested Readings

20. Environmental Concerns and Corporations Online

- Introduction
- Industrial Pollution
- Evidence of Pollutants
- Natural Environment and Business
- Pollution Prevention
- Improving Corporate Environmental Performance
- The Need for a New Approach
- Environmental Management in India

- Corporate India Gets Eco-friendly
- India's Environment Policy

Conclusion
Keywords
Discussion Questions
Notes
Suggested Readings

21. The Corporation in a Global Society **Online**

- Introduction
- Factors Facilitating Globalisation
- Role of Multinational Corporations
- Caux Round Table
- Key Global Issues for Business
- Corporate Governance—A Prerequisitie for Globalisation

Conclusion
Keywords
Discussion Questions
Notes
Suggested Readings

GOLDEN CASE STUDIES

Case Study 1: Infosys Technologies: The Best Among Indian Corporates 533

Case Study 2: Tata Steel: A Company That Also Makes Steel 542

Case Study 3: ITC Limited: Is Corporate Governance Only Skin Deep? 548

Case Study 4: The Tussle over Corporate Governance at Reliance 560

Case Study 5: The Tylenol Crisis: How Ethical Practices Saved Johnson & Johnson from Collapse 569

Case Study 6: How Unethical Practices Almost Destroyed WorldCom 575

Case Study 7: The Rise and Fall of Arthur Andersen 582

Case Study 8: Global Trust Bank: The Bank That Went Bust 590

Case Study 9: The Enron Fiasco: Does End Justify the Means? 598

Case Study 10: TVS Group of Companies: Commitment Far Beyond a Sense of Corporate Social Responsibility 609

Case Study 11: World's Worst Man-made Disasters 618

Case Study 12: Bhopal Tragedy: Mother of All Industrial Disasters 621

Case Study 13: Ketan Played Around with Others' Money 627

Case Study 14: Problems and Issues of Corporate Governance in Emerging Economies: Russian Example 629

Case Study 15: Insider Trading: HLL–BBLIL Merger 640

Glossary *644*

Bibliography *653*

Useful Web Sites on Corporate Governance and CSR *659*

Official Reports *660*

Prominent Guidelines on Corporate Governance *661*

Links on Corporate Governance *662*

Name Index *664*

Subject Index *666*

Abbreviations

AAIFR	–	Appellate Authority for Industrial and Financial Reconstruction
ADB	–	Asian Development Bank
AFL-CI0	–	American Federation of Labor and Congress of Industrial Organisations
AGM	–	Annual General Meeting
AIST	–	Australian Institute of Superannuating Trustees
ALI	–	American Law Institute
AMCs	–	Asset Management Companies
AMFI	–	Association of Mutual Funds of India
AOP	–	Association of Persons
ARF	–	Assets Reconstruction Fund
AS	–	Accounting Standards
ASB	–	Accounting Standards Board
ASC	–	Accounting Standards Committee
ASSOCHAM	–	Associated Chambers of Commerce and Industry
BCCI	–	Bank of Credit and Commerce International
BIFR	–	The Board for Industrial and Financial Reconstruction
BIS	–	Bank of International Settlements
BOL	–	Build–Own–Lease
BOOS	–	Build–Own–Operate System
BOOT	–	Build–Own–Operate Transfer
BOP	–	Balance of Payments
BPE	–	Bureau of Public Enterprises
BSE	–	Bombay Stock Exchange
CAC	–	Capital Account Convertibility
CAD	–	Current Account Deficit
CAG	–	Comptroller and Auditor-general
CAGR	–	Compound Average Growth Rate
CAO	–	Chief Accounts Officer
CARE	–	Credit Analysis and Research Ltd.
CBDT	–	Central Board of Direct Taxes
CBEC	–	Central Board of Excise and Customs
CCFI	–	Cabinet Committee on Foreign Investment
CCI	–	Controller of Capital Issues
CDSL	–	Central Depository Security Ltd
CEO	–	Chief Executive Officer
CFE	–	Certified Fraud Examiner
CFO	–	Chief Financial Officer
CFS	–	Consolidated Financial Statement
CG	–	Corporate Governance
CII	–	Confederation of Indian Industry
CIS	–	Commonwealth of Independent States
CISCO	–	The City Group for Small Companies
CLA	–	Central Listing Authority
CLB	–	Company Law Board

CMD	–	Chairman and Managing Director
CMIE	–	Centre for Monitoring Indian Economy
COFEPOSA	–	Conservation of Foreign Exchange and Prevention of Smuggling Activities
COPU	–	Committee on Public Undertakings
COR	–	Capital–output Ratio
COSO	–	Committee of Sponsoring Organisations
CPA	–	Certified Public Accountant
CPA	–	Consumer Protection Act, 1986
CPI	–	Consumer Price Index
CPSC	–	Consumer Product Safety Commission
CRA	–	Credit Rating Agencies
CRF	–	Consumer Redressal Forum
CRISIL	–	The Credit Rating Information Service of India Ltd.
CRR	–	Cash Reserve Ratio
CSO	–	Central Statistical Organisation
CSR	–	Corporate Social Responsibility
CUTS	–	Consumer Unity and Trust Society
D&OLI Policy	–	Directors and Officers Liability Insurance Policy
DCA	–	Department of Company Affairs, Government of India
DCC	–	Depositories and Custodian Cell (of SEBI)
DEA	–	Department of Economic Affairs
DEMAT	–	Dematerialisation
DGCI&S	–	Directorate General of Commercial Intelligence and Statistics
DICGC	–	Deposit Insurance and Credit Guarantee Corporation
DP	–	Depository Participants
DRI	–	Differential Rate of Interest
DTL	–	Demand and Time Liabilities
EC	–	Executive Chairman
ECB	–	External Commercial Borrowing
ECM	–	European Common Market
ED	–	Executive Director
EDIFAR	–	Electronic Data Filing and Retrieval System (SEBI)
EEC	–	European Economic Community
EEOC	–	Equal Employment Opportunity Commission
EFTA	–	European Free Trade Association
EMR	–	Exclusive Marketing Rights
ESAF	–	Enhanced Structural Adjustment Facility
ESCAP	–	Economic and Social Commission for Asia and the Pacific
ESI	–	Employees State Insurance; Environmental Sustainability Index
ESOP	–	Employee Stock Option Plan
ESOS	–	Employee Stock Option Scheme
ESPS	–	Employee Stock Purchase Scheme
EXIM BANK	–	Export and Import Bank
FRB	–	Federal Reserve Board
FAO	–	Food and Agriculture Organisation
FASB	–	The Financial Accounting Standards Board
FBI	–	Federal Bureau of Investigation
FCCBs	–	Foreign Currency Convertible Bonds
FD	–	Fixed Deposits

FDI	–	Foreign Direct Investment
FEMA	–	Foreign Exchange Management Act
FER	–	Foreign Exchange Reserves
FERA	–	Foreign Exchange Regulation Act
FERC	–	Federal Energy Regulatory Commission
FICCI	–	Federation of Indian Chambers of Commerce and Industry
FIIA	–	Foreign Investment Implementation Authority
FIIs	–	Foreign Institutional Investors
FIPB	–	Foreign Investment Promotion Board
FIPC	–	Foreign Investment Promotion Council
FMCG	–	Fast Moving Consumer Goods
FTC	–	Federal Trade Commission
FTZ	–	Free Trade Zones
GAAP	–	Generally Accepted Accounting Principles
GATT	–	General Agreement on Trade and Tariff
GCA	–	General Currency Area
GCF	–	Gross Capital Formation
GDCF	–	Gross Domestic Capital Formation
GDP	–	Gross Domestic Product
GDRs	–	Global Depository Receipts
GEF	–	Global Environment Fund
GFCF	–	Gross Fixed Capital Formation
GFD	–	Gross Fiscal Deficit
GRT	–	Gross Registered Tonnage
GSTP	–	Global System of Trade Preference
HDI	–	Human Development Index
HPAEs	–	High Performing Asian Economies
IAS	–	International Accounting Standards; Indian Administrative Service
IASB	–	International Accounting Standards Board
IASC	–	International Accounting Standards Committee
IBM	–	International Business Machines
IBPs	–	Inter-bank Participations
IBRD	–	International Bank for Reconstruction and Development (World Bank)
ICAEW	–	The Institute of Chartered Accountants in England and Wales
ICAI	–	The Institute of Chartered Accountants of India
ICC	–	Interstate Commerce Commission
ICICI	–	Industrial Credit and Investment Corporation of India
ICL	–	Indian Confederation of Labour
ICRA	–	The Investment Information and Credit Rating Agency
ICRR	–	Independent Cash Reserve Ratio
ICSI	–	The Institute of Company Secretaries of India
ICWAI	–	The Institute of Costs and Works Accountants of India
IDA	–	International Development Association
IDBI	–	Industrial Development Bank of India
IDI	–	Industrial Development Index
IDRA	–	Industrial Development and Regulation Act
IEBR	–	International Extra Budgetary Resources
IEPC	–	Investor Education and Protection Committee
IEPF	–	Investor Education and Protection Fund

IFAC	–	International Federation of Accountants
IFC	–	Indian Fiscal Commission
IFCI	–	Industrial Finance Corporation of India
IIF	–	Institute of International Finance
IFSA	–	Investment and Financial Services Association
IGG	–	Investors Grievances and Guidance Division, SEBI
IIBI	–	Industrial Investment Bank of India
IIDC	–	Integrated Infrastructure Development Centre
IIM	–	Indian Institute of Management
IIP	–	Index of Industrial Production
ILO	–	International Labour Organisation
IMF	–	International Monetary Fund
IPO	–	Initial Public Offer
IPPs	–	Independent Power Producers
IRDA	–	Insurance Regulation and Development Authority
IRS	–	Internal Revenue Service
IUCN	–	International Union for the Conservation of Nature and Natural Resources
LA	–	Listing Agreement
LATAM	–	Latin America
LERM	–	Liberalised Exchange Rate Mechanism
LIBOR	–	London Inter-bank Borrowing Rate
LLP	–	Limited Liability Partnership
LTFP	–	Long-term Fiscal Policy
MAOCARO	–	Manufacturing and Other Companies (Auditors Report) Order
MAPIN	–	Market Participation and Investor Database (SEBI)
MD	–	Managing Director
MF	–	Mutual Funds
MFA	–	Multi-fiber Agreement
MFN	–	Most Favoured Nations
MIC	–	Monopolies Inquiry Commission
MIS	–	Management Information System
MMMFs	–	Money Market Mutual Funds
MODVAT	–	Modified Value Added Tax
MOF	–	Ministry of Finance
MOU	–	Memorandum of Understanding
MRTP	–	Monopolies and Restrictive Trade Practices
MRTP Act	–	Monopolies and Restrictive Trade Practices Act
MRTPC	–	Monopolies and Restrictive Trade Practices Commission
MSBs	–	Market Stabilisation Bonds
MTN	–	Multilateral Trade Negotiations
MTO	–	Multilateral Trade Organisation
NACD	–	National Association of Corporate Directors
NAFTA	–	North American Free Trade Agreement
NASSCOM	–	National Association of Software and Services Companies (India)
NAV	–	Net Asset Value
NBFCs	–	Non-banking Finance Companies
NCAER	–	National Council of Applied Economic Research
NCDRC	–	National Consumer Disputes Redressal Commission
NCL	–	National Commission on Labour

NCLT	–	National Company Law Tribunal
NDP	–	Net Domestic Product
NEAT	–	National Exchange Automated Trading System
NEF	–	National Equity Fund
NEP	–	New Economic Policy
NFCG	–	National Foundation for Corporate Governance
NGOs	–	Non-government Organisations
NIEs	–	Newly Industrialised Economies
NLRB	–	National Labour Relations Board
NPAs	–	Non-performing Assets
NRIs	–	Non-resident Indians
NRNR	–	Non-resident Non-repatriable Rupee Account
NSDL	–	National Securities Depository Ltd
NSDP	–	Net State Domestic Product
NSE	–	National Stock Exchange
OECD	–	Organisation for Economic Cooperation and Development Organisations
OGL	–	Open General License
OPEC	–	Organisation of Petroleum Exporting Countries
OTCEI	–	Over the Counter Exchange of India
PAC	–	Public Accounts Committee
PBT	–	Profit Before Tax
PCAOB	–	Public Company Accounting Oversight Board
PCDs	–	Partially Convertible Debentures
PCFC	–	Packing in Credit in Foreign Currency
PDS	–	Public Distribution System
PMS	–	Portfolio Management Scheme
POB	–	Public Oversight Board
PPDs	–	Process-cum-product Development Centres
PPPs	–	Purchasing Power Parities
PSEs	–	Public Sector Enterprises
PSU	–	Public Sector Undertakings
QRB	–	Quality Review Board
R&D	–	Research and Development
RBI	–	Reserve Bank of India
RCF	–	Risk Capital Foundation
ROC	–	Registrar of Companies
ROI	–	Return on Investment
SAARC	–	South Asian Association for Regional Cooperation
SADF	–	South Asian Development Fund
SAT	–	Securities Appellate Tribunal
SBI	–	State Bank of India
SCDRC	–	State Consumer Disputes Redressal Commission
SCMRD	–	Society for Capital Market Research and Development
SEBI	–	Securities and Exchange Board of India
SEC	–	Securities and Exchange Commission (USA)
SFC	–	State Financial Corporation
SLR	–	Statutory Liquidity Ratio
SNA	–	System of National Accounts
SOX	–	Sarbanes Oxley Act (USA)

SPC	–	Small Private Company
SRI	–	Socially Responsible Investing
SRO	–	Self-regulatory Organisation
STCI	–	Securities Trading Corporation of India Ltd.
STP	–	Straight Through Processing
TCOs	–	Technical Consultancy Organisations
TDC	–	Technology Development Cell
TDICI	–	Technology Development and Information Company of India Ltd.
TNCs	–	Transnational Corporations
TRIMs	–	Trade Related Investment Measures
TRIPs	–	Trade-related Intellectual Property Rights
UNCTAD	–	United Nations Conference on Trade and Development
UNDP	–	United Nations Development Programme
UNESCO	–	United Nations Educational, Scientific and Cultural Organisation
UNRID	–	United Nations Research Institute for Development
UPS	–	Usual Principal Status
UR	–	Uruguay Round
UTI	–	Unit Trust of India
VAM	–	Value Added by Manufacture
VAT	–	Value Added Tax
VCF	–	Venture Capital Fund
VOICE	–	Voluntary Organisation in Interest of Consumer Education
WDR	–	World Development Report
WHO	–	World Health Organisation
WPI	–	Wholesale Price Index
WTO	–	World Trade Organisation
XGS	–	Exports of Goods and Services
ZBB	–	Zero-base Budgeting

Foreword

When we introduced 'corporate governance' as an elective during my tenure as Director of LIBA, we found the course to be an extremely popular one. The course became popular, partly because of the subject, but largely because of the popularity of Professor Fernando. His book *Corporate Governance: Principles, Policies and Practices* distills and collects the results of all those years of teaching by Professor Fernando at LIBA. I am greatly honoured by the privilege accorded to me by my former colleague in being asked to write the foreword to his book. Today, governance has become a hot subject in every field. We need good governance in government, especially in people-elected governments. In fact, governance is important for effective delivery of the vision of any organisation—NGOs, religious bodies, trade unions, even families.

Corporate governance gains greater importance since it is the largest sector in any country involving most of the human and natural resources and making the largest contribution to the economic development of a country. Unless there is proper corporate governance, no country can progress. Though the importance of corporate governance was always implicit, its relevance came to the fore only after the crisis created by Enron, Andersen and others. Human tendency is to lock the stable after the horses are stolen but, thank God, people awoke to the situation before all the horses were stolen. Today, like the three sisters of a religion—faith, hope and charity—three sisters of corporations—business ethics, corporate governance and social responsibility—are necessary to satisfy all the stakeholders. Everyone speaks about them, most management schools teach them but, alas, very few practise them. At this juncture, it is very timely to have a book on corporate governance from a person who has many years of corporate experience and is an eminent professor of the subject.

The book, starting with the meaning of corporate governance and why it rose to a preeminent position, tackles various issues. Any organisation in a social order has to comply with legal obligations. But this is the minimum one should do. If a corporation fails to comply with the law, the law enforcers will deal a severe blow as they have done to so many corporations. Unfortunately, they catch the culprits very late or after others have caught them, as we often see in movies. But if a corporation believes that it is sufficient to meet the legal requirements alone and aim at maximising profit, it will meet a tragic end sooner than it expects. Today, an organisation has to move beyond legal compliance; it has to have social welfare, quality of life and the country's development at heart. Unless a corporation tries to practise these, it will be swept away by the mighty current of self-interest. If it wants to follow the path of the "invisible hand", its "survival" will be at stake. Professor Fernando, while considering legal compliance, business ethics, corporate governance and social responsibility, also deals with the need for the corporations to have a deep concern for environment. Environmental concern should arise not merely from social responsibility and ethical compliance concerns, but also from the point of view of profitability, growth and ultimately to offer quality of life to its employees and customers. This implies that a corporation, for its very existence, has to be concerned about environment. Professor Fernando deals with all these areas with a large number of examples, in his usual lucid and powerful style. These days, a lot of books are trickling in on these subjects, but very few are comprehensive. I have seen only one, but it is in four volumes. This book will meet the need of management schools, corporations and enforcing authorities.

St Ignatius of Loyola used to speak of his little book *Spiritual Exercises* as a collection of exercises to be practised if one wished to transform oneself. Similarly, this book is a collection of chapters on corporate governance, not just to be read but to be practised. One has to practise it with great sincerity and zeal. It will transform not only the corporate world, but also politics, NGO administration and religious bodies.

N. Casimir Raj, S. J.
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Jamshedpur

Preface to the Third Edition

We are happy to acknowledge that the second edition of the book *Corporate Governance: Principles, Policies and Practices* has been well received both by academicians as well as students. The book fulfilled a void that existed at that point of time for a well-conceptualized and structured book on the subject of corporate governance, which was then emerging as a new discipline in management science.

Though there were very few institutions that had adopted corporate governance as an elective course, still the demand for the book surged as years went by. More and more libraries and faculty in the department of management started patronising the book.

Thanks to the faculty, students and others who took time to go through the book and also for communicating with us the need to incorporate certain salient features they thought the new edition of the book should have. We are happy to include some of their suggestions.

The Organisation of the Book

The book *Corporate Governance: Principles, Policies and Practices* is divided into four parts with a view to providing instructors and students a convenient and systematic build-up of knowledge on the subject that is being dealt with herein.

Part One: "Understanding of Corporate History and Governance" deals with the basics of corporate governance a student of the subject ought to know such as an overview of the subject, the theory and practice of corporate governance and landmarks in the emergence of corporate governance as a systematised body of knowledge.

Part Two: "Legal Framework and Agents in Corporate Governance" deals with all those agents, institutions and mechanisms that are engaged in promoting corporate governance, and includes the study of shareholders—their rights and privileges; investors' problems and their protection; corporate governance and other stakeholders; the role of board of directors and auditors in ensuring corporate governance and how it is important for commercial banks.

Part Three: This part provides an in-depth study of "Components and Facilitators of Corporate Governance", which deals with all those institutions and role players that are engaged in promoting corporate governance. In this part, students are exposed to the study of business ethics in its relation to corporate governance, corporate social responsibility and environment, besides the role of the media in ensuring corporate governance and how monopoly and competition provide different situations in its implementation in corporations. Part three also deals with such topics as the role of public policies in governing business, the Indian capital market regulator, SEBI and the role of the government in ensuring corporate governance.

Part Four: "Issues and Problems of Corporate Governance in Developed and Emerging Economies" deals with issues and problems of corporate governance in emerging economies such as Russia and India. The last chapter deals with the corporation in a global society.

Features

The book presents a detailed study of corporate governance written in simple and lucid language. Starting with the explanation of the basic issues relating to the subject, it guides the readers from elementary to complex concepts. All theoretical concepts are illustrated with examples from the Indian corporate sector. The book incorporates several features that make it a student-friendly text. Designed to cater to the needs of students both as a text and as a reference volume on corporate governance, the book provides an in-depth coverage of all topics a student ought to know on the subject.

Golden Case Studies: The inclusion of real-world cases for the appropriate chapters presents students with snapshots from the corporate world. These cases have been selected to enable readers understand the multifarious and diverse environment within which Indian corporations operate.

Conclusion: Each chapter includes a conclusion to help students review the key points presented in the chapter.

Notes: Notes provided under each chapter provide not only the explanation for references found in the text, but also the context and a detailed analysis thereof.

Keywords: Keywords highlight the important terms discussed in the chapter.

Discussion Questions: End-of-chapter questions are designed to check the student's comprehension of concepts presented in the chapter.

Suggested Readings: Each chapter includes a list of suggested readings for those who wish to know more about the topics discussed in the chapter from authors who are experts on the subject.

The other features include a Glossary, Useful Web Sites on Corporate Governance and CSR, Official Reports, Prominent Guidelines on Corporate Governance, Links on Corporate Governance and Abbreviations.

The Teaching and Learning Package

The teaching and learning package includes PowerPoint lecture slides, which can be downloaded from the book's companion Web site www.pearsoned.co.in/cg3e

Acknowledgements

I am greatly indebted as the author of this book on corporate governance to all the original thinkers and contributors to the subject. In all humility, I acknowledge with gratitude the contributions of the writers, commentators and committees who elucidated the theoretical and practical aspects of corporate governance, which enabled me to borrow from these writings. I have acknowledged, wherever required, their contributions under notes and references. However, if there are errors or discrepancies in the book, I have no hesitation to accept them as mine and mine alone.

I gratefully acknowledge the help rendered by the following persons in the preparation of this book: Rev. Fr. N. Casimir Raj, S.J., Ph.D., Director, XLRI, Jamshedpur, who provided me an opportunity to handle the course on the subject when he was the director at LIBA and obliged me most willingly by writing the foreword for the book; Rev. Fr. P. Christie, S.J., Ph.D., Director, LIBA, who was most pleased to offer me all facilities to complete my work; M. U. Alagusundaram, who assisted me obligingly in getting my script typed time and again; my students for their help in various ways; Rev. Fr. James Antony for his inputs on the chapter on business ethics; Pradha Narasimhan, who sourced for me all relevant materials on the subject; Prashant Menezes, Sharon Jose, Yashwanti, Edward Paul, Lissle Simcock and Michael, all of whom helped me in numerous ways; and our Librarian, Surya, who went out of her way to get me the books I wanted—which were too many—at the quickest possible time.

I also owe a debt of gratitude to Pearson Education, especially Satish Kumar KVC, who first mooted the idea of the book. Last, but not the least, I owe it to my wife, Mrs Jossie C. Fernando who had to lead a lonely life for almost two years as I was immersed during all my waking hours in writing, proof-reading, editing and reshuffling the chapters of the book.

A. C. Fernando

We acknowledge the support and encouragement given by former professors of Department of Commerce and Management Studies Prof. K. C. Vijayakumar, Prof. T. Govindankutty Nair and Prof. E. P. Sainul Abideen. We also acknowledge the contribution and support given by all the teachers, students, non teaching staff and librarian of the Department of Commerce and Management Studies, University of Calicut for the timely completion of the work.

Eventually, I spotlight my record of appreciation for the unstinted and incomparable support provided by my friends in Pearson Education for carving this book, Pradeep Kumar Bhattacharjee and M. Balakrishnan.

K. P. Muraleedharan
E. K. Satheesh

Preface

It gives me great pleasure to place *Corporate Governance: Principles, Policies and Practices* in the hands of teachers, students and other interested readers. As a college teacher of economics, I developed an interest in India's industrial growth and all connected issues. After almost two decades as a professor, I moved to industry and was able to observe, at close quarters, how companies were run and how often they were misgoverned.

This exposure to developments in the corporate world prompted me to pen a well-received article "Corporate Governance—The Time for a Metamorphosis" in *The Hindu* in July 1997. Corporate governance was, at this time, gaining currency among stakeholders. When I returned to academics soon thereafter, I got an opportunity to teach a course on corporate governance at the Loyola Institute of Business Administration (LIBA). I realised then that though there were many books on the subject, almost all of them dealt with specific areas, like the role of directors or compensation for managers. There was not a single book that catered to the all-inclusive needs of postgraduate commerce, economics or management students in an elective (3-4 credit) course on corporate governance (an increasingly popular option). My students encouraged me to write a book that would contain in one volume all the material they would normally have to collect from diverse sources.

Having realised the need for a comprehensive book on corporate governance for not only students, but also researchers, scholars of issues relating to company management, and general readers, I have attempted to provide an in-depth analysis of the subject in a single volume. This text covers the emergence of the concept of corporate governance, the manner in which it was crystallised into a subject of significance, its various problems and issues, its constituents, and how it is being implemented, both in India and abroad.

This book also presents a comparative study of how various countries approach the concept, how they have institutionalised mechanisms for governance, and where they are headed. It addresses multi-dimensional perspectives—of shareholders and other stakeholders like employees, regulators, environmentalists, creditors, the government, and society at large.

The text has been written with the beginner and general reader in mind. Simple, yet lucid, language is used to explain concepts and theories, and illustrations are provided wherever necessary. For those not familiar with economic, commercial, and corporate jargon, a glossary of terms is provided at the end of the book. Likewise, a list of acronyms and their expansions is also provided.

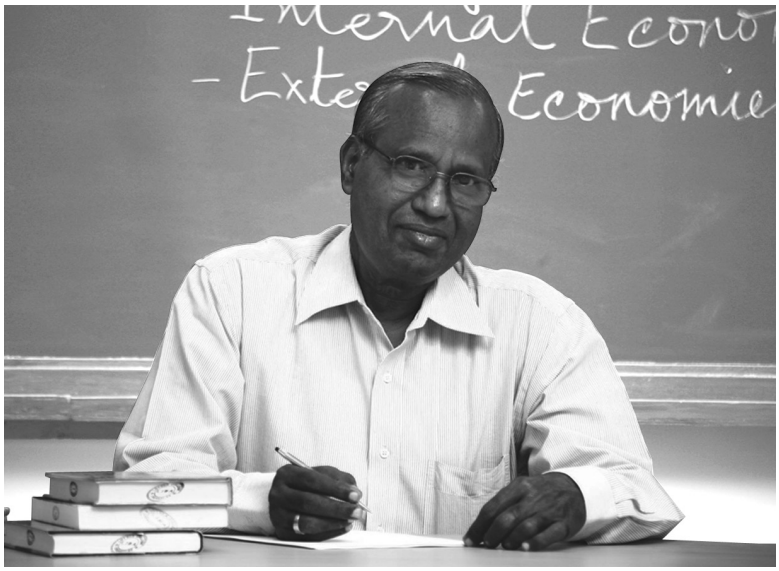
For researchers and advanced learners too, this book provides ample material. An exhaustive reference of books, magazines and journals on the subject is included to facilitate research. Likewise, a long list of Web sites, containing a wealth of material, has been added along with guidelines on corporate governance and quick links to what has been done by governments, international organisations, NGOs and industry federations.

This book is written in a way that would be highly helpful for those who teach the subject. It offers comprehensive coverage of the subject, while never overstressing or elaborating the trivial. Fifteen case studies, appended to appropriate chapters, will enable professors to guide their students effectively.

I am fully aware that this book will serve its purpose only if it fulfils every need of students, teachers and other readers. While I request their indulgence for any error or flaw found in the book, I also solicit their opinions, reviews, comments and suggestions to improve the successive editions of the book.

A. C. Fernando

About the Author



Late A. C. Fernando has just retired as a senior professor of Economics and Corporate Governance at the Loyola Institute of Business Administration (LIBA), Loyola College, Chennai. He was then the Director of the Loyola Centre for Business Ethics and Corporate Governance, a centre of excellence established by LIBA. He has been teaching economics-related subjects and Corporate Governance at LIBA since 1990. He was also the Editor of *Management Matters*, a bi-annual business journal of the institution.

Professor Fernando obtained a postgraduate degree in economics from the University of Madras, following which he was appointed a lecturer in the Department of Economics, Sophia College, Bombay, where he taught all courses relating to economics for 15 years. He was also associated with the University of Bombay where he taught Public Finance for a couple of years at the postgraduate level and pursued research. Concurrently, he also conducted a socio-economic survey on Catholic orphanages for Miserior and worked as a consultant in industry.

Subsequently, Professor Fernando moved to Chennai as the Director of the Training Division of Datamatics Corporation, Chennai, where he designed and conducted several short-term non-formal management and other inter-disciplinary programmes. Having spent a decade as a non-formal educational administrator, he joined a large Chennai-based industrial conglomerate as Corporate Manager, Publicity and Public Relations and Editor of their world-renowned industrial directory, a position he held for almost ten years. During this time, he continued to teach management courses as visiting faculty at the University of Madras, the Institute of Chartered Accountants of India, the Institute of Company Secretaries of India, the Institute of Bankers and LIBA.

He has co-authored six books on economics, edited three issues of a prestigious industrial directory, Kothari's Industrial Directory of India, apart from several issues of *Management Matters*, authored articles on education, economics, management and corporate governance, which have been published by frontline publications including *The Hindu*. His latest books—*Business Ethics* and *Corporate Ethics, Governance and Social Responsibility*—have been well-received by instructors and students in institutes and universities across the country.

A communicator par excellence, Professor Fernando's expertise in corporate governance stems from his 50-year long teaching experience of the subject as well as his incisive knowledge of the functioning of the Indian economy.

About the Contributors



K. P. Muraleedharan was the former Director and Dean of School Business Studies, University of Calicut and also Head of the Department of Commerce and Management Studies. He was born and raised in Feroke, a small town in the district of Calicut, Kerala. Dr K. P. Muraleedharan owns an impeccable academic career by completing his under-graduation and post-graduation in the department of Commerce from Farook College affiliated under the University of Calicut. With a stint of academic excellence, he also pursued his MBA from Bharathiar University and was honoured with Ph.D. in Marketing from the University of Calicut. Dr K. P. Muraleedharan has been teaching Marketing and Finance for the past 36 years.

Dr Muraleedharan has been associated with multiple institutions throughout his teaching career for a succinct period of time. He kickstarted his professional teaching career from several NSS Colleges in Kerala and contributed his extensive academic knowledge to the Department of Commerce at the University of Kerala and the University of Calicut till his tenure as a professor in 2017. He also served as a professor in Marketing for a brief period in the Modern College of Business and Science, Sultanate of Oman.

For acquitting himself well in the teaching profession, Dr Muraleedharan have successfully guided 18 students for Ph.D. and 45 students for M.Phil. so far. He has also published more than 45 research papers in both national and international journals. His major areas of interest in research includes Marketing, Corporate Governance, Investment Management and other Finance related domains.

Dr Muraleedharan served as a Dean for the Faculty of Commerce at the University of Kerala for two terms and was acquainted as a Dean for the Faculty of Commerce and Management Studies at the University of Calicut for three terms. Apart from his professional service as the Coordinator of MBA and MHA programs at the School of Management Studies, Aranattukara, Trichur for the past 16 years, Dr Muraleedharan has served as the member of the Academic Council of the University of Kerala and the University of Calicut for 12 years. He also served as the Director for the College Development Council at the University of Calicut and a functional Member, Syndicate at Sree Sankaracharya Sanskrit University, Kalady for three years.

Dr Muraleedharan is recognized with a membership in various professional bodies like the Indian Commerce Association, the Indian Accounting Association, the Trichur Management Association and various expert committees of different universities, UGC and AICTE.



E. K. Satheesh is a Professor of Financial Management in the Department of Commerce and Management Studies. He is currently the Dean for the Faculty of Commerce and Management and former Head, Department of Commerce and Management Studies, University of Calicut. E. K. Satheesh completed his M.Com. degree from the Department of Commerce and Management Studies. He was also honoured with an endowment award for best performance in M.Com. and MBA degree courses from Pondicherry University. With a subtle academic performance, Satheesh received his Ph.D. in Merchant Banking and Financial Services from the Department of Commerce and Management Studies, University of Calicut associated with a fellowship from the University Grants Commission. Since 1995, he has held various academic and administrative positions in NSS College and University of Calicut. Satheesh has contributed his knowledge by providing guidance to 2 Ph.D. and 10 M.Phil. students for preparing dissertations. He is also a life member of Indian Institute of Public Administration, New Delhi. Notably, E. K. Satheesh has published more than 25 research papers in reputed journals and played a major role as a resource person and key note speaker. His papers have been presented in more than 50 national and international conferences, seminars, workshops, symposiums throughout India. For having completed his one minor project and one major project from the University Grants Commission, in November 2017, he received an invitation from the British High Commission for academic collaboration. Owing to his remarkable academic career, Satheesh was also invited to UAE to address the postgraduate students.



PART ONE

Understanding of Corporate History and Governance



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Corporate History, Structure and Ownership Pattern

CHAPTER OUTLINE

- Introduction
- Characteristics of a Company
- Types of Company
- History of Modern Corporate Form of Business
- History of Company Form of Business in India
- Cotton Boom and Jute Boom and Formation of Stock Exchanges in India
- Growth of Public Sector Companies
- SEBI
- Disinvestment Policy of Government of India
- Corporate Structure in India
- Corporate Ownership Pattern
- Corporate Ownership in Different Countries
- Shareholding Categories

Introduction

The discussion on corporate governance is as old as the history of company form of business model. The English word 'Company' has originated from the French word '*Compaignie*' which means a body of soldiers. In strict sense a company is an association of person formed for the purpose of achieving some common objectives. In other words a **Company** is a legal entity made up of an association of persons, be it natural, legal, or a mixture of both, for carrying on a commercial or industrial enterprise. Company members share a common purpose and unite in order to focus their various talents and organize their collectively available skills or resources to achieve specific, declared goals. Companies take various forms such as:

According to Marshall, "A company is a artificial person, invisible, intangible and existing only in the contemplation of law".

It is a incorporate association—artificial person-perpetual succession—common seal—transferability of share—limited liability-separation of ownership and management.

- Voluntary associations organised in public and private sector which may include any non-profit organisation.
- A group of soldiers organised to accomplish a task.
- Business entities with an aim of gaining profit.
- Financial entities and banks.

A more broad definition of company is that it is an artificial person created by law, having perpetual succession and common seal, who can sue and be sued on it.

According to the US law a company may be a "Corporation, partnership, association, Joint Stock Company, trust, fund or organised group of persons whether incorporated or not including any receiver, trustee in bankruptcy or similar official or liquidating agent for any of the for going". In the US a company need not necessarily be a corporation. As per the British law a company is a body corporate or a corporate company registered under the British Company Act or similar legislation. The common establishments of company in Britain include private company limited by guarantee, companies without share capital, private company limited by shares and public limited company.

As per the Indian Companies Act a company is "One formed or registered under the Indian Companies Act 2013 or an existing company". An existing company is a company formed or registered under any of the previous company laws. This definition does not reveal the distinctive characteristics of a company. According to Marshall, "A company is a person artificial, invisible, intangible and existing only in the contemplation of law. It possesses only those properties which the character of its creator confers up on it either expressly or as incidental to its very existence".

Another comprehensive and clear definition of a company is given by Lord Justice Lindley, "A company means an association of many persons who contribute money or money's worth to a common stock and employs it in some trade or business, and who share the profit and loss (as the case may be) arising there from. The common stock contributed is denoted in money as the capital of the company. The persons who contribute it, or to whom it belongs are members. The proportion of capital to which each member is entitled is his share. Shares are always transferable although the right to transfer them is often more or less restricted". According to Haney, "A Joint Stock Company is a voluntary association of individuals for profit, having a capital divided into transferable shares. The ownership of which is the condition of membership".

From the above definitions, it can be concluded that a company is a registered association which is an artificial legal person, having an independent legal entity with a perpetual succession, a common seal for its signatures, a common capital comprising transferable shares and carrying limited liability.

Characteristics of a Company

The main characteristics of a company are:

1. **It is an incorporated association.** A company is created when it is registered under the Companies Act. It comes into being from the date mentioned in the certificate of incorporation. For establishing a public company at least seven persons and for a private company at least two persons are required. These persons will subscribe their names to the Memorandum of Association and also comply with other legal requirements of the Act in respect of registration to form and incorporate a company, with or without limited liability.
2. **Artificial legal person.** A company is an artificial person. Negatively speaking, it is not a natural person. It exists in the eyes of the law and cannot act on its own. It has to act through a board of directors elected by the shareholders. But for many purposes, a company is a legal person like a natural person. It has the right to acquire and dispose of the property, to enter into contract with third parties in its own name, which can sue and be sued in its own name. However, it is not a citizen as it cannot enjoy the rights under the Constitution. The company does not become a citizen of India.
3. **Separate legal entity:** A company has a legal distinct entity and is independent of its members. The creditors of the company can recover their money only from the company and the property of the company. They cannot sue individual members. Similarly, the company is not in any way liable for the individual debts of its members. The property of the company is to be used for the benefit of the company and not for the personal benefit of the shareholders. On the same grounds, a member cannot claim any ownership rights in the assets of the company either individually or jointly during the existence of the company or on its winding up. At the same time the members of the company can enter into contracts with the company in the same manner as any other individual can.
4. **Perpetual succession:** A company is a stable form of business organisation. Its life does not depend upon the death, insolvency or retirement of any or all shareholder(s) or director (s). Law creates it and law alone can dissolve it. Members may come and go but the company can go on forever.
5. **Common seal.** As pointed out earlier, a company being an artificial person has no body similar to natural persons and as such it cannot sign documents for itself. It acts through natural persons who are called its directors. But having a legal personality, it can be bound by only those documents which bear its signature. Therefore, the law has provided for the use of common seal, with the name of the company engraved on it, as a substitute for its signature. Any document bearing the common seal of the company will be legally binding on the company.
6. **Limited liability:** One of the most distinguishing characteristics is the limited liability. A company form differs from a sole trader or partnership form model of business mainly because of these characteristics. A company may be limited by shares or limited by guarantee. In company limited by shares, the liability of members is limited to the unpaid value of the shares.
7. **Transferable shares.** In a public company, the shares are freely transferable. The right to transfer shares is a statutory right and it cannot be taken away by a provision in the articles. However, the articles shall prescribe the manner in which such transfer of shares will be made and it may also contain bona fide and reasonable restrictions on the right of members to transfer their shares. But absolute restrictions on the rights of members to transfer their shares shall be ultra vires. However, in the case of a private company, the articles shall restrict the right of member to transfer their shares in companies with its statutory definition.

8. **Separate property:** As a company is a legal person distinct from its members, it is capable of owning, enjoying and disposing of property in its own name. Although its capital and assets are contributed by its shareholders, they are not the private and joint owners of its property. The company is the real person in which all its property is vested and by which it is controlled, managed and disposed of.
9. **Separation of ownership and management:** A joint stock company is an autonomous, self-governing and self-controlling organisation. Since it has a large number of members, all of them cannot take part in the management of the affairs of the company. Actual control and management is, therefore, delegated by the shareholders to their elected representatives, known as directors. They look after the day-to-day chores of the company. This characteristic gives a peculiar relationship between the shareholders and the Board of directors called 'Agent- Principle relations' or 'Shareholders theory' which is the main focus of the discussion on corporate governance.

Types of Company

Joint Stock Company can be of various types. The following are the important types of company.

Classification of Companies by Mode of Incorporation

Depending on the mode of incorporation, there are three classes of joint stock companies:

1. **Chartered companies:** These are incorporated under a special charter of the King or Queen. The East India Company and The Bank of England are examples of chartered companies incorporated in England. The powers and nature of business of a chartered company are defined by the charter which incorporates it. A chartered company has wide powers. It can deal with its property and bind itself to any contracts that any ordinary person can. In case the company deviates from its business as prescribed by the charter, the Sovereign can annul the latter and close the company. Such companies do not exist in India.
2. **Statutory companies:** The companies which are incorporated by a Special Acts of parliament or state legislature are called statutory company. Reserve Bank of India, State Bank of India, Industrial Finance Corporation, Unit Trust of India, State Trading Corporation and Life Insurance Corporation are some of the examples of statutory companies. Such companies do not have any memorandum or articles of association. They derive their powers from the acts constituting them and enjoy certain powers that companies incorporated under the Companies Act. Alterations in the powers of such companies can be brought about by legislative amendments.
3. **Registered companies:** These are formed under the Companies Act, 2013 or under the Companies Act passed prior to this. Such companies come into existence only when they are registered under the Act and a certificate of incorporation has been issued by the Registrar of Companies. This is the most popular mode of incorporating a company. Registered companies may further be divided into three categories namely:
   (a) Companies limited by shares: These types of companies have a share capital and the liability of each member or the company is limited by the Memorandum to the extent of face value of share subscribed by him. In other

words, during the existence of the company or in the event of winding up, a member can be called upon to pay the amount remaining unpaid on the shares subscribed by him. Such a company is called the company limited by shares. A company limited by shares may be a public company or a private company. These are the most popular types of companies.

(b) Companies limited by guarantee: These types of companies may or may not have a share capital. Each member promises to pay a fixed sum of money specified in the memorandum in the event of liquidation of the company for payment of the debts and liabilities of the company This amount promised by him is called 'Guarantee'. The articles of association of the company state the number of member with which the company is to be registered. Such a company is called a company limited by guarantee. The amount of guarantee of each member is in the nature of reserve capital. This amount cannot be called upon except in the event of winding up of a company.

(c) Unlimited companies: A company not having any limit on the liability of its members is called an 'unlimited company'. The liability of each member extends to the whole amount of the company's debt and liabilities. It is more or less similar to a partnership form of entity except the fact that third party cannot sue the members of the company directly as in the case of partnership because of the separate legal entity status. Thus the creditors shall have to institute the proceedings for winding up of the company for their claims. The official liquidator may be called up on the members to discharge the debts and liabilities without limit. An unlimited company may or may not have a share capital. If it has a share capital it may be a public company or a private company. If the company has a share capital, the article shall state the amount of share capital with which the company is to be registered.

On the Basis of Number of Members

On the basis of number of members, a company may be:

1. Private Company
2. Public Company

Private Company

The term Private Company has been defined under section 2(68) of the Indian Companies Act 2013. According to it a private Company means a company, which has a minimum paid up share capital of ₹1,00,000 and which provides the following restrictions through its Articles of Association and Memorandum:

- Restricts the transfer of shares by its members.
- Limits the maximum number of members to 50.
- Prohibits any invitation to public for debentures of the company. It also enjoys special privilege's, such as:
  - It can be started with only two members,
  - It is not required to issue a prospectus and
  - It can start its operations immediately after receiving the Certificate of Incorporation.

According to section 2(68) of the Indian Companies Act 2013, a private company means a company having a minimum paid up capital of ₹1 lakh, and its article restricts transfer of shares, maximum number of members to 50, prohibits invitation to public to subscribe shares or debentures, etc.

Public Company

According to Indian Companies Act 2013 'A public company is not a private company'. If we explain the definition of Indian Companies Act in regard to the public company, we note the following:

1. The articles do not restrict the transfer of shares of the company.
2. It imposes no restriction on the maximum number of the members on the company.
3. It invites the general public to purchase the shares and debentures of the companies.
   (a) **Minimum number:** The minimum number of persons required to form a public company is seven.
   (b) **Maximum number:** There is no restriction on maximum number of members in a public company, whereas the maximum number cannot exceed 50 in a private company.
   (c) **Public subscription:** A public company can invite the public to purchase its shares or debentures.
   (d) **Issue of prospectus:** Unlike a public company a private company is not expected to issue a prospectus or file a statement in lieu of prospectus with the Registrar before allotting the shares.
   (e) **Transferability of shares.** In a public company, the shares are freely transferable.

On the Basis of Control

Public company is a company defined as a company which is not a private company

On the basis of control, a company may be classified into

1. Holding companies
2. Subsidiary company

Holding Company

A company is known as the holding company of another company if it has control over the other company. A company is deemed to be the holding company of another if, but only if, the other is its subsidiary. A company may become a holding company of another company in either of the following three ways:

(a) by holding more than fifty per cent of the normal value of issued equity capital of the company; or

(b) by holding more than fifty per cent of its voting rights; or

(c) by securing to itself the right to appoint, the majority of the directors of the other company, directly or indirectly. The other company in such a case is known as a 'Subsidiary company'. Though the two companies remain separate legal entities, yet the affairs of both the companies are managed and controlled by the holding company. A holding company may have any number of subsidiaries. The annual accounts of the holding company are required to disclose full information about the subsidiaries.

Subsidiary Company

A company is known as a subsidiary of another company when its control is exercised by the latter (called holding company) over the former called a subsidiary company. Where a company (company S) is subsidiary of another company (say Company H), the former (company S) becomes the subsidiary of the controlling company (company H).

On the Basis of Ownership of Companies

(a) **Government companies:** A Company of which not less than 51 per cent of the paid up capital is held by the Central government or by the State government singly or jointly is known as a government company. It includes a company subsidiary to a government company.

The share capital of a government company may be wholly or partly owned by the government, but it would not make it the agent of the government.

(b) **Non-government companies.** All other companies, except the government companies are called non-government companies. They do not satisfy the characteristics of a government company as given above.

On the Basis of Nationality of the Company

(a) **Indian companies:** These companies are registered in India under the Companies Act, 1956 and have their registered office in India. Nationality of the members in their case is immaterial.

(b) **Foreign companies:** It means any company incorporated outside India which has an established place of business in India. A company has an established place of business in India if it has a specified place at which it carries on business such as an office, store house or other premises with some visible indication of premises.

Forms of Business Organisation

Right from the beginning of the economic history of mankind to date, the business is carried out in four different forms namely sole proprietorship form, partnership form, corporate form and cooperative form.

Forms of Business
Proprietary firms—partnership firms—company form and cooperative organisation.

Proprietary Form of Business

The earliest and mostly widely used model of business all over the world is the sole proprietorship or proprietary business. As the name indicates it is one man business. The proprietor or sole trader generates business idea; contributes capital and takes complete risk of running the business. He also takes the whole profit. He is personally liable for the whole obligations of the business. Not only are his business properties liable for the obligation of the business but also his private properties. The ownership and control also rests with the same individual. There is no separation of ownership and management. There is no distinction between business and business man. Hence the business ceases to exist at the death of the proprietor. This mode of business is used when the amount of capital required is less, business risk is low and scale of operation is not large.

Partnership Form

When the scale of operation is increased, more capital is required and risk level increases, the business assumes partnership form with two or more business men joining together and conduct the business. According to section 4 of the Indian

Partnership Act, a partnership is the relation between two or more persons who have agreed to share the profits of a business carried out by all or any one acting for all. The persons who have entered into the partnership with one another are called individually as partner and collectively as firm. This form of business is able to generate more capital and reduce individual risk. Profit and loss are shared by the partners in an agreed proportion. Control and management are also shared by the partners. Partners are jointly and severally liable for the whole obligations of the firm as is in the case of sole tradership. There is no independent existence of the firm. It ceases to exist with the retirement or death of one or more partners. The firm cannot sue on its own or be sued upon it.

Joint Stock Company Form

During the last two centuries all over the world we have witnessed significant changes such as advent of industrial revolution, trend of colonization, identification of huge unexploited natural wealth, emergence of the US as a super power, increased economic integration between nations, convergence of human needs and wants, advent of modern technology in manufacturing and service sectors, increased trade cooperation between nations, elimination of barriers of trade within and between nations, free movement of technology and capital across nations, etc. All these have contributed to the development of new thinking about large types of business forms with huge capital, reduced risk, limited liability, separation of ownership and control, transferability of rights, liquidity, etc. The development of company form of business format is the result of this thinking. Today, all over the world a large part of business in terms of volume and value assumed joint stock company format of business with characteristics like, separate entity, separation of ownership and control, transferability of right, risk diversification, etc.

According to section 120, a co-operative society is an association of persons varying in number who are having the same or similar economic difficulties and who voluntarily associate on the basis of equal rights and obligation, endeavour to solve these difficulties mainly by conducting at economic functions that correspond to their common needs.

Co-operative Form of Business Organisation

Another form of business organisation though not very popular but powerful in certain sectors in commercial line is the co-operative society. But it eliminates most of the negative aspects of joint stock form of business. A cooperative society is an enterprise formed and directed by an association of users, applying within directly intended to serve both its own members and the society as a whole. To put it in other words, a cooperative organisation is an association of persons who come together voluntarily to achieve some common purpose, through an economic enterprise, working at their own risk and with resources which all members contribute.

In the words of International Labour Organization, a co-operative society is an association of persons varying in number who are having the same or similar economic difficulties and who voluntarily associate on the basis of equal rights and obligation, endeavour to solve these difficulties mainly by conducting at their own risk and undertaking to which they have transferred one or more such economic functions that correspond to their common needs.

The basic principles up on which a cooperation form of enterprise is built are:

1. Universality of membership
2. Democratic control
3. Political and religious neutrality
4. Self-help and mutual help
5. Principle of limited liability and
6. Limited interest on capital

History of Company Form of Business

The history of business format similar to some of the characteristics of a modern company dates to 500 AD in Europe and Asia. Business establishments with the characteristics of pooling of capital from many, separation of ownership and control, separate entity distinct from the capital contributors, etc. existed in different parts of the world. According to the available history, 'Kongo Gumi' was the first such business established in the year 578 AD to undertake construction work in Japan. In 705 AD 'Nishigama Onsen Keiunkan' was started and 'Koman' in 717 AD to undertake hotel business in Japan. Since then several business establishments were started in Japan in that format.

In Europe this format was first introduced in Germany in 862 AD by 'Staffelter Hof' for manufacture of Wine. By 953 AD a business called "Bingley Arms" was formed in the UK in this format for manufacturing arms and ammunitions. This was followed by the establishment of 'Marinelli Bell Foundry' in Italy to under take foundry business. In France a company called "Egghebella" was formed for manufacturing Wine in 1239.

Starting of 'Bian Yi Fang' for conducting hotel business in 1416 laid the foundation of this format of business in China followed by 'Guangzhou Chen Lei' for conducting pharmaceutical business.

It was in the farming business this format was tried first in US. During the early years of 16th century three business houses were started in this format in US, namely Shirley Plantation in 1613, Tuttle's Red Barn in 1623 and field View Farm in 1639. Since then a number of business units were formed in different sectors in different parts of the world like Australia, Canada, New Zealand, Russia.

History of Modern Corporate Form of Business

As has been stated above the origin of business format with the characteristics of modern joint stock company can be traced to medieval guilds which were established with separate legal entity, pooling of capital from several people and sharing of profit in proportion to capital contribution, the most important distinguishing characteristics of a corporate form of business from other forms. The emergence of joint stock Company during 16th century occurred as foreign trade expanded to newly discovered parts of the world. Trade monopolies were granted by the Royal charter to those who furthered the government policy by equipping navy, establishing colonies and discovering new trade routes. Initially permissions were given to individuals but later to group of individuals as more capital is required for this and higher risk involved. The most famous and successful of these companies were centred in England and Northern Europe, namely the English East India Company started in 1600 and the Dutch East India Company started in 1602.

History of Old Company Format of Business
History of corporate form of business dates back to 500 AD in Europe and Asia. The first such business was started in Japan in 578 AD to undertake construction work. In Germany, this format was first introduced in 862 AD to manufacture wine and in the UK in 953 to manufacture arms and ammunitions. In France, this format was first started in 1239 for manufacturing wine. In China the first company was started in 1416 in the hotel business. In US this form was first experimented in farming business in 1613.

The **Dutch East India Company** was established with the approval and backing of the government of the Netherlands. In the early seventeenth century some of the most sought-after trade goods in Europe were spices namely, cinnamon,

nutmeg, and cloves. Such spices were tremendously expensive and rare in the European market and grown only in a small number of distant islands in Asia. The Dutch East India Company was able to establish trade connections with several key trading ports in Asia and to ship high-value Asian trade goods back to Europe for sale. The Dutch focused most of their efforts on the islands of Southeast Asia but established trading centres in places like Japan and Africa.

The **English East India Company** established in 1600, traded in Indian textiles, precious metals, Chinese silks and tea throughout the Indian Ocean regions. Like the Dutch in Southeast Asia, English merchants conquered key port cities and provinces throughout South Asia. By the close of the eighteenth century the English East India Company controlled vast portions of India. After the initial success of the Dutch East India Company and the English East India Company several other companies were formed in Europe for high-risk ventures like trading and mining. For example, after witnessing the success of the Dutch and English, the French formed their own French East India Company in 1664. There were also companies formed in Sweden, Scotland, Denmark and the North America.

History of Modern Company Format of Business

Modern history of corporate form of business dates back to 1600 with the establishment of English East India Company followed by Dutch East India Company in 1603 for mobilizing capital and skills conducting overseas spices trade under royal charter of King/ queen. The Virginia Company started in Jamestown Virginia in 1606 was the first joint stock company formed in USA. In Germany two companies were formed in two different formats namely public limited company format and private limited company format. Frederick the Great's Asiatic Company started in Ernden in 1750 was the first public limited company formed in Germany.

At first it was a loose association of merchants rather than a company in its present form. Along with the company conducting business, members were also allowed to carry out trade in their individual capacity. Profits were divided at the end of each voyage and members could choose to invest or not in each voyage. Only by mid-17th century it has become a permanent entity. This type of entity during the earlier period focused on trade and mercantilism, not in manufacturing.

In the early years of the establishment of these companies there were two groups of people involved in it, namely (1) people actively involved in trade activity in addition to contribution of capital called insiders and (2) people do not directly involved in business but contributed capital and undertake risk called outsiders. Investors were also given freedom to opt out of a particular voyage, they were also given all information relating to all voyages, risk involved in each voyage, etc. When the business expanded, promoters required more capital which they could not garnish through personal contacts. This forced them to project some people as key persons in the business as directors and raise outside capital with the reputation of directors. The high risk and the variety of skills needed in foreign trade and colonization necessitated the development of skilled managers and the broadening individual base beyond the membership in a particular merchant group. The extended source of capital and skilled managerial talents strengthened the organisation by 17th century.

Till 1688, the companies were incorporated under the Royal Charter of the King/Queen. After 1688, the powers for starting companies were transferred to the parliament. Many companies were started to mobilize private equity for undertaking basic infrastructure like roads, water supply, river navigation, etc., as public funding was limited at that time.

Along with the incorporated public corporations, the unincorporated companies similar to the characteristics of partnership firms were also started during the period without charter or act. These unincorporated companies adopted partnership law and made their own provisions to deal with large number of shareholders, but without corporate entity. After 1688, there was a boom in the joint stock company form, in both incorporated and unincorporated format in a wide range of economic activities like mining, insurance, water supply, banking, manufacturing, etc. This boom was followed by a period of decline until late 1710 due to some unfair practices in stock trading. This was followed by the introduction of The Bubble Act of 1720 for ensuring fair trade practices in share trading.

During this period joint stock form of business format started in different parts of the world. The Virginia Company started in Jamestown Virginia in 1606 was the first joint stock company formed in the USA. In Germany during this period companies were formed in two formats, namely, public limited company format and private limited company format. Ferederick the Great's Asiatic Company started in Ernden in 1750 was the first public limited company formed in Germany. In Italy joint stock companies were formed under *Societa Per Azioni* (SPA) during this period. In China under the reformist Qing dynasty period from 1872 joint stock companies were stated. In 1904, a comprehensive Companies Act was also introduced in China for governing the Chinese companies.

Growth of company form of business during 19th and 20th century: The history of corporate form of business format since 1800 is closely associated with many things, namely, (1) Acceptance of the new concept of 'Limited liability' around the world, (2) The growth of stock exchanges around the world, (3) Popularization of capitalism as an economic philosophy for development, (4) The great industrial revolution, (5) Introduction of separate legislation for formation and management of the Joint Stock company in different countries (6) The end of cold war and changes in economic, cultural, social, political and trade environment around the world, (7) Development of Big emerging markets, and (8) Acceptance of American supremacy in the economic issues around the world.

In 1855, the concept of limited liability was first accepted in the company form of business in England and subsequently in the other parts of the world. This has revolutionized the company format of business around the world. Even though many of the characteristics of modern company existed during that period, but the liability of members was unlimited. This has prevented many rich people from entering this format of business. The limited liability concept has restricted the liability of the shareholders to the amount contributed by them or amount guaranteed to contribute to the venture. Shareholders' personal properties were totally exempted from the firm's liability. Slowly during this period other features of modern joint stock company such as distribution of dividend, transferability of share, appointment of directors by shareholders in general meeting, keeping accounts on permanent basis, disclosure to the shareholders through statement of accounts have developed.

Introduction of Limited Liability Concept

The concept of limited liability was introduced in 1855 first in England. Starting of London Stock Exchange in 1698 was another milestone in the growth of corporate form of business. The US introduced the first company law with limited liability in 1846, followed by the British company law in 1856. In Asia, Japan and China also introduced their company laws in 1844 and 1872 respectively. The great industrial revolution of 1830 revolutionized this format of business around the world.

The introduction of the trading mechanism for the buying and the selling of shares popularly known as 'Stock Exchanges' which ensured liquidity, transparency, price stability, dispersed ownership and regular valuation of investment strengthened the development of Joint Stock Company form of business around the world. The London Stock Exchange established in 1698 was the first of its hind, which popularized this format of business in England and Europe. Similarly the establishment of the New York Stock Exchange in 1817 in New York, America, Tokyo stock exchange in 1878 in Tokyo Japan and Shanghai Stock exchange in 1860 in China contributed significantly in the development of joint stock company form

of business around the world. This has simplified the procedure of investment of money in the corporate establishments.

Prior to the nineteenth century companies around the world were formed under the Royal Charters of the King or the Queen. For example, The English East India Company or the Dutch East India Company. In the middle of the 19th century different countries introduced separate legislations for the formation and the governance of Joint Stock form of companies. The USA was the first country to introduce a comprehensive company law in 1846 with limited liability concept. England has stopped the incorporation of Companies and introduced a comprehensive company legislation known as 'Companies Act, 1856'. Immediately after this most of the European countries like France, Germany, Austria, the Netherland, also introduced their own company laws. The German Companies act is known as Prussian Act 1843. In Asia, Japan and China introduced their own companies act in 1844 and 1923 respectively.

Another important development during this period contributed to the growth of the company form of business is the popularity gained for the capitalistic mode of economic development. Capitalism is an economic philosophy based on free market, private capital, freedom in economic activities, etc. In Europe and America this concept has gained attention of private individuals having money to invest in the corporate form of enterprises.

Another factor contributing to the growth of companies during this period was the emergence of the US as a super power and the acceptance of this by most of the European nations. Leading nations of the world had accepted the political, technological and economic super power characteristics of the US and started emulating it in development activities. The growth of financial market in the US attracted many people to invest in corporate securities and earn lucrative returns from it. The development of strong banking and capital market structure and regulatory mechanism won the confidence of small investors during that time.

The Great Industrial Revolution of 1830 is another factor that contributed to the growth of companies during the 19th century. The introduction of modern technology in manufacturing and service industries necessitated the need for more capital which could not be shared by a few people. Hence, the industries slowly started approaching large number of people having small savings through equity participation through stock exchanges. During this period the scale of operations of most of the industries increased and they enjoyed the economies of large scale operations. This has to some extent solved the demand-side problems of many products and services.

During the last two hundred years we have been witnessing tremendous changes in the economic, demographic, social, cultural, trade, technological and natural environment around the world. Global economic integration took place to a large extent during the last 200 years. The economic integration that was about 10 per cent at the beginning of 19th century, it has increased to 60 per cent now. Trade integration has also increased significantly through the bilateral and multilateral trade agreements between nations resulting in the formation of WTO. Convergence of the needs and wants of the people also took place during this period because of increased means of transport and communication. Unity in diversity principle has been accepted all over the world in the cultural and the social issues. Convergence is also taking place in the legal and the financial systems as part of globalization. All these have contributed to the growth of corporate format of business.

One of the recent developments contributing to the growth of the joint stock company format is the emergence of 'Big emerging markets' consisting of ten nations such as India, China, Korea, Indonesia, Brazil, Argentina, Mexico, Turkey,

Russian Federation, Poland and the South Africa, having more than 70 per cent of the world population and one third of the global purchasing power. Most of the markets of the developed countries are saturated and hence business corporations are eyeing on these ten nations. To exploit these markets large scale cost effective production and marketing is necessary for which a huge amount of capital is also required.

Major Global Companies in the World

Sl. No	*Name of the company*	*Country of origin*	*Year of starting*	*Business area*
1.	Coco Cola	The US	1886	Food and beverages
2.	General Electrics	The US	1892	Electrical
3.	Pepsi	The US	1898	Food and beverages
4.	Nestle	Switzerland	1905	Food
5.	Royal Dutch Shell	The UK	1907	Oil & Natural gas
6.	Toyota	Japan	1937	Automobile
7.	Volkswagen	Germany	1937	Automobile
8.	Apple	The US	1976	Electronics
9.	Walmart	The US	1962	Retail
10.	AT&T	The US	1983	Telecommunication

History of the Company form of business in India: The history of business format with a number of characteristics of modern company in India dates back to 800 BC. The old form of company in the name of 'Sreni', 'Nigama' and 'Pani' were present in India during that period. Sreni and Nigama are the economic organisations of merchants, craftsman and artisans. They were similar to the guilds in medieval period in Europe. Pani was a type of organisation of merchants traveling in a caravan to trade their products. These organisation of the traditional traders possessed many similar characteristics of a modern company in terms of structure, governance and regulations. Srenis were given separate legal entity, centralized management, separation of ownership and management, registration with state, election of managers and voting representation. But at the same time they did not enjoy the characteristics such as limited liability and transferability of share as is enjoyed by the modern company. This business format continued till the advent of Islamic invasion around 1000 AD in India. According to Vikarmaditya S. Khanna the following characteristics of modern corporate form of business were seen in ancient 'Sreni' also.

Comparison of Characteristics of Modern Company and Traditional Sreni

Sl. No	*Characteristics*	*Modern company*	*Traditional sreni*
1.	Separate entity	Yes	Yes
2.	Centralized Management	Yes	Yes
3.	Transferability of funds	Yes	Probably No
4.	Limited liability	Yes	No
5.	Agents' power to bind entity	Yes	Yes
6.	Election of Management	Yes	Yes

(*Continued*)

Sl. No	Characteristics	Modern company	Traditional sreni
7.	Removal of management by owners	Yes	Yes
8.	Registration with the State	Yes	Yes
9.	Sharing the assets and the liabilities	Yes	Yes
10.	Easy to Exit	Yes	Yes
11.	Open discussion at general meeting	Yes	Yes

Modern Company form in India: The history of the modern corporate format of business in India can be divided into in five stages namely:

1. From 1600 to 1850 associated with the British colonization in India and the introduction of an exclusive legislation for the formation and the governance of Joint Stock Company.
2. From 1850 to 1900 associated with cotton and jute boom and the establishment of Stock exchanges in India.
3. From 1901 to 1947 associated with the establishment of family business by big business families in India like Tatas, Birlas, Godrej, etc.
4. From 1947 to 1990 associated with the post independent industrialization.
5. From 1991, associated with liberalization and globalization era.

The first stage of 1600 to 1850 is closely associated with the arrival of the English East India Company and the Dutch East India Company in 1600 and 1602 respectively. Both these companies were registered under the Royal Charter and were in the form of private limited companies for raising capital for the voyages for trade. At that time they concentrated on spices trade with India. At that time the Dutch East India Company had a slight edge in trade with India because of their superior financial power. From 1610 onwards these companies slowly shifted their focus to cotton and textile and the first textile factory was started in 1613 in Surat, Gujarat, for manufacturing textiles in India. This was followed by the Company rule in India from 1757 to 1858 and then British rule in India till 1947. During this period especially upto 1850 several companies were formed by the British Govt. in port cities of Bombay, Calcutta and Madras. Some of the important businesses formed in the company format were Commonwealth Trust, Peirce and Leslie, Aspinwall & Company, etc.

Company Law in India

Another landmark in the history of corporate form of business in India during the period is the introduction of an exclusive legislation for the formation and governance of company form of business. The English Common Law is the source of origin of the Company legislations in India. Various companies' acts that were passed in India from time to time were based on the English Companies Act. In 1850, the first law on 'registration of joint stock companies' was enacted in India which was based on the English Companies Act of 1844 known as the Joint Stock Companies Act, 1844. This Act of 1850 recognized the company as a distinct legal entity but the privilege of limited liability was not granted to the company under the Act. The principle of limited liability was recognized in India by virtue of the Joint Stock Companies Act, 1857 which was passed following the English law, the Joint Stock Companies Act, 1856. The next law relating to Company in India was the Companies Act of 1866 legislated (based on English Companies Act of 1862)

'for consolidating and amending the law relating to the incorporation, regulation and winding up of trading companies and other associations.' This Act was amended and remodelled in 1882 and it remained effective till 1913. In 1913, the Indian Companies Act of 1913 was legislated following the English Companies (Consolidation) Act, 1908. This act for the first time recognized Private Limited Companies. This Act of 1913 was found to be highly inadequate in the course of its operation and thus it went through numerous amendments till the enactment of the Companies Act, 1956. The Companies Act, 1956 was enacted in compliance with the recommendations of the Bhabha Committee. The major amendments in this Act were brought in 2002 which provided for the constitution of the National Company Law Tribunal in place of the Company Law Board. It was during this period a shift from the democratic voting right to plutocratic voting right (one vote to one share from one vote to one member) took place in company decision making process.

Cotton Boom and Jute Boom and Formation of Stock Exchanges in India

The second stage begins with the 'Cotton Boom' in Maharashtra and Gujarat during 1850 and the 'Jute Boom' in Bengal during the same time. At that time the cotton textiles were made in indigenous manner and there were no modern textile mills in India. The British companies were exporting raw cotton from India and textiles that were manufactured in England and imported to India for marketing. All the value additions and employment were generated in England. This has annoyed the Indian business men and they thought of establishing modern textile mills in India. But mobilizing huge capital was the main problem. To solve this problem Bombay business men decided to start a Stock exchange and established the Bombay Stock Exchange, the first stock exchange in India in 1875. This was followed by the establishment of the Ahmedabad Stock Exchange in 1894. This has made the real beginning of the company format of business in India with all the characteristics of a modern corporate organisation. Similarly, the Calcutta Stock Exchange was started in 1908 for mobilizing finance for establishing Jute mills in Bengal. This was followed by the establishment of the Madras Stock Exchange in 1920 and the Indore Stock Exchange in 1930. Since then a number of stock exchanges were formed for ensuring liquidity to capital market investment.

During this period itself the two big family business groups in India namely Tata and Birla established their business empire in India by converting their holding companies namely Tata sons established by Sri. Jamsetji Tata in 1874 and Aditya Birla Group established by Sri Seth Shri Narayan Birla in 1857. The first Tata Company started was the Central India Spinning Weaving and Manufacturing Company in 1874.

The history of corporate form of business in India since 1900 is closely associated with big family business houses established by Tatas, Birlas, Godrej, etc.

Tata Group is one of India's largest conglomerates. In 2015–16, the revenue of Tata companies, taken together is $103.51 billion. These companies collectively employ over 660,000 people. Each Tata company or enterprise operates independently under the guidance and supervision of its own board of directors and shareholders. There are 30 publicly-listed Tata enterprises with a combined market capitalization of about $116 billion as of March 2016. Tata companies with significant size include Tata Steel established in 1907, Tata Motors started in 1945 which is the 17th largest automobile company in the world and 4th largest in the world in truck manufacturing and 2nd largest in bus manufacturing. Tata Consultancy Services was established in 1965; Tata Power, Tata Chemicals, Tata Global Beverages, Tata Tele Services Titan, Tata Communications and Taj Group of Hotels followed its establishment.

The **Aditya Birla Group** is another Indian multinational conglomerate named after Aditya Vikram Birla, headquartered in the Aditya Birla Centre in Worli, Mumbai, India. It operates in 40 countries with more than 120,000 employees worldwide. The group's interests are sectors as viscose staple fibre, metals, cement (largest in India), viscose filament yarn, branded apparel, carbon black, chemicals, fertilizers, insulators, financial services, telecom (third largest in India), BPO and IT services. Very important companies under the group are Hindalco, UltraTech Cement, Grasim Industries, IDEAL Cellular, Birla Fashions and Retails. The group had whopping overall revenue of approximately US$41 billion in year 2015. It is the third-largest Indian private sector conglomerate behind the Tata Group with a revenue of just over US$100 billion and RIL with a revenue of US$74 billion.

The Godrej Group is another Indian conglomerate headquartered in Mumbai, Maharashtra, India, managed and largely owned by the Godrej family. It was founded by Ardeshir Godrej and Pirojsha Burjorji Godrej in 1897 and operates in sectors as diverse as real estate, consumer products, industrial engineering, appliances, furniture, security and agricultural products. Subsidiaries and affiliated companies include Godrej Industries and its subsidiaries Godrej Consumer Products, Godrej Agrovet, and Godrej Properties, as well as the private holding company Godrej & Boyce.

Growth of Public Sector Companies

The nationalization of certain important foreign and domestic corporations functioning in key areas, the starting of new public sector companies in basic and key sectors of the economy, the introduction of a comprehensive company law, the starting of new private corporate business in emerging areas like IT, Pharmaceuticals, communication, the emergence of some new business families, the starting of a number of stock exchanges, dominate the post-independence history of corporate form of business in India.

After the independence of the country, the government has nationalized some of the important foreign and domestic private enterprises functioning in corporate mode in key sectors like oil refinery, steel and other metal industries, coal sector, financial and insurance sectors. Along with this, new public sector companies were formed for the twin purpose of preventing corporate monopoly and channelizing profit from business for nation building activities. A number of heavy industries like BHEL (1964), Air India (1971), FACT (1943), Hindustan Insecticides (1954), BEL (1954), BPCL (1952), Coal India Limited (1973), Damodar Valley Corporation (1948), GAIL (1984), FCI (1965), Bharat Refractories (1974) NFCI, HMT, NTPC, ONGC, GIC, SAIL, Shipping Corporation of India, were started during this period.

A comprehensive company law has been passed in parliament called Indian Companies Act, 1956 replacing the earlier company laws. The new company legislation emphasizes a simple and transparent way of company formation, its governance, share capital issue, investor protection, separation of ownership and management, etc. The act envisages the formation of different types of companies such as public limited company private limited company, companies limited by shares, companies limited by guarantee, non-profit companies, unlimited liability company. It also specifies the types of securities to be issued for raising capital, its characteristic features, the method of issue of shares, mergers, amalgamation and capital reconstructive of companies. Issues relating to winding up, liquidation, etc., of companies were also specified in the law.

The emergence of IT as a strong sector to support all other sectors of the economy was another notable event that happened during the period. Several

IT companies were formed in the joint stock format during the period. Some prominent among them are Infosys, Wipro, TCS, Sathyam Computers (Now Tech Mahendra). Some new family business groups were also formed during the period like the Ambani Group (Reliance Industries) started by Sri. Dhirubhai Ambani, the Adani group started by Sri. Gaudam Adani, the Bharathi enterprises started by Mr Sunil Bharathi Mittal. These groups also started several joint stock companies by raising capital from general public. Twelve stock exchanges were also formed during this period.

Reliance Industries Limited (RIL) is an Indian conglomerate holding company headquartered in Mumbai, Maharashtra, India. Reliance owns businesses across India dwelling into various business ventures in energy, petrochemicals, textiles, natural resources, retail, and telecommunications. Reliance is the third most profitable company in India, the second-largest publicly traded company in India by market capitalization and the second largest company in India as measured by revenue after the government-controlled Indian Oil Corporation. The company is ranked 215th on the *Fortune Global 500* list of the world's biggest corporations as of 2016. RIL contributes approximately 20 per cent to India's total exports. It is ranked 8th among the Top 250 Global Energy Companies by Platts as of 2016.

The Adani Group is an Indian multinational conglomerate company headquartered in Ahmedabad, Gujarat, India. Its diversified businesses include resources, logistics, agro-business and energy sectors. The Adani Group commenced as a commodity trading firm in 1988, grew quickly and diversified into the import and the export of multi-basket commodities. In the 1990s, it developed its own port in Mundra to provide a base for its trading operations. In 1995, Adani started construction at Mundra. In 1998, it became the top net foreign exchange earner for India. Soon in 1999, the company commenced coal trading, followed by a joint venture in edible oil refining in 2000 by forming Adani Willmar.

The group's second phase started with the creation of large infrastructure assets. The company established a portfolio of ports, power plants, mines, ships and railway lines within and outside India. In 2002, Adani handled 4 million tonnes of cargo at Mundra, becoming the largest private port in India. Later in 2006, the company became the largest coal importer in India with 11 million tonnes of coal handling. The company expanded its business in 2008 as they bought Bunyu Mine in Indonesia having 180 million tonnes of coal reserves. In the subsequent year, the firm started 330 MW thermal power generation, followed by 2.2 million tonnes per annum capacity of edible oil refining in India. Adani Enterprises is the largest trading house of India in importing coal with a market share 60 per cent. It also supplies coal to NTPC Limited, India.

In 2012, the Adani Group took up the next phase of growth. It has embarked on the third phase of development, an integration of infrastructure business. It revamped its logo and developed a new identity. The company focuses on three important business clusters that include resources, logistics and energy. In 2014, Adani Power emerged as India's largest private power producer. The total installed capacity of Adani Power now stands at 9280 MW.

On 16 May 2014, the Adani Ports acquired for ₹5500 crore, the Dhamra Port on East Coast of India, a 50 : 50 joint venture of Tata Steel and L&T Infrastructure Development Projects. The port commenced its operations in May 2011 and handled a total cargo of 14.3 million tonnes (mt) in 2013–14. The acquisition of Dhamra port will help the company ramp up its capacity to over 200 million tonne by 2020, making it a leader among private sector port operators in the country.

Bharti Enterprises is an Indian business conglomerate headquartered in New Delhi, India. It was founded in 1976 by Sunil Bharti Mittal and it operates in 18 countries across Asia and Africa. Bharti Enterprises owns businesses spanning across telecommunications, agriculture business, financial services and manufacturing.

Post Liberalization Period

The foreign exchange crisis of 1989 and the consequent pledging of gold by the central government with Bank of England is a land mark event in the economic history of the country. To overcome the crisis, the government has initiated Liberalization, Privatization and Globalization (LPG) of the economy through a series of economic measures since 1990. This includes de-licensing of many industries, simplification of licensing procedure for those industries requiring license, initiating banking, capital market and insurance reforms, starting of a new regulatory body for capital market namely SEBI, starting of the NSE, removal of restrictions for FDI in many sectors, privatization of many public sector companies by name of Exit policy, etc. Significant growth of some new business family enterprises, the exponential growth of IT and the financial sector, a series of mergers and acquisitions and a series of corporate frauds and consequent failures such as Sathyam Computers, King Fisher Airlines are some of the major events that took place during the post liberalization period.

The first initiative taken by the government immediately after the foreign exchange crisis in 1989–90 as part of LPG was the de-licensing of many industries from the list of industries requiring license from the central government for establishing business. The number of industries reserved for public sector was reduced from 17 (as per 1956 policy) to only 8 industries namely Arms and Ammunition, Atomic Energy, Coal, Mineral Oil, Mining of Iron Ore, Manganese Ore, Gold, Silver, Copper, Lead, Zinc, Atomic Minerals and the Railways. Currently only two categories from the above such as atomic energy and the railways are reserved for public sector. Further, Atomic minerals come within the purview of the Atomic Energy Act. The Government of India does not grant license to the private sector for mining of atomic minerals and mineral sand. However, for mining of mineral present in beach sand deposits, the state governments can grant license to private parties subject to the prior consent of the Department of Atomic Energy. Further, the policy had implied the threat of closure of sick public sector enterprises to increase efficiency of the public sector.

Further by introducing new Industrial Licensing Policy the government has abolished the Industrial licensing for all industries except for a short list of 18 industries. This list of 18 industries was further pruned in 1999 to six industries namely drugs and pharmaceuticals, hazardous chemicals, explosives such as gun powder and detonating fuses, tobacco products, alcoholic drinks, and electronic, aerospace and defence equipment. The compulsion for obtaining prior approval for setting units in metros was also removed. However, in this policy, industries reserved for the small scale sector were continued.

The licensing procedure for those industries which require license from the central government has been simplified and a single window system introduced. The Foreign Direct Investment Promotion Board was also set up for clearing the applications for foreign direct investment.

Security Exchange Board of India (SEBI)

The formation of SEBI was another significant event that took place during this period. Till then the work relating to capital issue of companies was controlled by the office of Controller of Capital Issue under the Ministry of Company Affairs. There were many complaints about the functioning of that office from the company people. To overcome these complaints, the Government of India abolished the office and established SEBI in 1988 as an advisory body first and from 1992 as the regulatory body of the capital market operations in India. This is a professional body consisting representatives of all the stakeholders of the capital market operation such as investor representative, company representatives, government representatives with the following objectives:

1. Investor protection
2. Ensuring fair trade practices by brokers, merchant bankers, companies, etc.
3. Promotion of efficient services by market intermediaries.
4. Collection and dissemination of stock market information.

Functions of SEBI

SEBI was entrusted with two types of functions, such as

1. Regulatory functions
2. Developmental functions

Regulatory Functions of SEBI

The regulatory functions include the following:

1. Registration of brokers
2. Registration of mutual funds.
3. Registration of merchant bankers and portfolio managers.
4. Prohibition of unfair trade practices by companies.
5. Controlling insider trading.
6. Controlling wide price fluctuations in stock markets.
7. Controlling hostile takeover bids.
8. Checking the observance of listing rules.

Developmental Functions

The developmental functions include the following:

1. Investor education
2. Training of intermediaries
3. Fixing code of conduct to all stock market operators and conducting equity research.

Major Reforms Initiated by SEBI in Primary Capital Market

- Free entry by companies and investors in primary market.
- Free pricing of new issues.
- Minimum subscription by promoters at 25 per cent of issue in case the issue is below ₹100 crores and 20 per cent in case if the issue is more than ₹100 crores.
- Permitting of FFIs and Foreign Security Firms to operate in the new issue market through Indian brokers.
- Introduction of Stock invest scheme.
- Prohibition of Private placement of non-transferable shares of promoters.
- Raising of Minimum shares to be applied from 100 to 200.
- Making of Proportional allotment in case of over subscription compulsory
- Fixing of Lock in period of promoter's quota as 5 years.
- Introduction of Minimum interval of 12 months between two issues.
- Introduction of Employee's stock option scheme (10 per cent of the paid up capital with 3-year lock in period, there was maximum allotment of 200 shares).

- Introduction of New financial instruments.
- Making of underwriting optional.
- Making of market making compulsory.
- Making of credit rating obligatory for all debt issue.
- Introduction of monitoring system for the deployment of funds raised by new issues.
- Controlling of takeover bids.
- Introduction of book building requirements for any public issue of more than ₹100 crores.
- Allocation of retail individual investors has been increased from 25–35 per cent of the total issue in case of book build issues.
- Redefining of retail investor as one who applies or bids for securities not exceeding ₹1 lakhs in place of ₹5000 earlier.
- Introduction of electronic fund transfer to ensure faster and hassle free refunds.
- Efforts have been made to raise the standards of disclosure in public issue and enhance their transparency.
- Under the listing agreement listed companies are required to make continuous disclosures to the stock exchange.
- In case of fixed price issue companies are required to disclose the issue price or price band in the offer documents submitted to SEBI.

Reforms Initiated in the Secondary Capital Market

- Compulsory audit and inspection of stock exchanges introduced.
- Transparency in price and brokerages in contract notes introduced.
- Brokers account and client's accounts should be separated.
- 50 per cent of BOD of the stock exchanges should be non-brokers.
- Restricted forward trading introduced.
- 8 per cent day by day price variation introduced.
- Uniform trading period of 5+2 introduced.
- Capital adequacy norms introduced for brokers. (3 per cent for individual brokers and 6 per cent for corporate brokers)
- Guidelines for FFI introduced.
- Grievance redressal cells introduced in all stock exchanges.
- Customer protection funds introduced in all stock exchanges (maximum compensation of ₹2 lakhs).
- The governance boards and various committees of stock exchanges have been reorganized, restructured and broad-based.
- All stock exchanges have been directed to establish either a clearing house or a clearing corporation.
- All the recommendations of the Dave Committee for improving the working of the OTCEI have been accepted.

Reforms in the Mutual Fund Sector

For the development of mutual fund business in India the SEBI has introduced the following:

- Al mutual funds excluding UTI were asked to register with SEBI.
- Mutual funds are required to have a board of trustee or trustees separate from the asset management company.
- Securities belonging to various schemes are required to be kept with an independent custodian.

- There must be an arm's length relationship between trustees, Asset Management Company and custodians.
- Portfolio disclosure introduced.
- Standardization of accounting policy for all MF companies introduced.
- Valuation norms for determining NAV and pricing introduced.

Reforms in Investor Protection Measures

As one of the main aims of SEBI is investor protection and retaining their confidence in capital market a series of measures have been initiated in this direction. Some of the important measures are as follows:

- Introduced automated complaint handling system to deal with investor complaints.
- Started publishing the names of companies against whom maximum number of complaints have been received on fortnightly basis.
- SEBI supervision introduced in allotment process to prevent malpractices in share allotment.
- Recognition scheme introduced inactive investor's association/forums.
- Complaint classification system introduced under which the investors complaints have been classified as follows:
  - Non receipt of refund order allotment letter, etc.
  - Non receipt of dividends.
  - Non receipt of share certificates/bonus shares.
  - Non receipt of debenture certificates/interest on debentures/redemption amount/interest on delayed payment of debenture interest.
  - Non-receipt of annual reports, right issue forms, etc.

Disinvestment Policy

If the post-independence period from 1947–1990 was one of strengthening of the public sector in the Indian economy, then the period from 1991 was of disinvestment and privatization of public sector companies.

Disinvestment can be defined as the action of an organisation (or government) selling or liquidating an asset or subsidiary. It is also referred to as 'divestment' or 'divestiture.' In most contexts, disinvestment typically refers to sale from the government, partly or fully, of a government-owned enterprise.

A company or a government organisation will typically disinvest an asset either as a strategic move for the company, or for raising resources to meet general/specific needs.

Objectives of Disinvestment

The new economic policy initiated in July 1991 clearly indicated that the PSUs had shown a very negative rate of return on capital employed. Inefficient PSUs had become and were continuing to be a drag on the government's resources turning to be more of liabilities to the government than being assets. Many undertakings traditionally established as pillars of growth had become a burden on the economy. The national gross domestic product and gross national savings were also getting adversely affected by the low returns from PSUs. About 10–15 per cent of the total gross domestic savings were getting reduced on account of low savings from the PSUs. In relation to the capital employed, the levels of profits were too low. Of the various factors responsible for low profits in the PSUs were their Price policy, Under–utilization of capacity, Problems related to planning and construction of projects, Problems of labour, personnel and management and Lack of autonomy.

Hence, the need for the government to get rid of these units and to concentrate on core activities was identified. The government also took a view that it should move out of non-core businesses, especially the ones where the private sector had now entered in a significant way. Finally, disinvestment was also seen by the government to raise funds for meeting general/specific needs. In this direction, the government adopted the 'Disinvestment Policy'. This was identified as an active tool to reduce the burden of financing the PSUs. The following main objectives of disinvestment were outlined:

- To reduce the financial burden on the government.
- To improve public finances.
- To introduce, competition and market discipline.
- To fund growth.
- To encourage wider share of ownership.
- To depoliticize non-essential services.

Importance of Disinvestment

Presently, the government has about Rupees two lakh crores locked up in PSUs. Disinvestment of the government stake is, thus, far too significant. The importance of disinvestment lies in the utilization of funds for:

- Financing the increasing fiscal deficit.
- Financing large-scale infrastructure development.
- For investing in the economy to encourage spending.
- For retiring government debt by almost 40–45 per cent of the Centre's revenue receipts go towards repaying public debt/interest.
- For social programs like health and education.

Disinvestment also assumes significance due to the prevalence of an increasingly competitive environment, which makes it difficult for many PSUs to operate profitably. This leads to a rapid erosion of value of the public assets making it critical to disinvest early to realize a high value.

Period from 2001–02 to 2003–04

This was the period when a maximum number of disinvestments took place. These took the shape of either strategic sales (involving an effective transfer of control and management to a private entity) or an offer for sale to the public, with the government still retaining control of the management. Some of the companies which witnessed a strategic sale included:

- Bharat Aluminium Co. Ltd.
- CMC Ltd.
- Hindustan Zinc Ltd.
- Hotel Corp. of India Ltd. (3 Properties: Centaur Hotel, Juhu Beach, Centaur Hotel Airport, Mumbai and Indo Hokke Hotels Ltd.,)
- HMT Ltd.
- IBP Co. Ltd.
- India Tourism Development Corp. Ltd.(18 Hotel Properties)
- Indian Petrochemicals Corp. Ltd.
- Jessop & Co. Ltd.
- The Lagan Jute Machinery Co. Ltd.
- Maruti Suzuki India Ltd.
- Modern Food Industries (India) Ltd.
- Paradeep Phosphates Ltd.
- Tata Communications Ltd.

The valuations realized by this route were found to be substantially higher than those from minority stake sales.

During this period, against an aggregate target of ₹38,500 crore to be raised from the PSU disinvestment, the Government managed to raise ₹21,163.68 crore.

Period from 2004–05 to 2008–09

The issue of the PSU disinvestment remained a contentious issue through this period. As a result, the disinvestment agenda stagnated during this period. In the 5 years from 2003–04 to 2008–09, the total receipts from disinvestments were only ₹8515.93 crore.

Period from 2009–10 to 2015–16

A stable government and improved stock market conditions initially led to a renewed thrust on disinvestments. The government started the process by selling minority stakes in the listed and the unlisted (profit-making) PSUs. This period saw disinvestments in companies such as NHPC Ltd., Oil India Ltd., NTPC Ltd., REC, NMDC, SJVN, EIL, CIL, MOIL, etc., through public offers.

However, from 2011 onwards, the disinvestment activity slowed down considerably. As against a target of ₹40,000 crore for 2011–12, the government was able to raise only ₹14,000 crore. However, the subsequent years saw some improvement and the government was able to raise ₹23,857 crore against a target of ₹30,000 crore (Revised Target: ₹24,000 crore) in 2012–13 and ₹21,321 crore against a target of ₹54,000 (Revised Target: ₹19,027 crore) in 2013–14. The achieved target dropped to ₹24,338 crore against a target of ₹58,425 crore in 2014–15 and ₹18,409 crore against a target of ₹69,500 (Revised Target: ₹30,000 crore) in 2015–16.

For 2016–17

The NDA Government has set an ambitious disinvestment target of ₹56,500 crore.

Formation of the NSE

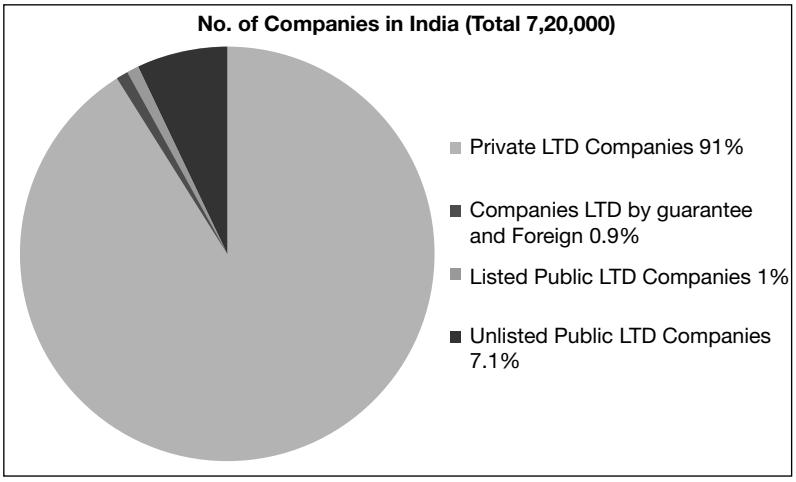
Another major event that took place during the period was the establishment of The **National Stock Exchange of India Limited** (NSE), located in Mumbai. NSE is the first demutualized electronic exchange in the country. NSE was the first exchange in the country to provide a modern, fully automated screen-based electronic trading system which offered easy trading facility to the investors spread across the length and the breadth of the country.

The National Stock Exchange has a total market capitalization of more than US$1.41 trillion, making it the world's 12th largest stock exchange as of March 2016. NSE's flagship index, the NIFTY 50, the 51 stock index (50 companies with 51 securities inclusive of DVR), is used extensively by investors in India and around the world as a barometer of the Indian capital markets.

The NSE was set up by a group of leading Indian financial institutions at the behest of the Government of India to bring transparency to the Indian capital market. Based on the recommendations laid out by the government committee, the NSE has been established with a diversified shareholding comprising domestic and global investors. The key domestic investors include Life Insurance Corporation of India, the State Bank of India, IFCI Limited, IDFC Limited and the Stock Holding Corporation of India Limited. The NSE offers trading, clearing and settlement services in equity, equity derivatives and debt and currency derivatives segments. It is the first exchange in India to introduce electronic trading facility thus connecting together the investor base of the entire country. The NSE has 2500 VSATs and 3000 leased lines spread over more than 2000 cities across India.

Corporate Structure and Ownership Pattern in India

Corporate structure of India presented in Table-1.1 sets out the growth of the companies in India from the time the last major legislation on company law was enacted in 1956. There are about 7,20,000 business establishments in the company mode. Of this 5,94,646 are private limited companies representing approximately 91 per cent of total business units that were registered under the company format. As per law these companies cannot issue prospectus and invite share capital from the general public, transfer of share is restricted and maximum number of members is restricted to 50, owners and managers are more or less the same people. Hence, many agency issues in corporate governance do not arise in these companies. The remaining 59,646 units representing 9 per cent come under public limited companies. In this, around 50000 to 54000 companies are unlisted public limited companies representing about 7.1 per cent of the total companies. They are closely held companies and shares of these companies are not available for buying and selling in the capital market. They are mostly held by promoter groups and their close relatives. Around 6500 companies are either companies limited by guarantee or foreign companies and another seven thousand companies representing one per cent of the total comes under listed (BSE and NSE) public limited companies. 328 private limited companies come under the government sector and the remaining 6,54,581 companies come under private sector. The main issue of corporate governance arises in this one per cent of listed companies.



Source: Table 2.4 and XI (pp. 18, 87) 55th Annual Report on the Working and Administration of the Companies Act, 1956: Year ended 31 March 2011; Ministry of Corporate Affairs, Government of India. Listed companies from websites of respective stock exchanges.

Ownership Patterns in India

Corporate ownership in India is predominantly concentrated in the hands of domestic individuals and promoter groups, multinational parents, or the state. Many of the family and other domestic holdings could be traced back to the days of the British Managing Agencies. Many of these agencies were acquired by Indian groups when their British owners chose to depart from India on the country attaining Independence in 1947.

The Government of India was the other major dominant shareholder in a number of large corporations when as a part of national policy, state owned enterprises were set up to reach commanding heights in the Indian economy; many of these are now publicly traded corporations as a result of the government's privatization initiatives.

The third group responsible for concentrated ownership in the country is the foreign multinational sector: many international corporations have identified India along with China as the future economic power engines of the world and set up shop in the country. With several sectors of the economy gradually opening up for foreign participation, this sector may grow substantially in the near future.

Though the listed segment out of this huge population is, of course, miniscule in number but significant in value: 1657 companies were listed on the National Stock Exchange as of September 2012, with a market capitalization of ₹64,31,658 crores (US$ 1.18 trillion); the much older (in fact the first Asian) Bombay Stock Exchange has a listed company population of over 6000 companies in 2012 with a market capitalization of ₹58,30,000 crores (US$ 1.06 trillion). Given the fact that some 50 to 55 thousand unlisted public companies would be virtually wholly managed by the promoters, the other absentee shareholders in those companies (although admittedly fewer in number because of the lack of public participation) would pretty much be in the same situation as the absentee shareholders in their listed counterparts, with the added vulnerability to no regulatory supervision or rigorous disclosure requirements other than what the company legislation imposes upon them. The Companies Act 2013 seeks to bring about a change in this position with several good governance practices being made applicable to unlisted public companies as well.

TABLE 1.1 Corporate Structure in India 1957–2011

Year	*Company limited by shares*			*Unlimited companies*	*Guarantee company*	*Foreign companies*
	Govt.	*Non-Govt.*	*Total*			
1957	74	29,283	29,357	–	1364	551
1961	142	20,007	26,149	–	1169	569
1971	314	30,008	30,322	–	1270	540
1981	851	61,863	62,714	174	1478	300
1991	1167	2,23,285	2,24,452	317	1478	300
2001	1266	5,67,834	5,69,100	461	2918	1141
2011	1316	7,13,239	7,14,555	437	3600	3127
2016*	432	10,05,585	10,06,017 lakhs (Active)			
Total Public Ltd. Company	**988**	**58,658**	**59,646**			
Total Pvt. Ltd. Company	**328**	**6,54,581**	**6,54,909**			
Listed company						
BSE	6000+					
NSE	1657					

*Incomplete.

Source: Table 2.4 and XI (pp. 18, 87) 55th Annual Report on the Working & Administration of the Companies Act, 1956: Year ended 31 March 2011; Ministry of Corporate Affairs, Government of India; Listed companies from websites of respective stock exchanges.

Shareholding Categories

Shareholding pattern of a company shows how its shares are split among the entities that make up its owners. There are two main groups, the promoter and the promoter group and the public shareholding. Promoters are the entities that

floated the company and to a large extent have seats on the Board of Directors or the management. Relatives of the promoters who hold shares also fall under this class and are termed as the promoter group. Promoters are further split between domestic and foreign promoters. In the public shareholding section, first comes institutional shareholding or financial bodies that hold shares. Here, holdings are separated into mutual funds, financial institutions, insurance companies and foreign institutions. Institutional and promoter holdings make up the bulk of shareholding, and these are the categories to which you must pay the most attention. Last comes the general public, ordinary investors who hold shares as part of their investment portfolio.

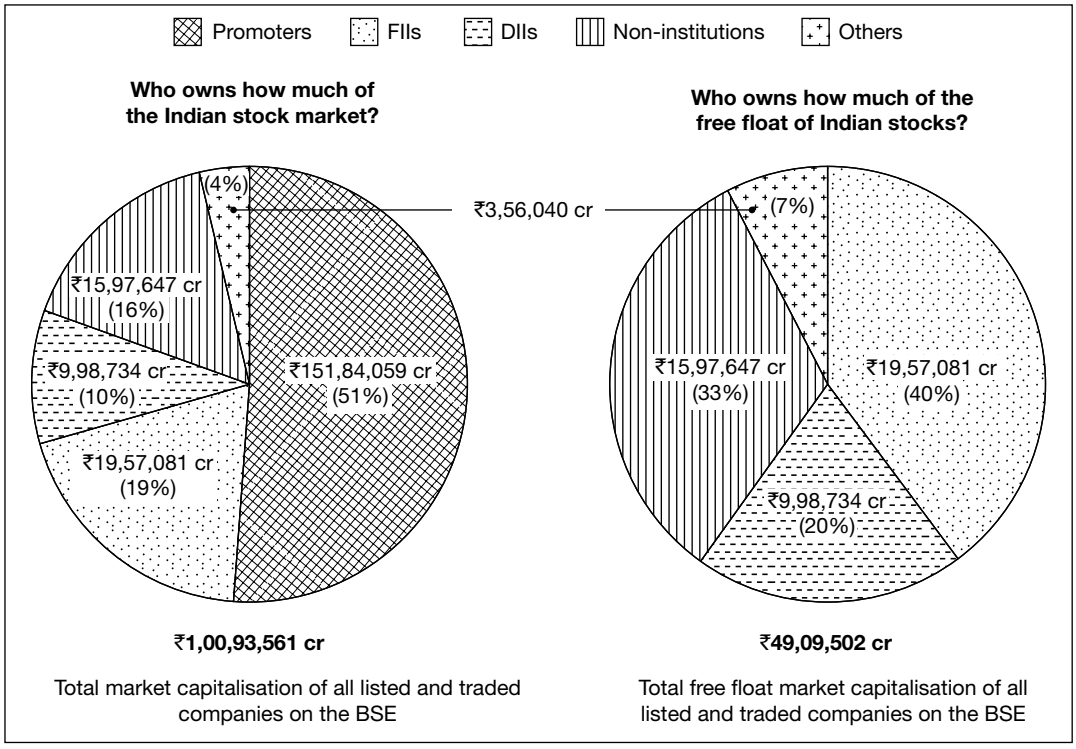
Holdings in various categories provide insight into control in the company, favour the stock holds with the market players, and entities that hold high stakes in the stock, changes in whose holdings will affect stock prices. FIIs, for instance, hold a sizeable chunk of the free float market capitalization. Stocks in which they have high stakes could suddenly nosedive if FIIs exited in a hurry, whatever be the reason. Stocks with lower stakes could then prove less volatile. Holding by mutual funds and insurance companies is another indicator on how favoured a stock is.

Next, the promoter holdings show the extent of control promoters have over running of the business. A more diversified holding and a good presence of institutional investors indicate that promoters have little room to make and carry out random decisions that benefit them without gauging how it would affect the earnings and other shareholders.

Companies also disclose the individual entities (other than the promoters) that hold more than a 1 per cent stake. Companies further disclose the promoters' shares that have been pledged as debt collateral. Should there be a failure in making payments; the lender may sell the shares, prompting a fall in stock price. If prices of pledged shares fall below a threshold, the promoters are required to make up for the difference. Share prices could suffer as a combined effect of the margin call on promoters and selling by the lender if the promoter fails to cover the difference. Pledges of shares, their revocation or invocation have to be announced as they occur.

Major Shareholders of the Indian Stock Market

As per the latest available shareholding pattern (as of March 31, 2015), the combined market value of the stakeholders (also called market capitalization) of all the listed companies on the BSE crossed $100 trillion. The biggest chunk of the value is still held by the promoter group, which is 51 per cent of the total market value. The remaining 49 per cent is the share between DII's (19%), DII's (10%), Retail investors (16%) and others (4%). Promoter's shares normally do not come in the market for purchase or sale. The remaining 49 per cent of the equity is marketable and it amounts to ₹49 trillion. If we look at this marketable portion of the equity, which is also known as free float, then the biggest holders are the foreign institutional investors (FIIs) holding 40 per cent of the free float, thus impacting the market movement with their flows of funds. Retail investors own 33 per cent of the free float, which is far less than retail holding in the developed economies and many developing economies as well. Domestic Institutional Investors (DIIs), which mainly comprise insurance companies, banks and mutual funds, own about 20 per cent of the non-promoters shares. The category labelled as 'Others' includes depositories receipts like ADRs and GDRs, and shares held by custodians.



Top Ten Promoters in the Indian Equity Market

The following table shows the top ten promoters of the Indian equity market.

Sl. No	*Promoter*	*₹ In crores*	*%*
1.	Government of India	11,85,223	68.0
2.	Tata Sons	4,43,071	2.5
3.	Unilever	97,274	5.0
4.	Bharat Telecoms	68,840	4.0
5.	Tobacco Manufacturers Association	64,822	3.5
6.	Suzuki	62,830	3.6
7.	HCL	58,774	3.5
8.	Adhani	57,000	3.5
9.	Bharat Airtel	52,330	3.1
10.	Bosch	56,731	3.3
	Total	17,47,300	100

Source: BSE Annual Report various issues.

Government of India is the biggest promoter group shareholder in India. All other major promoters have three to five per cent holdings.

Top Public Shareholders

The following table shows the top public shareholders of the Indian equity market.

Top Ten Public Shareholders of the Indian Equity Market

Sl. No	*Name of the shareholder*	₹ *In crores*	*%*
1.	LIC	3,92,737	22
2.	Deutsche Bank	53,131	3
3.	Euro Pacific Growth Fund	46,470	3
4.	Specified Undertaking of UTI	42,247	2
5.	HDFC MF	35,035	2
6.	ICICI Prudential Insurance	31,754	2
7.	Opponheimer Developing Market Fund	27,066	2
8.	Aberdeen Global	23,325	1
9.	Singapore Government	20,676	1
10.	Abu Dhabi Investment Authority	19,883	1
	Others	10,54,976	60
	Total	17,47,300	100

The UK

Britain has a different share holding pattern among the different category of owners as compared to India. In general a dispersed ownership pattern was seen in Britain. However, during the last 50 years significant changes have taken place in this respect. In 1960, 54% of the shares of public corporations were held by retail investors, 27% by domestic institutional investors and only 7% by Foreign Institutional Investors. By 2010 this has changed to 41% by FII'S, 36% by DII'S and only 12% by retail investors. This can be seen from the below table given.

British Share-holding Pattern

Category of investors	*1960*	*2010*
Retail investors	54%	12%
Domestic Institutional Investors (DII)	27%	36%
Foreign Institutional Investors (FII)	07%	41
Others	12%	11%

Japan

Historically Japan had been a deeply conservative country where business families were not considered at the top of the hierarchy of caste system. Though some changes had taken place after the opening of Japanese market to the American traders, the subsequent rulers restored Japan's economic conservatism by bringing Japan's business mostly under the state control. After a long period of state control of business the rulers realized that the government control over business has not contributed positively. Mounted debts and operational inefficiency of the state controlled business forced the rules to privatize the major business of Japan.

Most of the enterprises were sold to Mitsui and Sumitomo families. Such family controlled pyramidal listed business groups which were collectively known as 'Zaibatsu'. Only these families having proximity to banks had access to bank finance to survive the great depression of 1920–30. After some time, with the rise of the Soviet Union, the Japanese government followed the economic policy of the Soviet Union and all corporate bodies were put under government control. After the Second World War, the Roosevelt's New Deal Policy was implemented under which inter corporate equity blocks were confiscated and sold to public and the so called business families received minimum compensation. Since then family business and inter-corporate holdings strengthened. Now concentrated holding pattern with huge inter-corporate holdings exist in Japan. Banks and other financial institutions hold a substantial part of the shares of public corporations.

South Korea

As Korea was ruled by Japan for many years during the last century, Japanese business practices were followed Korea for many years. Korean corporate form was demonstrated by the 'Chaebol' which can be defined as 'a business group consisting of large companies that are owned and managed by family members or relatives in many diversified business areas'. The conglomerate groups were developed with government support and traditionally owned and managed by members of founding families. The members of these founding families built successful corporations through networking with appropriate people as well as through the provision of cheap loans by state owned financial institutions. This relationship had allowed them to raise necessary finance and built reputation. The liberation of Korea from the Japanese rule and the end of Korean War gave them an opportunity to penetrate into the managerial positions in Chaebol and facilitate to adopt the US style of management.

Although there has been no separation of ownership and control in Chaebol through dispersion of equity ownership, they have been indirectly influenced by the government due to their significant holding of debt finance as the Korean banks have traditionally been under the government influence.

An essential characteristic of Korean business is the influence of Confucian ethics as Confucianism was the state religion for about 500 years. Under Confucianism Korean family power filtered down from the father to the son and eventually to daughters. Within traditional Korean Chaebol also power filters down from chairman to all ways down to most junior member in the hierarchy. This 'insider dominated' structure led to concentrated share holding pattern in Korea.

France

French history significantly influenced the country's corporate ownership structure. Historically money and capital market in France was recourse to self-financing. This has resulted strong concentration of family ownership in French corporate structure. By 1930 there were 200 French families who controlled all aspects of French business life, Banque de France, the stock exchange and then press. Even now this concentrated shareholding pattern continues in France.

Germany

Germany also followed similar corporate structure and ownership pattern as had been in France. The industrialization in Germany progressed in the late 19th century were financed by wealthy merchants firms, foreign investors and

private banks. The company Law of 1870 created the structure of dual boards namely supervisory board and management board in turn with modern view of corporate governance explicitly to protect the small shareholders and public from self-serving insiders.

The new Shareholder's Law of 1937 freed the corporate managers and directors of their specific fiduciary duties to shareholders and substituted a general duty to all stakeholders including workers. Modern German corporate structure primarily consists of family controlled pyramidal groups and nominally wide-held firms that are actually controlled by a few top banks through proxies.

Ownership Structure of Selected Countries (Figures in Percentage)

Ownership	*Czech Rep.*	*Hungary*	*Poland*	*Romania*	*Russia*	*Ukraine*
Insiders	3.0	11.0	10.0	15.0	40.0	45.0
State	51.0	53.0	26.0	45.0	8.0	21.0
Individuals/ families-outsiders	6.0	8.0	31.0	20.0	40.0	22.0
Institutional outsiders	40.0	21.0	24.0	20.0	5.0	6.0
Others	0	5.0	9.0	0	7.0	6.0
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: World Bank Business Environment Survey 1999.

China

The early industrialization of China was carried out with private equity floated through the Shanghai Stock Exchange. The private equity structures of companies were protected by the then rulers from foreign competition. After the defeat of China in the Sino-Japanese war in 1895, China introduced a company Law in 1904 known as 'Da Quin Goug Si Lu' on the line of English and Japanese model under which different types of companies were established including limited liability companies. After several modifications in 1914 and 1929 a new company law was the enacted in 1946 that aimed to achieve a compromise between the state capitalism and foreign competition. In 1950 after the formation of the People Republic of China, the communist government nationalized and collectivized the industries as part of nationalization of the economy. As a result the companies lost their corporate status, they become non-independent economic units either state owned or collectively owned. After Chairman Mao's death in 1974, Deng Xiao Ping steered the country towards economic growth and welcomed foreign investment. As a result, Sino-Foreign Joint Venture Law was enacted in 1979 to legalize the establishment of foreign invested limited liability companies. But even today the state dominates the ownership pattern in the Chinese companies.

Canada

Historically, Canada was a French colony first and then became a British colony. Early industrialization of Canada was under the French rulers and focused on mercantile policy of the French government. It was predominantly based on family controlled pyramidal business groups supplemented by large widely-held firms. With the British settlements and colonization during the first half of the 20th century, the government imposed huge estate taxes on the wealthy families which

forced the big business families to sell a part of their holdings in big companies and dilute their stake in big companies. But the early 1970's state intervention in the economy emasculation of estate taxes again led to the resurgence of family controlled pyramidal corporate structure with more dynamic and professionally managed format.

Australia

Australia was basically a British colony for a long period of time. It was an agricultural country with farming and pasturing as the main occupation. Though there were huge mineral deposits including gold, it was not exploited in early years. Early industrialization of the country was based on the British colony laws. When the colonies received more freedom and parliamentary autonomy, power relating to company formation shifted to Parliament. Increase in the value of private lands for farming and pasturing resulted in the increase in commercial activities in Australia that triggered the growth of demand of transport, food and accommodation resulting in the accumulation of money capital in the country. The Bank of New South Wales was the first company formed in New South Wales, Australia in 1817 in the form of an unincorporated joint stock company by the partnership law with transferability of share and management by representatives such as board of directors. The Australian Agricultural Company (1824), Australian Gas Light company (1936) a stock broking company known as William Barten (1935) were the companies formed in Australia in early days.

In 1950, limited liability partnership with some characteristics of modern company was introduced in New South Wales and Victoria for undertaking mining business operations. The first company law in Australia dealing with joint stock company characteristics was passed in New South Wales in 1939 which enabled joint stock Company to sue and be sued (Independent identity).

CONCLUSION

Right from the beginning of the economic history of mankind, business is carried out in four different formats, namely, Sole Proprietorship, Partnership, Company and Cooperative Society. Proprietorship form is the simplest and the most widely used format all over the world because of the ease of formation and transparency. But at the same time, it has its own limitations such as unlimited liability and lack of perpetual succession. The corporate form is the biggest in terms of volume of business because of its unique characteristics such as limited liability, separation of ownership and management, independent existence and perpetual succession. The modern corporate form of business is the product of Industrial Revolution. The history of corporate form of business dates back to 500 AD in Europe and Asia, especially in Japan, China, UK, Germany and France. Studies reveal that business organizations having some of the characteristics of modern companies existed in India in the name of 'Sreni' even during 800 BC.

The establishment of The Dutch East India Company and The English East India Company in the 1600s marked the beginning of the modern corporate history. The introduction of 'Limited Liability' concept in 1855 and the establishment of The London Stock Exchange gave great leverage to this form of business all over the world.

Even in India, the company form of business gained popularity during this period, under the influence of the British colonial rule. The Cotton and Jute boom in India during 1850s and the establishment of the Bombay Stock Exchange in 1875 further propelled this. The Managing Agency System prevalent in India at the time, also contributed significantly to the start of this form of business. Added to this was the emergence of business families like Tata, Birla and Godrej during the pre-independence period that gave strong foundation for the company form of business in India in the early days. This has

also motivated the emergence of new business families like the Reliance group, the Adani Group and the Sahara Group during the last four decades. The introduction of Indian companies Act 1956, the globalization of business, the formation of SEBI in 1992 and the increased importance of public sector in the early days of independence also played its role in the development of the company form of business.

Regarding, the corporate structure, approximately 90% of the companies in India are Private Limited Companies, 7% Unlisted Public Limited Companies and about 1% listed Public Limited Companies. The corporate ownership in India is predominantly concentrated in the hands of domestic individuals, promoter groups, and multinational parents or with the state. Approximately 51% of the market capitalization of BSE is in the hands of promoter groups. FII's and DII's control 19% and 10% respectively and the retail investors' share is 4% of the total market capitalization of Mumbai Stock Exchange. All these indicate that the corporate governance issue is not as serious in India as in US or UK.

KEYWORDS

- Articles of Association
- Chaebol
- Chartered company
- Company limited by guarantee
- Company limited by shares
- Cotton boom
- Disinvestment policy
- Holding company
- Jute Boom
- Legal entity
- Liberalisation
- Limited Liability concept
- Memorandum of Association
- NSE
- Perpetual succession
- Private company
- Public Company
- Registered company
- SEBI
- Statutory company
- Subsidiary company
- Unlimited companies

DISCUSSION QUESTIONS

1. Define a company and discuss its characteristics.
2. Discuss the different types of companies.
3. Explain the development of company form of organisation in its historical perspective.
4. Discuss the growth of company form of business during 19th and 20th Century.
5. Discuss the growth of public sector companies in India.
6. Discuss the role and the functions of SEBI.
7. Discuss the structure and the ownership pattern of companies in India.

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Corporate Governance: An Overview

CHAPTER OUTLINE

- Corporate Stakeholders
- What is Corporate Governance?
- Narrow Versus Broad Perceptions of Corporate Governance
- Governance Is More Than Just Board Processes and Procedures
- Need and Importance of Corporate Governance
- A Historical Perspective of Corporate Governance
- Issues in Corporate Governance

Introduction

Corporate governance refers to actions taken by organisations to improve relationships and interactions with various stakeholders of corporations such as investors, workers, government, consumers and business partners, NGOs engaging in community activities and promoting good environmental practices**.** The concept of corporate governance covers a set of rules, procedures and operational structure that guides the short-term and the long-term actions of companies. These actions include establishing codes of conduct for employees and balancing the interests of all stakeholders. It is a system by which the organs of corporations such as the board, managers, shareholders and other stakeholders spell out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides a structure through which the company objectives are set and the means of attaining those objectives and monitoring performance.

The concept of corporate governance covers a set of rules, procedures and operational structures that guides the short-term and long-term actions of companies.

Corporate Stakeholders

Corporate stakeholders are those groups without whose support the corporate organisation would cease to exist. They are broadly grouped into (1) internal stakeholders and (2) external stakeholders.

1. Internal stakeholders are those who engage in economic transactions with the organisation such as owners, employees, managers.
2. External stakeholders are those who do not engage in direct economic transaction but their actions can affect the business. e.g. Government, Suppliers, Creditors. These stakeholders have certain interest in the organisation without which some conflict will arise.

Main Stakeholders and Their Concern in a Company

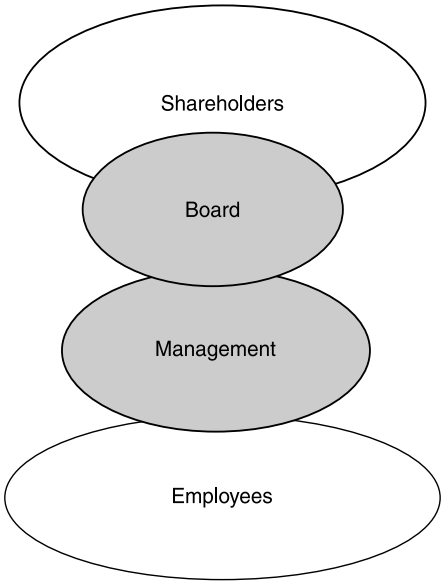
Corporate stakeholders	*Concerns*
Shareholders	Value maximization-Profitability, Liquidity-growth-market price
Employees	Benefit maximization
Government	Tax, employment, true reporting, diversity.
Creditors	Liquidity, debt servicing
Customers	Quality, price, care
Community	Job, environment protection, equity
Trade unions	Quality of work (worker's) life
Competitors	Fair play, ethical business

What is Corporate Governance?

Corporate governance is typically perceived by academic literature as dealing with "problems that result from the separation of ownership and control." From this perspective, corporate governance would focus on: the internal structure and rules of the board of directors; the creation of independent audit committees; rules for disclosure of information to shareholders and creditors; and, control of the management. Figure 2.1 explains how a corporation is structured.

Figure 2.1

Separation of ownership and management



Definitions of Corporate Governance

The concept of corporate governance sounds simple and unambiguous, but when one attempts to define it and scan available literature to look for precedence, one comes across a bewildering variety of perceptions behind available definitions. The definition varies according to the sensitivity of the analyst, the context of varying degrees of development and from the standpoint of academics versus corporate managements. However, there is an underlying uniformity in the thinking of all analysts that there is a definite need to eradicate corporate misgovernance and promote corporate governance at all costs. It is not only the stakeholders who are keenly interested in ensuring adoption of the best governance practices by corporates, but also societies and countries worldwide.

From the Academic Point of View

From the *academic standpoint*, corporate governance is seen as one that addresses "the problems that result from the separation of ownership and control."[1] Viewed from this perspective, corporate governance focusses on some structures and mechanisms that would ensure a proper internal structure and the rules of the board of directors; the creation of independent committees; the rules for disclosure of information to shareholders and creditors; a transparency of operations and an impeccable process of decision-making and the control of management.

A recent academic survey of corporate governance defined it as follows: "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return for their investment. How do the suppliers of finance get the managers to return some of the profits to them? How do they make sure that the managers do not steal the capital they supply or invest it in bad projects? How do suppliers of finance control the managers?"[2]

From this point of view, the corporate governance tends to focus on a simple model:

1. Shareholders elect directors who represent them.
2. Directors vote on key matters and adopt the majority decision.
3. Decisions are made in a transparent manner so that the shareholders and others can hold directors accountable.
4. The company adopts the accounting standards to generate the information necessary for directors, investors and other stakeholders to make decisions.
5. The company's policies and practices adhere to applicable national, state and local laws.[3]

A McKinsey & Company Report published in 2001 under the title "Giving New Life to the Corporate Governance Reform Agenda for Emerging Markets" suggests that by using a two-version "governance" chain model, we can illustrate the governance practices throughout the world.

Model 1

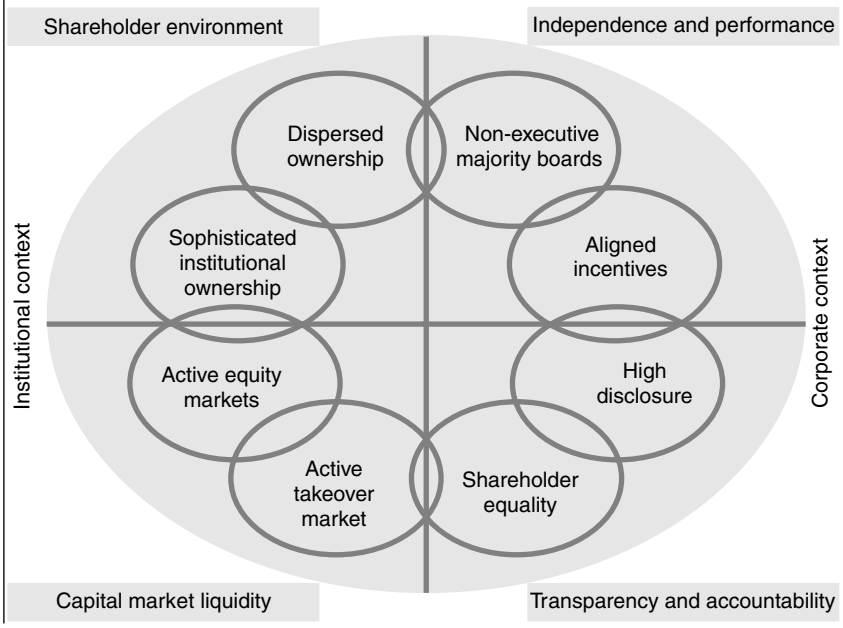
In the first version of McKinsey's model called "The Market Model" governance chain, there are efficient, well-developed equity markets and dispersed ownership, something common in the developed industrial nations such as the US, the UK, Canada and Australia. Corporate governance is basically how companies deal fairly with problems that arise from "separation of ownership and effective control." This model illustrates conditions and governance practices that are better understood and appreciated and as such highly valued by sophisticated global investors.

Model 2

In the second version of McKinsey's model called "The Control Model," governance chain is represented by underdeveloped equity markets, concentrated (family) ownership, less shareholder transparency and inadequate protection of minority and foreign shareholders, a paradigm more familiar in Asia, Latin America and some east European nations. In such transitional and developing economies there is a need to build, nurture and grow supporting institutions such as a strong and efficient capital market regulator and judiciary to enforce contracts or protect property rights.

Figure 2.2

The "market model" governance chain
(more common in the US, the UK,Canada and Australia)



From the Angle of Developed Versus Developing Countries

The concept of corporate governance can also be viewed from the context of economic development achieved by countries. While the principles underlying the concept are the same and there is no question of the norms governing it being different, the evolution of the systems and procedures that are required to implement it are at varying degrees of maturity. The earlier definitions quoted assume that in all societies an efficient and functioning legal system is in place, which is unfortunately, not so.

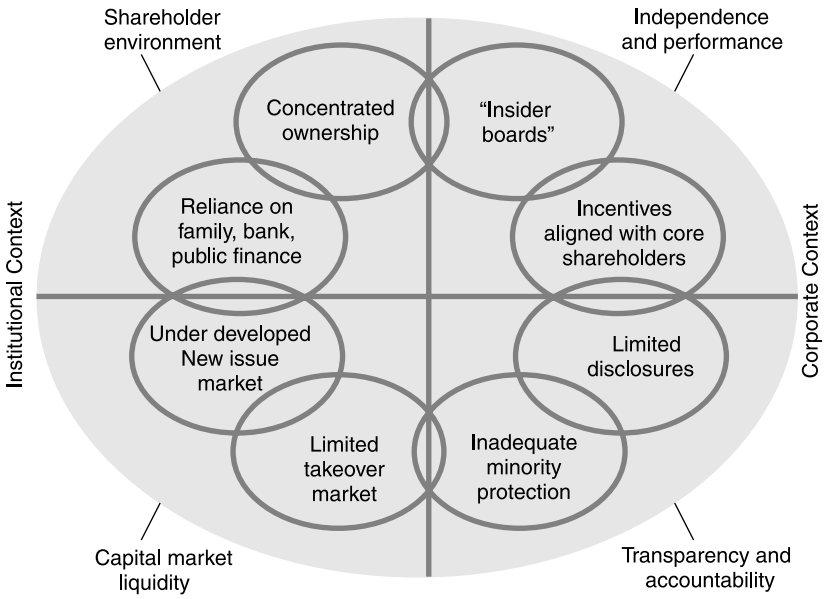
The Anglo-American, German, Japanese and other mature and developed economies have all well-functioning market systems and highly developed legal institutions, although there are considerable differences between them as there are in other features of democracy. In fact, it is these well-developed and mature institutions that have played a significant role in ushering in faster economic development of these countries. Therefore, in such economies, proper checks and balances exist to ensure good corporate behaviour. Even if any aberration occurs and corporate misdemeanour is noticed, quick remedial action can be taken to arrest the spread of such virus throughout the system, as was promptly done in the US by the Bush administration through the enactment of the Sarbanes–Oxley Act in the wake of corporate failures in 2002.

In the context of developed societies, the essence of corporate governance as expressed in the words of Patricia A. Nodoushani and Omid Nodoushani is as follows: "It is a relationship among various participants in determining the direction and performance of a corporation. However, corporate governance goes beyond the simple concept of who is in charge and who has the power. Chief among its goals are improving shareholder value and supporting a continuing commitment to growth."

Providing the foundation to this more "traditional" view of corporate governance are three basic assumptions: Primacy of the shareholder; diversity of the shareholder group; and the maximisation of shareholder wealth as a fundamental *raison d'être* of a company.[4] This view is consistent with both the Anglo-American

Figure 2.3

The "control model" governance chain
(more common in Asia, Latin America, parts of Europe)



system and the Continental European or German systems. Yet another crisp definition was from the former President of World Bank, J. Wolfensohn, who expressed the view that "corporate governance is about promoting corporate fairness, transparency and accountability."[5]

In such a scenario, in the absence of mature supporting institutions, governance practices tend to be designed as more *ad hoc* to suit the needs of controlling or influencing the shareholders. According to McKinsey, "the Market Model is a natural goal or target for any reform process of developing or transition economies which will however require fundamental institutional reform" to usher in material changes in the functioning of corporates.

According to some other experts: "Corporate governance means doing everything better to improve relations between companies and their shareholders; to improve the quality of outside directors; to encourage people to think of long-term relations; information needs of all stakeholders are met and to ensure that executive management is monitored properly in the interest of shareholders."

Sir Adrian Cadbury, chairman of the Cadbury Committee, defined the concept thus: "Corporate governance is defined as holding the balance between economic and social goals and also between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interest of individuals, corporations and society. The incentive to corporations is to achieve their corporate aims and to attract investment. The incentive for states is to strengthen their economies and discourage fraud and mismanagement."[6]

Defining corporate governance is not an easy task. It varies according to the sensitivity of the analyst, the context of the degree of development of the country to which it is referred and the different standpoints of the analysts, though there is an underlying unity in all these definitions. The Cadbury Report was a forerunner and made a significant contribution to the understanding of the concept.

Experts at the Organisation of Economic Co-operation and Development (OECD) have defined corporate governance as "the system by which business corporations are directed and controlled." According to them, "the corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the Board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs" (OECD, April 1999). By doing this, it provides the structure through which the company objectives are set, and also provides the means of attaining those objectives and monitoring performance. OECD's definition, incidentally is consistent with the one presented by Cadbury Committee.

All these definitions which are shareholder-centric capture some of the most important concerns of governments in particular and the society in general. These are: (i) management accountability, (ii) providing adequate investments to management, (iii) disciplining and replacement of bad management, (iv) enhancing corporate performance, (v) transparency, (vi) shareholder activism, (vii) investor protection, (viii) improving access to capital markets, (ix) promoting long-term investment, and (x) encouraging innovation.

All these traditional views reflect the necessity of corporate governance for improved performance of corporates themselves. However, there is a growing school of thought that maintains that this traditional theory does not go far enough. Good governance is critical not only for the success or failure of companies, but also for industries and economies as well. Besides, there is a need to extend the concept of governance to corporates of developing and transitional economies and standardise it to accommodate "well-entrenched" local and regional customs, traditions and business practices, which may be very different from what are obtained in advanced societies.

Of late, corporate governance has become the cynosure of all issues connected with corporations. National business communities are gradually realising the fact that there is no substitute for getting the basic business and management systems in place in order to be competitive in the global market and to attract investment.

From the standpoint of *developing economies and transition societies*, ensuring corporate governance becomes difficult in the absence of a well-developed corporate culture, capital market, money market, regulatory systems, well-defined and suitable public policies, proactive governments, well-informed stakeholders and the presence of corruption, bribery, discrimination and a culture of accepting misgovernance, fraud and corporate misdemenour as part of human frailities. This has been amply demonstrated in the manner in which corporates have been run in developing countries by all-pervasive family-owned concerns. Shareholders, on the other hand, have remained scattered, mute and often oblige managements and pass resolutions without a murmur for the meagre dividends and petty gifts. In such a scenario, development of strong and powerful regulatory institutions, legal structures and evolving healthy precedence is of great importance.

Corporate governance systems depend upon a set of institutions (laws, regulations, contracts, and norms) that create self-governing firms as the central element of a competitive market economy. These institutions ensure that the internal corporate governance procedures adopted by firms are enforced and that management is responsible to owners (shareholders) and other stakeholders.[7] As John D. Sullivan asserts : "In developing economies one must look to supporting institutions—for example, shoring up weak judicial and legal systems in order to enforce contracts and protect property rights in a better way."[8] This need for an institutional arrangement being the *sine qua non* for adopting better corporate governance practices is underlined in the following definition: "Corporate governance is not just corporate management; it is something much broader to include a fair, efficient and transparent administration to meet certain well-defined objectives. It is a system of structuring, operating and controlling a company with a view to achieving long-term strategic goals to satisfy shareholders, creditors, employees, customers and suppliers and to comply with the legal and regulatory requirements, apart from meeting environmental and local community needs. When it is practised under a well-laid out system, it leads to the building of a legal, commercial and institutional framework and demarcate the boundaries within which these functions are performed."[9]

Definitions point to the fact that corporate governance systems depend upon a set of institutions such as laws, regulations, contracts and norms that create self-governing firms as the central element of a competitive market economy. These institutions ensure that the internal corporate governance procedures adopted by firms are enforced and that managements are responsible to owners and other stakeholders.

A critical factor in the corporate governance is the inherent need to accept it, and to get acclimatised to, change with its fast phase and unpredictability in a market-driven global economy, even while getting even with cut-throat competition at all levels. Every country wants its corporates to flourish and grow, provide wealth and welfare to its people, enhance standards of living and ensure social cohesion to the extent feasible.

But these concerns are not limited to the developing countries and the transition societies alone. There is a global trend towards strengthening corporate governance. For example, in recent years, the Cadbury Committee in the United Kingdom, the Vienot Commission in France, and the Organisation for Economic Co-operation and Development (OECD) have all issued new guidelines. In the United States, there is

mounting concern over the "independence" of independent audits as witnessed in the recent publicity surrounding violations of rules prohibiting auditors to invest in companies that they audit. In all of these cases, the underlying concerns centre around ways to accomplish the core values of corporate governance including transparency, accountability and building values.[10]

In this context, it is refreshing as well as interesting to note another definition of corporate governance: "Some commentators take too narrow a view, and say it (corporate governance) is a fancy term for the way in which directors and auditors handle their responsibilities towards shareholders. Others use the expression as if it is synonymous with shareholders' democracy. Corporate governance is a topic recently conceived, as yet ill-defined, consequently blurred at the edges... Corporate governance is a subject, has an objective, or has a regime to be followed for the good of shareholders, employees, customers, bankers, and indeed for the reputation and standing of our nation and its economy."

Narrow Versus Broad Perceptions of Corporate Governance

According to an article that appeared in Financial Times in 1997, "Corporate governance is defined narrowly as the relationship of a company with its shareholders or, more broadly, as its relationship with society." Thus, the concept covers a vast canvas and cannot be put into one straitjacket.

Corporate governance can also be defined from a very narrow perception to a broad manner. According to an article that appeared in Financial Times in 1997: "Corporate governance... is defined narrowly as the relationship of a company to its shareholders or, more broadly, as its relationship to society."

The earliest definition of corporate governance in its narrow sense is from the Economist and Nobel Laureate, Milton Friedman. According to him, "corporate governance is to conduct the business in accordance with the owner's or shareholders' desires, which, generally, will be to make as much money as possible, while conforming to the basic rules of the society embodied in law and local customs." This definition is based on the economic concept of market value maximisation that underpins shareholder capitalism. In the present day context, Friedman's definition appears narrow in scope. In this narrow sense, corporate governance can be viewed as a set of arrangements internal to the corporation that define the relationship between the owners and the managers of the corporation. For instance, Monks and Minow[11] define corporate governance as "the relationship among various participants in determining the direction and performance of corporations. The primary participants are: (1) the shareholders, (2) the management, and (3) the board of directors."[12]

The World Bank defines corporate governance from two different perspectives. From the standpoint of a corporation, the emphasis is placed on the relations between the owners, the management, the board and other stakeholders (the employees, the customers, the suppliers, the investors and the communities). Major significance in corporate governance in this narrow perspective is given to the board of directors and its ability to attain long-term, sustained value by balancing these interests. From a public policy perspective, corporate governance refers to providing for the survival, growth and development of the company, and at the same time, its accountability in the exercise of power and control over companies. The role of public policy is to discipline companies and, at the same time, to stimulate them to minimise differences between private and social interests.[13] The OECD also offers a broader definition: "...Corporate governance refers to the private and public institutions, including laws, regulations and accepted business practices, which together govern the relationship in a market economy, between the corporate managers and the entrepreneurs (corporate insiders) on one hand, and those who invest resources in corporations, on the other."[14]

From all the above definitions, any discerning reader can understand that good corporate governance is a desideratum to the growth and development of

enterprises worldwide. To attain sustainable economic growth, the economy should boast of a growing enterprise sector which is, *inter alia* responsible, accountable, transparent and fair not only to its shareholders, but also to the entire groups of stakeholders. These characteristics of good corporate governance are now recognised as a *sine qua non* for access to, and development of, financial markets, and are being increasingly demanded by both international and domestic investors.

In the case of transition economies which are eager to convert their command economies to market-driven economies, it is improved corporate performance that will justify and accelerate their efforts to reach their goal. In the case of India too, the government found implementation of delicensing, deregulation and liberalisation relatively "easy going" because of the improved performance of the corporate sector in the wake of the new economic policy initiated in and after 1991, which in turn, boosted the growth of the country's national income, in the aftermath of the changed strategies in economic policy.

Ensuring better corporate governance practices in the country's mega corporations will result in boosting investors' confidence so that they can confidently commit their funds to them. Having a transparent and fair system to govern markets, equitable treatment of all stakeholders and an opportunity to enterprises to prove their worth in competitive markets are all very important to the successful development of an economy. And in this scenario, corporate democracy should go hand-in-hand with political democracy.

Perceptional Differences in Definitions

We have seen several definitions of corporate governance and any intelligent reader would not have failed to note the fact that even while all of them emphasise the importance of ensuring good corporate governance practices for the good of the economy and the nation, there is a perceptible difference in the emphasis they lay in terms of objectives, goals and the means and tools to achieve and realise it. In this context, it will be appropriate to recall the contention of many writers of the history of economic thought. Having gone through the chequered history and development of economic thought with their profound impact on the policy formulations and functioning of economies world-wide, they come to the inevitable conclusion that economic doctrines—though they appear to be permanent and inexorable—reflect the conditions of the times in which they are enunciated; so also the contexts and the situations in which they are to be tested or to be put into practice. Lest one is tempted to jump to the conclusion that such economic doctrines have no scientific relevance, one should be clear in one's mind that economics being a social science studying human behaviour that can not be put into one strait-jacket, can hardly have inflexible and exact doctrines like physics or mathematics.

In the several definitions of corporate governance that are available any intelligent reader would not have failed to note the fact that even while all of them emphasise the importance of ensuring good corporate governance practices for the good of the economy and the nation, there is a perceptible difference in the emphasis they lay in terms of objectives, goals, means and tools to achieve and realise it.

Therefore, corporate governance which reflects a practical field of economics too has definitions that lay varying degree of emphasis on time, context and the dimensions of corporate governance issues. According to some economists: "Corporate governance is a field in economics that investigates how to secure/motivate efficient management of corporations by the use of incentive mechanisms, such as contracts, organisational designs and legislation. This is often limited to the question of improving finance performance, for example, how the corporate owners can secure/motivate that the corporate managers will deliver a competitive rate of return."[15]

Thus, in today's world different governance practices exist in different markets reflecting the business reality. But there is a *common view* that the "natural goal" for all markets, be they developed or developing, should be essentially the same. But even though there is common goal, writers on the topic also come to the conclusion that "One Size Does Not Fit All." For example, Mayer is of the view that

"governance is more than shareholder/management alignment; it is about who is in control, for how long and over what critical important corporate activities." Other commentators argue that new economy companies' governance structures should adopt themselves rapidly to the fast-moving changes in control, while this adoption may be slow in old economy companies. It is, therefore, important that governance structures and practices should be tailored to meet appropriate requirements and needs.

There are many writers who hold the view, as Mayer does, that governance is moving in a direction that encompasses *corporate strategy* as a key element. To Mayer, "corporate governance is not... solely concerned with the efficiency with which companies are operated in the interests of shareholders. It is also intimately related to company strategy and *life cycle development*."

There are writers who would want corporate governance to include *management discipline* (including financial discipline), *business ethics, corporate social responsibility*, and *stakeholder participation in the decision-making processes*. It is also being presumed that corporates have a responsibility to promote *sustainable economic development of* the countries in which they operate. In this era of globalisation, it is being increasingly realised that instituting corporate governance is not only a means to survive in today's competitive world, but a good *strategy* to prosper.

Need for and Importance of Corporate Governance

Corporate governance is needed to create a corporate culture of consciousness, transparency and openness. It refers to a combination of laws, rules, regulations, procedures and voluntary practices to enable companies to maximise shareholders' long-term value. It should lead to increasing customer satisfaction, shareholder value and wealth.

Many large corporations are multinational and/or transnational in nature. This means that these corporations have impact on citizens of several countries across the globe. If things go wrong, they will affect many countries, *albeit* some more severely than others. It is, therefore, necessary to look at the international scene and examine possible international solutions to the corporate governance difficulties.

Corporate governance is needed to create a corporate culture of consciousness, transparency and openness. It refers to a combination of laws, rules, regulations, procedures and voluntary practices to enable companies to maximise shareholders' long-term value. It should lead to increasing customer satisfaction, shareholder value and wealth. With an increasing government awareness, the focus is shifted from economic to the social sphere and an environment is being created to ensure greater transparency and accountability. It is integral to the very existence of a company.

Basic principles of corporate governance: The concept of corporate governance is based on certain principles as

(i) **Principle of fairness:** This principle presupposes that the corporate governance framework should ensure an equitable treatment of all shareholders, including minority and foreign shareholders and other stakeholders such as employees, customer's community, etc. Minority shareholders should have the opportunity to obtain effective redress for violation of their rights. The principles also state that all shareholders of the same series of a class should be treated equally. Insider trading and abusive self-dealing should be prohibited. Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation.

(ii) **Transparency principle:** Transparency is the cornerstone of the laws and codes of corporate governance. Transparency means openness, a willingness by the company to provide clear information to the shareholders and other

stakeholders in all aspects of the conduct of business. Business organisations should disclose their financial and operating results, timely and accurately ensuring that their shareholders and other stakeholders understand the nature of the organisation's operations, the current state of affairs and the future direction in terms of developments. For financial reporting, most countries now require that listed companies use the International Financial Reporting Standards (IFRS) as a reporting framework/guideline. The board of directors should also disclose the inherent risks and the estimates used in preparing the financial and operating results in order to give investors a clear understanding of the board and management's business judgment. Organisations should clarify and make publicly known the roles and the responsibilities of the board and management to provide the shareholders with a level of accountability. Transparency ensures that stakeholders have confidence in the decision-making and management processes of a company.

(iii) **Principle of accountability:** Corporate accountability refers to the obligation and the responsibility to give an explanation or reason for the company's actions and conduct. The board should present a balanced and understandable assessment of the company's position and prospects. The board is responsible for determining the nature and the extent of the significant risks it is willing to take. The board should maintain sound risk management and internal control systems. The board should establish formal and transparent arrangements for corporate reporting and risk management and for maintaining an appropriate relationship with the company's auditor and the board should communicate to stakeholders at regular intervals, a fair, balanced and understandable assessment of how the company is achieving its business purpose.

(iv) **Fiduciary principle:** Another principle of good corporate governance is the fiduciary principle. The directors who are the agents of the shareholders who invest money and own the organisation must act with trust while discharging their duties .They must act with loyalty; ensure full disclosure, diligence and obedience to the principle. The directors or officers should not exploit their position of trust and confidence for personal gain at the expense of the principal. Law demands a fiduciary to exercise highest degree of care and utmost good faith in maintenance and preservation of the principal's assets and rights, and imposes compensatory as well as punitive damages on the erring fiduciary.

(v) **Reliability principle:** This principle focuses on honouring the words and the commitment of the directors to all stakeholders.

(vi) **Principle of Dignity:** Another principle of good corporate governance is to respect the rights and privileges of all stakeholders. On many occasions there may be conflict of interest in protecting the rights and privileges of different stakeholders. Minority shareholders are the most affected groups in a corporate organisation.

(vii) **Propriety principle:** This principle emphasises respecting the rights of those who own property. Shareholders being the ultimate owners of the corporate property, in corporate governance utmost importance is given to protect the interest of the shareholders especially outside shareholders who are not represented in the board of directors.

(viii) **Responsiveness principles:** Another principle governing the good corporate governance is to respond efficiently and effectively to the societal needs**.** Responsive governance is one which responds or reacts to issues, characters and situations and takes decisions only after a thorough and dispassionate screening of all the implications as also the alternative courses of action

open. Speed is the essence in the decision-making process although speed does not necessarily mean haste or inadvertence. Tomorrow will be too late and one has to take the bull by its horns at the appropriate moment without the slightest procrastination or vacillation or delay. Any attempt to delay decision-making or allow a critical situation to drift could be suicidal in consequences.

Governance Is More Than Just Board Processes and Procedures

Corporate governance is generally perceived as a set of codes and guidelines to be followed by companies. But governance is more than just board processes and procedures. It involves relationships between a company's management, its board, shareholders and other stakeholders.

To most of us, corporate governance is just a set of codes and guidelines to be practised diligently by companies. We have the Cadbury Code and the CII Code of Desirable Corporate Governance. These Codes generally enjoin corporations to ensure changes in their Board structures and procedures with a view to making the company more accountable to shareholders. To achieve such an objective, they would recommend increasing the number of independent directors on boards and not to have one person acting both as the chairman and CEO, and to introduce committees for specific purposes such as the audit committee and remuneration committee.

However, "governance is more than just Board processes and procedures. It involves the full set of relationships between a company's management, its Board, its shareholders and its other stakeholders, such as its employees and the community in which it is located. The quality of governance is directly linked to the policy framework. In the 21st Century, stability and prosperity will depend on the strengthening of capital markets and the creation of strong corporate governance systems."[16] In such a scheme of things, therefore, governments play a crucial role in making the legal, institutional and regulatory framework within which governance systems are kept in place. The efficiency or otherwise of the governance system will directly depend on the framework conditions, which would include legal rights of shareholders and how these are protected when violated by managements.

Writers on the theme of quality of governance link it to the efficiency or otherwise of the economies. Poor governance, for instance, can wreak havoc on the performance of national economies, which in turn, will upset global financial stability. The financial crises in Russia and Asia had created ripples that affected not only the countries in their regions, but the entire world's economy. Poor governance undermines investor confidence in the markets and holds the whole financial system hostage. This is the reason why even in advanced countries like the US, the UK, France, Germany, Sweden and Australia, important long-term efforts have been initiated in the sphere of company law, mergers and acquisitions by companies.

Most worldwide organisations that strongly promote corporate governance as a means of enhancing economic growth of member nations such as World Bank, APEC and OECD insist on the inalienable rights of shareholders, equitable treatment to all of them, role of stakeholders in realising corporate governance, through disclosure, transparency and the boards' responsibility in ensuring all these.

All these broader visions of corporate governance and the consequent improvements that have been effected in the systems, procedures and the frameworks are the direct outcome of the increasing public awareness about the necessity to have better governance practices. In this effort, not only governments are involved, but also world-level organisations such as the World Bank, the OECD, and Asia Pacific Economic Co-operation (APEC). The OECD, for instance, had elaborated the corporate governance system which had been adopted by its member governments.

The OECD has emphasised the following requirements of corporate governance:

1. **Rights of shareholders:** The rights of shareholders which have been stressed as important for ensuring better corporate governance by all writers and organisations including the World Bank and the APEC, include secure ownership of their shares, voting rights, the right to full disclosure of information, the

participation in decisions on sale or any change in corporate assets (including mergers) and new share issues. Shareholders have the right to know the capital structures of their corporation and arrangements that enable certain shareholders to obtain control disproportionate to their holding. All transactions should be at transparent prices and under fair conditions. Anti-takeover devices should not be used to shield management from accountability. Institutional shareholders should consider the costs and the benefits of exercising their voting rights.

2. **Equitable treatment of shareholders:** The OECD and other organisations such as APEC have stressed the point that all shareholders including minority and foreign shareholders should get equitable treatment. All shareholders should have equal opportunity for redressal of their grievances and violation of their rights. Shareholders should not face undue difficulties in exercising their voting rights. Any change in their voting rights should be subject to a vote by shareholders. Insider trading and abusive self-dealing that are repugnant to the principle of equitable treatment of shareholders should be prohibited. Directors should disclose any material interests regarding transactions. They should avoid situations involving conflict of interest while making decisions. Interested directors should not participate in discussions leading to decisions that concern them.
3. **Role of stakeholders in corporate governance:** The OECD guidelines as also others on the subject of corporate governance recognise the fact that there are other stakeholders in corporations apart from the shareholders. Apart from the dealers, the consumers and the government who constitute the stakeholders' group, there are others too who ought to be considered. Banks, bondholders and workers, for example, are important stakeholders in the way in which companies perform and make decisions. Corporate governance framework should, apart from recognising the rights of the shareholders, allow employee representation on the board of directors, profit sharing, creditors' involvement in insolvency proceedings, etc. For an active stakeholder participation, it should be ensured that they have access to relevant information.
4. **Disclosure and transparency:** The OECD lays down a number of provisions for the disclosure and dissemination of key information about the company to all those entitled for such information. These may range from company objective to financial details, operating results, governance structure and policies, the board of directors, their remuneration, significant foreseeable risk factors and material issues regarding employees and other stakeholders. The OECD guidelines also spell out that annual audits should be performed by independent auditors in accordance with high quality standards. Like the OECD, the APEC also provides guidelines on the establishment of effective and enforceable accountability standards and timely and accurate disclosure of financial and non-financial information regarding company performance. Moreover, in the administration and management of a company, there may be several grey areas that baffle managers as to which course of action must be pursued to be on the right side of law. In such a piquant situation, they are expected to disclose their options to stakeholders. "When in doubt, disclose" is the ideal guideline one must follow.
5. **Responsibilities of the board:** The OECD guidelines explain in detail the functions of the Board in protecting the company, its shareholders and its other stakeholders. These functions would include concerns about corporate strategy, risk, executive compensation and performance, accounting and reporting systems, monitoring effectiveness and changing them, if needed. the APEC guidelines include establishment of rights and responsibilities of managers and directors.

The OECD guidelines focus only on those governance issues which arise due to separation between ownership and control of capital. Though these have limited focus, they are comprehensive, especially with reference to voting rights of institutional shareholders and obligations of the Board to stakeholders. Though the APEC principles too reiterate them, they give foremost importance to disclosures. Again, instead of rights of shareholders, they reiterate the rights and also of the responsibilities of shareholders, managers and directors. To them, establishment of accountability standards is a separate principle by itself.

To conclude, most of the earlier definitions of corporate governance centre around issues and problems arising out of the separation between ownership and control of capital, such as rights of shareholders, equitable treatment of all shareholders including minorities, foreigners and other stakeholders, disclosure and transparency, and the responsibilities of the board of directors. Later day commentators on the topic stress the importance of corporate governance covering a wider spectrum of policies and procedures encompassing management disciplines, stakeholder participation in decision making processes, social responsibility and corporation's contribution to sustainable development. There is now a definite emphasis on the quality of governance which is imperative and vital to achieve and realise all these policies. Moreover, it is necessary that we have to have different hats to fit different heads. One Size Does Not Fit All. The Broad objectives and principles of corporate governance may be the same to all societies, but when it comes to applying them to individual countries we have to reckon the peculiar features, socio-cultural characteristics, the history of its people, their value systems, economic system, political set-up, stage and maturity of development and even literacy rates. All these factors have an impact on both political and corporate governance systems. Superimposing the governance systems and procedures that are effective in mature Western democracies on transition economies will be inappropriate, ineffective and may even be inimical to the interests of the people these are intended to serve.

A comparative study of corporate governance guidelines issued by three international organisations, namely, the Organisation for Economic Co-operation and Development, the International Corporate Governance Network and the Asia-Pacific Economic Co-operation which fairly represent the thinking and perceptions of people on several governance issues of corporates is given on the next page.

A Historical Perspective of Corporate Governance

From a Narrow to a Broader Vision

Corporate governance has focussed traditionally on the problem of the separation of ownership by shareholders and control by management. It is now accepted that firms should respond to the expectations of more categories of stakeholders. The wide range of corporate governance practices include business ethics, social responsibility, management discipline, corporate strategy, life-cycle development, stakeholder participation in the decision-making processes and promotion of sustainable economic development.

As we have observed earlier, corporate governance has focussed traditionally on the problem of the separation of ownership by the shareholders and control by management. But with the passage of time, experiences gained from the historical developments of corporate misdemeanour and with the impact of a growing visions of society, we have come to recognise increasingly a broader framework of corporate governance. It is now accepted that firms should respond to the expectations of more categories of stakeholders which include employees, consumers, large institutional investors, government and the society as a whole. These diverse interests are to be harmonised and accommodated. Firms can achieve long-term value maximisation only if they respond to the expectations of these increasingly large number of stakeholders. In recent years, externalities such as product safety, job safety, and environmental impacts have increased the importance and significance of better governance of corporations to achieve these ends. Still more additions to the wide range of corporate governance practices

include as indicated earlier business ethics, social responsibility, management discipline, corporate strategy, life-cycle development, stakeholder participation in the decision-making processes, and the promotion of sustainable economic development. Nowadays commentators on the issue emphasise the importance of the quality of governance. All this growth in the perception of corporate governance from the very narrow definition of Milton Friedman (to conduct the business purely in accordance with shareholders' desires) to the very broad to include the entire society, has not been achieved in a short period. The evolution and development of corporate governance as an all-encompassing system of corporate behaviour with a great stake in sustainable development has an interesting and chequered history.

The Growth of Modern Ideas of Corporate Governance from the USA

The seeds of modern ideas of corporate governance were probably sown by the Watergate scandal during the Nixon presidency in the US. Subsequent investigations on the scandal revealed that the regulators and the legislative bodies failed to control and stop several major corporations from making illegal political contributions and bribing government officials. The need to arrest such unhealthy trend was translated into the legislation of the Foreign and Corrupt Practices Act of 1977 in America that provides for the maintenance and review of systems of internal control in an establishment. In the same year, the Securities and Exchange Commission (SEC) proposed mandatory reporting on internal financial controls. In 1985, a series of high profile business failures rocked the US which included the collapse of Savings and Loan. With a view to identifying the main causes of misrepresentation in financial reports and to recommend ways of reducing such incidences, the government appointed the Treadway Commission. Its report published in 1987 highlighted the need for a proper control environment, independent audit committees and an objective Internal Audit System. The Treadway Report underlined the need for published reports on the effectiveness of internal control and advised the sponsoring organisations to develop an integrated set of internal control criteria to enable corporations improve their control mechanisms. As a result of this recommendation, the Committee of Sponsoring Organisations (COSO) came into being. COSO's Report in 1992 stipulated a control framework for the orderly functioning of corporations.

The seeds of modern ideas of corporate governance were sown by the Watergate scandal during the Nixon presidency in the US. Subsequent investigations on the scandal revealed that the regulators and legislative bodies failed to control and stop several major corporations from making illegal political contributions and bribing government officials. It also paved the way for stiffer legislations.

England Catches Up

Even while these developments in the US stirred a healthy debate in the UK, a series of corporate scams and collapses in that country took place in the late 1980s and early 1990s which worried banks and investors about their investments and led the government in the UK to realise the inefficacy of the existing legislation and self-regulation. Famous corporations such as Polly Peck, Bank of Credit and Commerce International (BCCI), British & Commonwealth and Robert Maxwell's Mirror Group International collapsed like a pack of cards. Illustrious business enterprises, which witnessed spectacular growth in the boom time became disastrous failures later due to poor management and lack of effective control.

The Cadbury Committee

When it was realised in England that the existing rules and regulations were not adequate to curb unlawful and unfair practices of corporates so as to protect the unwary investors, it was thought necessary to look at the issues involved

TABLE 2.1 Corporate governance guidelines—a comparative study

	Key parameters elucidated by OECD	*Organisation for Economic Co-operation and Development (OECD) guidelines*	*International Corporate Governance Network (ICGN) global governance principles*	*Asia-Pacific Economic Co-operation (APEC) principles*
1.	Rights of shareholders	• Their rights to attend and participate in AGMs, to elect Board members, to receive dividends, and to avail relevant, timely, regular and accurate information. • Right to transfer shares. • To know capital structures and arrangements that confer on some members, disproportionate controlling rights. • Corporate control mechanism should function efficiently and transparently. • Transparent transactions; accountable management.	• Major organisational changes require their prior approval. • They have the opportunity to exercise their voting rights. • Right to have timely disclosure of the result of resolutions. • Adherence to one-share, one-vote standard. Institutional investors have proxy responsibilities to exercise voting rights.	Establishment of rights and responsibilities of all shareholders.
2.	Equitable treatment of shareholders	• All shareholders including minority and foreign shareholders receive equitable treatment. • Effective redressal for rights violations. • Change in voting rights subject to their vote. • Prohibition of insider-trading and self-dealing. • Directors to avoid decisions concerning their own interests.	• One-share, one-vote. • Protection of the rights of minority and foreign shareholders.	Equitable treatment of all shareholders.
3.	Role of stakeholders	• Recognition of their rights as established by law. • Encourage their active co-operation in creating sustainable enterprises. • Permit performance enhancing mechanisms. • Access to relevant information.	• Directors should build good and productive relationship with stakeholders. • Directors are responsible for providing accountability to shareholders.	Establishment of effective and enforceable accountability standards.
4.	Disclosure and transparency	Accurate and timely disclosure on company objective; major share ownership and voting rights; financial and operating results; directors and key executives and their remuneration; significant, foreseeable risk factors; governance structures and practices; material issues regarding employees and other stakeholders.	• Timely and full disclosure of all information. • Disclosure of share-holding and the status of voting rights. • Disclosure of Directors' compensation policies. • Annual audits by external statutory auditors.	Timely and accurate disclosure of financial and non-financial information with regard to company performance.
5.	Responsibilities of the Board of Directors	Specify key responsibilities of the Board-overseeing the process of disclosure and communication, monitoring the effectiveness of governance practices and change them, if necessary.	• Judgement of Directors, independent of management operation. • Establishment and nomination of committees for audit, compensation and outside directors.	Formation of Board of Directors and deciding their remuneration.

afresh and look for remedial measures. It was with this view a committee under the chairmanship of Sir Adrian Cadbury was appointed by the London Stock Exchange in 1991. This Cadbury Committee, consisting of representatives drawn from the echelons of British industry was assigned the task of drafting a code of practices to assist corporations in England in defining and applying internal controls to limit their exposure to financial loss, from whatever cause it arose.

The objective of the Committee was "to help raise the standards of corporate governance and the level of confidence in financial reporting and auditing by setting out clearly what it sees as the respective responsibilities of those involved and what it believes is expected of them." The Cadbury Committee, in a commendable pioneering effort, investigated extensively the accountability of the board of directors to the shareholders and to the society. The Committee submitted its report along with the "Code of Best Practices" in December 1992. In its globally well received report, the Committee elaborated the methods of governance needed to achieve a balance between the essential powers of the board of directors and their proper accountability. Though the recommendations of the Committee were not mandatory in character, the companies listed on the London Stock Exchange were enjoined to state explicitly in their accounts, whether or not the Code has been followed by them, and if not complied with, were advised to explain the reasons for non-compliance.

In England, Sir Adrian Cadbury was entrusted in 1991, by the London Stock Exchange, with the task of drafting a code of practices to assist corporations in defining and applying internal controls to limit their exposure to financial loss. The Cadbury Committee investigated extensively the accountability of the board of directors to the shareholders and to the society. The Committee that submitted its report along with the "Code of Best Practices" in December 1992 elaborated the methods of governance needed to achieve a balance between the essential powers of the board and their proper accountability.

The Cadbury Code of Best Practices had recommendations which were in the nature of guidelines relating to the board of directors, non-executive directors and those on reporting and control. These recommendations are given in Chapter 4: "Initiatives in Corporate Governance: Global and National."

The Aftermath of the Cadbury Report

The Cadbury Committee's Report, especially its recommendations concealed in the Code of Best Practices, shocked the corporate world in Britain and elsewhere. Its most revolutionary recommendations reverberated several transformatory changes that were to be incorporated in the corporate sector everywhere and its ramifications vibrated not only in the advanced countries of the West, but also could be heard in the emerging and transition economies like those of Russia, India and those in South East Asia. The most controversial of the Cadbury's recommendations was the one that required that the "*directors should report on the effectiveness of a company's system of internal control.*" It was the extension of control beyond the financial matters that caused the controversy.

After five years of the publication of the Cadbury Report, public confidence in corporates in England was again shaken by further scandals. To deal with the situation, a "Committee on Corporate Governance" headed by Ron Hampel was constituted with a brief to keep up the momentum by assessing the impact of Cadbury Report and developing further guidelines. The final report of the Hampel Committee submitted in 1998 contained some important and progressive guidelines, especially the extension of directors' responsibilities to "all relevant control objectives including business risk assessment and minimising the risk of fraud." Earlier, another Committee headed by Greenbury to address the issue of directors' remuneration submitted its Report in 1995. An amalgam of all these codes known as the Combined Code was subsequently derived. This Combined Code is appended to the listing rules of the London Stock Exchange and its compliance was made mandatory for all listed companies in the United Kingdom.

The Combined Code stipulated, *inter alia*, that the boards should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets. Further, the directors should conduct a review of the effectiveness

of the group's system of internal control and report to the shareholders at least once a year that they have done so. The review should cover all controls, including financial, operational and compliance and risk management.

The developments with regard to corporate governance led to the publication of Turnbull Guidance in September 1999, which required the board of directors to confirm that there was an ongoing process for identifying, evaluating and managing key business risks. Shareholders, after all, are entitled to ask if all the significant risks had been reviewed (and presumably appropriate actions taken to mitigate them) and why a wealth-destroying event was not anticipated and acted upon.

It was also found that the one common factor behind past failures of corporates was the lack of effective Risk Management. Risk Management subsequently grew in importance and is now seen as highly crucial to the achievement of business objectives by corporates.

It was clear, therefore, that the boards of directors are not only responsible for guidance, not just for reviewing the effectiveness of internal controls but also for providing assurance that all the significant risks have been reviewed. Furthermore, assurance was also required that the risks had been managed and an embedded risk management process was in place. In many companies, this challenge was being passed on to the Internal Audit function.

Corporate Governance in the Banking Sector

Some bank failures in the West underlined the necessity of close monitoring of the banking system. Weakness in the banking system of a country can threaten the financial stability, both within the country and globally. The Basel Committee on Banking Supervision has been working in this field for many years, both directly and through its many contacts with banking supervisors in every part of the world.

Around this time, some bank failures in the West underlined the necessity of close monitoring of the banking system. Weakness in the banking system of a country can threaten the financial stability, both within the country and globally. The need to improve the strength of the financial systems has attracted growing international concern. A communication issued at the close of the Lyon G-7 Summit in June 1996 called for action in this vital area. Several official bodies including the Basel Committee on Banking Supervision established by the Central Bank Governors of the Group of Ten Countries in 1975, the Bank for International Settlements, the International Monetary Fund and the World Bank have recently been examining ways and means to strengthen financial stability throughout the world.

The Basel Committee on Banking Supervision has been working in this field for many years, both directly and through its many contacts with banking supervisors in every part of the world.

Revival of Corporate Governance Issues in the New Millennium

As the stock market began to decline in the United States in early 2000, a number of thus far highly regarded companies began to collapse. Most dramatic was the demise of Enron. Serious problems were also reported at WorldCom, Adelphia, Global Crossing, Dynegy, Sunbeam, and Tyco. The revelations gave rise to anguished complaints of corruption, fraud, deception, insider trading and self-dealing at major corporations, which only months ago, looked invincible and almost infallible. Further research revealed that these examples of types of corporate fraud represented only a small sample of the murky goings on in hundreds of corporations. Between the period 2000 and 2002, the revelations of corporate fraud in the US were of such magnitude and inflicted such damage on investors that company reputations were irreparably destroyed and investor confidence dipped to a new low. Declining stock prices and erosion of billions of dollars of investors had severe and widespread impacts. The fraud and self-dealing revelations resulted in investigations by the US Congress, the Securities and Exchange Commission (SEC), and the State Attorney General in New York.

All these enquiries and the conclusions put their teeth in a comprehensive Act. The Sarbanes–Oxley Act (SOA) was enacted into a law on 30 July 2002.

It is said that eternal vigilance is the price of freedom. Such is also the price investors have to pay for ensuring corporate governance. Complacency and undue faith and trust in corporate managements have resulted in huge and unbearable losses of investors' hard-earned money. The history of corporate governance gives us an unforgettable lesson that vigilance and a continuing effort at building and strengthening it alone will give the investors the safety net they require.

Issues in Corporate Governance

Corporate governance has been defined in different ways by different writers and organisations. Some define it in a narrow perspective to include only the shareholders, while others want it to address the concerns of all stakeholders. Some talk about corporate governance being an important instrument for a country to achieve sustainable economic development, while some others consider it as a corporate strategy to achieve a long tenure and a healthy image. To people in developing societies and the transitional economies, it is a necessary incentive to usher in more powerful and vibrant institutions of control. To some, it provides another dimension to corporate ethics and social responsibility of business. Thus corporate governance has different meaning to different people. But to all, corporate governance is a means to an end, the end being long term shareholder, and more importantly, stakeholder value. Thus, all authorities on the subject are one in recognising the need for good corporate governance practices to achieve the end for which corporates are formed. They identify some governance issues being crucial and critical to achieve these objectives. These are:

Corporate governance conveys different meanings to different people. But to all, corporate governance is a means to an end, the end being long-term shareholder value, and more importantly, stakeholder value. Thus, all authorities on the subject are one in recognising the need for good corporate governance practices to achieve the end for which corporates are formed.

1. **Distinguishing the roles of board and management:** Constitutions of more and more companies stress and underline that the business is to be managed "by or under the direction of" the board. In such a practice, the responsibility for managing the business is delegated by the board to the CEO, who in turn delegates the responsibility to other senior executives. Thus, the board occupies a key position between the shareholders (owners) and the company's management (day-to-day managers of the company's resources). As per this arrangement, the board of a listed company has the following functions:
   (a) To Select, decide the remuneration and evaluate on a regular basis, and when necessary, change the CEO.
   (b) To oversee (not directly, but indirectly) the conduct of the company's business to evaluate whether or not it is being correctly managed.
   (c) To review and, where necessary, approve the company's financial objectives and major corporate plans and objectives.
   (d) To render advice top management including the Board of directors.
   (e) To identify and recommend candidates to the shareholders for electing them to the board of directors.
   (f) To review the adequacy of systems to comply with all applicable laws and regulations.
   (g) To perform all other functions required by law.
2. **Composition of the board and related issues:** A board of directors is a "committee elected by the shareholders of a limited company to be responsible for the policy of the company. Sometimes, full-time functional directors are appointed, each being responsible for some particular branch of the firm's work."[17]

   The composition of the board of directors refers to the number of directors of different kinds that participate in the work of the board. Over a period of

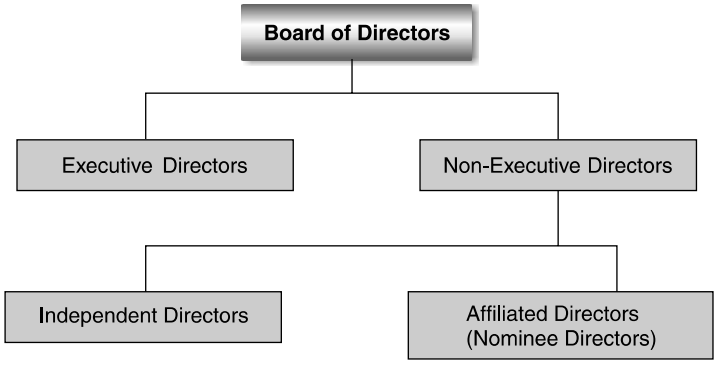
time there has been a change as to the number and proportion of different types of directors in the board of a limited company. Figure 2.4 illustrates the usual composition of the board in recent times in most of the countries.

The SEBI-appointed Kumar Mangalam Birla Committee's Report defined the composition of the Board thus: "The Board of Directors of a company shall have an optimum combination of executive and non-executive directors with not less than 50 per cent of the board of directors to be non-executive directors. The number of independent directors would depend on whether the chairman is executive or non-executive. In case of a non-executive chairman, at least one-third of the board should comprise independent directors and in case of an executive chairman, at least half of the board should be independent directors."[18]

As shown in Figure 2.4, an *executive director* is one who is an executive of the company and also a member of the board of directors, while a *non-executive director* has no separate employment relationship with the company. Independent non-executive directors are those directors on the board who are free from any business or other relationship which could materially interfere with the exercise of their independent judgement in the process of decision-making as a member of the board. An affiliated director or a nominee director is a non executive director who has some kind of independence, impairing relationship with the company or the company's management. For example, the director may have links with a major supplier or customer of the company, or may be a partner in a professional firm that supplies services to the company, or may be a retired top management professional of the company.[19]

Figure 2.4

Types of Directors



3. **Separation of the roles of the CEO and the Chairperson:** The composition of the board is a major issue in corporate governance as the board acts as a link between the shareholders and the management and its decisions affect the performance of the company. Professionalisation of family companies should commence with the composition of the board. All committees that studied governance practices all over the world, starting with the Cadbury Committee, have suggested various improvements in the composition of the boards of companies.

   It is now increasingly being realised that the practice of combining the role of the Chairperson with that of the CEO as is done in countries like the US and India leads to conflicts in decision-making and too much concentration of power in one person resulting in unhealthy consequences. In the United Kingdom and Australia, the CEO is prohibited from being the Chairperson of the company. The role of the CEO is to lead the senior management team in managing the enterprise, while the role of the Chairperson is to lead the board, one important responsibility of the Board being to evaluate the performance of senior executives including the CEO. Combining the role of both the CEO and the Chairperson removes an important check on senior management's activities. Besides, in large corporations, the job of the CEO as well as that of the Chairman may be heavy and onerous and one person, however much business acumen and astuteness he might possess, may not be able to deliver what he is expected to, competently, efficiently and objectively. That is the reason why many authorities on corporate governance recommend strongly that the Chairman of the board should be an independent director in order to "provide the appropriate counterbalance and check to the power of the CEO" (IFSA).[20]

Authorities on the subject identify some crucial and critical governance issues to achieve these objectives Distinguishing the roles of the board and management, composition of the board and related issues, separation of the roles of the CEO and chairperson, directors' and executives' remuneration, protection of shareholder–rights and their expectations are some of them.

4. **Should the board have committees?** Many committees on corporate governance have recommended in one voice the appointment of special committees for (i) nomination, (ii) remuneration and (iii) auditing. These committees would lessen the burden of the board and enhance its effectiveness. According to the Bosch Report, committees, apart from having written terms of reference outlining their authority and duties, "should also have clear procedures for reporting back to the board, and agreed arrangements for staffing including access to relevant company executives and the ability to obtain external advice at the company's expense."[21] When these committees are peopled with independent directors selected for their competence, professional expertise in their chosen fields and long years of work experience would help the respective committees decide issues objectively and in a manner that would promote the long term interests of the organisation.
5. **Appointments to the board and directors' re-election:** As per the Indian Company Law, shareholders elect directors to the board. However, shareholders are a legion in large companies and also scattered and to have them together to elect the directors will be expensive and time-consuming. Therefore, in actual practice, in most cases, the board or its specially constituted committee selects and appoints the prospective director and gets the person formally "elected" by the shareholders at the ensuing Annual General Body Meeting. In the Indian context, almost ninety percent of appointments to the board is done at the behest of the promoters who also double as CEOs or MDs. Although this is not an ideal situation, the practice continues because of the loopholes and the laxity in implementation of the spirit of law.

   Shareholders in fact only endorse the board's nominees and it is only in the rarest of rare cases that shareholders refuse to ratify the board's nominees for directorship. There are other issues of corporate governance in relation to the appointment of nomination committee, terms of office, duties, remuneration and re-election of directors and composition of the board on which several committees have made their own recommendations.
6. **Directors' and executives' remuneration:** This is one of the mixed and vexed issues of corporate governance that came to the centrestage during the massive corporate failures in the US between 2000 and 2002. Executive compensation has also in recent time become the most visible and politically sensitive issue relating to corporate governance.

   According to the Cadbury Report: "The over-riding principle in respect of the Board remuneration is that shareholders are entitled to a full and clear statement of Directors' present and future benefits, and how they have been determined." Other committees on corproate governance have also laid emphasis on other related issues as "pay-for performance," severance payments, pension for non-executive directors, appointment of remuneration committee and so on. "However, while controversy often surrounds the size or quantum of remuneration, this is not necessarily an issue of corporate governance—a payment that may be excessive in one context may be reasonable in another. The key corporate governance issues are: (i) transparency; (ii) pay for performance (whether the payment is justified); (iii) process for determination; (iv) severance payments; and (v) pensions for non-executive directors."[22]
7. **Disclosure and audit:** The OECD lays down a number of provisions for the disclosure and communication of "key facts" about the company to its shareholders. The Cadbury Report termed the annual audit as "one of the cornerstones of corporate governance." Audit also provides a basis for reassurance for everyone who has a financial stake in the company. Both the Cadbury Report and the Bosch Report stressed that the board of directors has a bounden responsibility to present the shareholders a lucid and balanced assessment of the company's financial position through audited financial statements. There are several issues and questions relating to auditing which

have an impact on corporate governance. There are, for instance, questions such as: (i) Should boards establish an audit committee? (ii) If yes, how should it be composed? (iii) How to ensure the independence of the auditor? (iv) What are the precautions to be taken or what are the positions of the state and the regulators with regard to provision of non-audit services rendered by auditors? (v) Should individual directors have access to independent resource? and (vi) Should boards formalise performance standards? These questions are being answered with different perceptions and with different degrees of emphasis by various committees and organisations that have gone into and analysed these issues in depth.

8. **Protection of shareholder rights and their expectations:** This is an important governance issue which has considerable impact on the rights and the expectations of shareholders. Corporate practices and policies vary from country to country. There are a number of questions relating to this issue such as: (i) Should companies always adhere to one-share-one-vote principle? (ii) Should companies retain voting by a show of hands or by poll? (iii) Can the shareholder's resolutions be "bundled"? i.e. to place together before the shareholders for approval a resolution that contains more than one discrete issue and (iv) Should the shareholder' approval be required for all major transactions? These questions have elicited answers with different emphasis from various committees and organisations that have addressed these issues.
9. **Dialogue with institutional shareholders:** The Cadbury Committee recommends that institutional investors should maintain regular and systematic contact with companies, apart from their participation in general meetings of the shareholders, use their voting rights positively, take a positive interest in the composition of the board of directors of companies in which they invest, and above all, recognise their rights and responsibilities as "owners" who should act in the best interests of those whose money they have invested by influencing the standards of corporate governance and by bringing about changes in companies when necessary, rather than by selling their shares, and quitting the companies.

   If institutional investors have to exercise their rights and carry out their responsibilities, companies have to provide them the required information and facilities.
10. **Should investors have a say in making a company socially responsible corporate citizen?:** This is an issue that highlights a conflict between two schools of thought. One school based on past experiences contends that institutional investors should act in the best financial interests of the beneficiaries. This is based on the assumption that socially responsible behaviour of the corporations such as ecological preservation, anti-pollution measures and producing quality and environment-friendly products which mostly enhance costs and thus reduce profits. But there is another school of thought which asserts environment friendliness and economic gains are not contradicting goals, but on the other hand, they benefit corporations in the long run and cite the examples of Ford Motors, Johnson & Johnson, Pfizer and Dow Chemicals to prove their point. Much can be, and are being, said on both sides and though the last word is yet to be said on the issue, present thinking worldwide across continents and divergent societies strongly prefer corporates that are committed to the overall welfare of people in whose midst they work and make their gains.

Different economies have systems of corporate governance that differ in the relative strength exercised by the stakeholders and how they influence managements. Good corporate governance means governing the corporation in such a way that the interests of shareholders are protected whilst ensuring that other stakeholders' requirements are fulfilled as far as possible.

Relevance of Corporate Governance

Internationally, over the past few years, much emphasis has been placed on the importance of corporate governance. Different economies have systems of corporate governance that differ in the relative strength of influence exercised by the stakeholders and how they influence the management.

Corporate governance is all about governing corporations. By their nature large modern enterprises are usually owned by one group of people (the owners or shareholders) whilst being run by another group of people (the management or the directors). This separation of ownership from management creates an issue of trust. The management has to be trusted to run the company in the interest of the shareholders and other stakeholders. If information were available to all stakeholders in the same form at the same time, corporate governance would not be an issue at all. Armed with the same information as managers, shareholders and the creditors would not worry about the former wasting their money on useless projects; suppliers would not worry about the customer not fulfilling his part of a supply agreement; and customers would not worry about a supplier for not delivering the goods/services agreed upon. In the real world of imperfect information, each agent will use whatever information advantage he may have.

Looking at the conventional firms, management will usually have an information advantage over other stakeholders and hence the need for corporate governance. Good corporate governance means governing the corporation in such a way that the interests of the shareholders are protected whilst ensuring that the other stakeholders' requirements are fulfilled as far as possible. It means that the directors will ensure that the company obeys the law of the land while carrying out its business.

In recent years, some high profile business frauds and questionable business practices in the United Kingdom, the United States and other countries including India have led to doubts being cast on the integrity of the business managers. This has led to the scrutiny of corporate governance and a desire for governments to tighten the regulation around corporate governance further.

When something goes wrong, governmental response the world over tends to be to set up an investigative committee. There have been a number of these committees set-up in various countries to look into what needs to be done following corporate governance problems.

High profile business frauds and questionable business practices in UK, USA and other countries including India have led to doubts being cast on the integrity of the business managers. This has led to the scrutiny of corporate governance and a desire for governments to tighten the regulations concerning corporate governance.

Governance and Corporate Performance

Several studies in the US have found a positive relationship between corporate governance and corporate performance. That is, improved corporate governance is linked with improved corporate performance—either in terms of rise in share price or profitability. However, it would be overstating the case to say that these studies are conclusive, because other researches have either failed to find a link or found it otherwise.

One difficulty in looking for statistical evidence of the value of good corporate governance is that governance is multi-dimensional. There are several different corporate governance mechanisms, which can interrelate with and, sometimes, substitute for one another.

There are strong signs that the world's business-ethical standards are becoming more stringent, and what constitutes good business practice is becoming clearer. Fifteen years ago, Korn/Ferry International and the Columbia University Business School conducted a 20-country poll on 1,500 business executives. They were asked to look ahead and identify a list of the most important characteristics of the ideal corporate CEO for the year 2000. It was found that "ethics" was right at the top of the list. Not anywhere else, but right at the top. The Conference Board in New York, together with the Institute of Business Ethics in London, did similar studies in 1992, and found 84 per cent of responding US firms had a corporate ethics code, followed by 71 per cent of UK firms, and 58 per cent for the rest. The figure for the UK grew particularly fast; 4 years earlier, it had been just 55 per cent. It seems that the business stress on ethics is a very Anglo-American phenomenon.

As these two countries are arguably the trendsetters in the global economy, their way of doing business would eventually affect the rest of the world and, with innovations and modifications to suit different countries and markets, could even become the global norm.

In India too, there are several examples to illustrate the positive relationship between corporate governance and corporate performance, though this is the case with fewer companies and there is a long road to traverse for the entire Indian corporate sector as such. Among the companies that have shown commendable success after introducing internationally acclaimed corporate governance practices are: Infosys Technologies Ltd that has consistently enhanced its performance and is a forerunner in espousing global governance standards; Tata Steel which is recognised and rewarded not only in India but also globally for its excellent corporate performance and/equally commendable social commitment and activism; Dr. Reddy's Lab which has excelled in all the important dimensions of corporate governance. There are several other group of companies belonging to the Tatas, the Birlas, Murugappas etc. in the private sector and the oil companies in the public sector that have done India proud in the sphere of corporate governance.

Investors' Preference for Good Governance

A recent survey of institutional investors found that a majority of investors consider governance practices to be at least as important as financial performance, when they evaluate companies for potential investment. They are prepared to pay a premium for shares in a well-governed company compared to a poorly governed one exhibiting similar financial performance.

A recent large-scale survey of institutional investors found that a majority of investors consider governance practices to be at least as important as financial performance when they are evaluating companies for potential investment. Indeed, they would be prepared to pay a premium for shares in a well-governed company compared to a poorly governed company exhibiting similar financial performance. In the US and the UK, the premium was 18 per cent while it was 27 per cent for Italian and 27 per cent for Indonesian companies.[23] Likewise, a survey by Pitabas Mohanty (Institutional Investors and Corporate Governance in India) has revealed that companies with good corporate governance records have actually performed better as compared to companies with poor governance records "and institutional investors have extended loans to them easily. Another similar survey of institutional investors, globally, has also revealed governance to be an important factor in investment decision-making."

Benefits to Society

According to John D. Sullivan, Corporate Governance brings to the society innumerable benefits. These benefits are as follows:

- A strong and vibrant system of corporate governance can be a major benefit to society. Even in developing countries where shares of most firms are not actively traded on stock markets, adopting standards for transparency in dealing with investors and creditors will bring benefit to all and also it helps to prevent systemic banking crises.
- Research has proved that countries with stronger corporate governance protections for minority shareholders have much larger and more liquid capital markets. Studies of countries that have their laws on different legal traditions show that those with weak systems tend to result in most companies being controlled by dominant investors while those with strong systems tend to have a widely dispersed ownership structure. Hence, for countries that try to attract investors corporate governance matters a great deal in getting the hard currency out of potential investors.

- Many economists and management experts point out that competition in product markets and for capital, act as constraints on corporate behaviour, in effect promoting good corporate governance. In many developing countries, competition in product or goods markets is quite limited, especially where significant regulatory barriers exist. These ground realities emphasise the importance of adopting the best possible corporate governance systems in countries where the market system is weak or yet to take proper shape.
- Corporate governance is also inter-related to another area that has emerged worldwide to a position of great prominence. In many societies, combating corruption is not a subject that is easy to deal with, both because of political sensitivities and potential yet often undependable and long-drawn legal action. When companies try to be transparent, having systems that provide full disclosure of accounting and auditing procedures, allowing transparency in all business transactions, corruption will not have a big role to play.
- Better corporate governance procedures can also improve the management of the firm and help a great deal in working out business strategy, ensuring that mergers and acquisitions are undertaken for sound business reasons and that compensation system reflect performance. It needs to be stressed that good corporate governance system also has to include improvements in management system. In many developing countries, there has been a tradition of very centralised management usually involving family—owned business. In many developing countries including India, for example, family business groups have tended to dominate the business landscape. This is changing for the better as a result of financial globalisation, observing the World Trade Organisation's liberalisation rules, and the increasing integration of regional markets. Now, firms in these countries are increasingly adopting modern management techniques, financial accounting systems, and business strategies. These changes require delegation of authority, paying increased attention to developing highly trained staff, and use of management information systems instead of the older centralised decision-making structures. It is highly likely that these trends will force similar changes throughout the emerging economies of the world.

Benefits of Good Corporate Governance to a Corporation

Good corporate governance secures an effective and efficient operation of a company in the interest of all stakeholders. It provides assurance that management is acting in the best interest of the corporation, thereby contributing to business prosperity through openness in disclosures and accountability. While there is only limited evidence to link business success to good corporate governance, good governance enhances the prospect for profitability. The key contributions of good corporate governance to a corporation include:

Good corporate governance secures an effective and efficient operation of a company in the interests of all stakeholders. It provides assurance that management is acting in the best interest of the corporation, thereby contributing to business prosperity through openness in disclosures and accountability.

1. **Creation and enhancement of a corporation's competitive advantage:** Competitive advantage grows naturally when a corporation or its services facilitate the creation of value for its buyers. Creating competitive advantage requires both the vision to innovate and the strategy to manage the process of delivering value. An effective board should be one that is able to craft strategies that fit the business environment of the corporation and are flexible to accommodate opportunities and threats, and to compete for the future. Corporations which develop their strategies by involving all levels of employees create widespread commitment to make the strategies succeed.

Key contributions of good corporate governance to a corporation include creation and enhancement of a corporation's competitive advantage; enabling a corporation perform efficiently by preventing fraud and malpractices; providing protection to shareholders' interests; enhancing the valuation of an enterprise; and ensuring compliance of laws and regulations.

Practical examples of strategies that create value to corporations are sales and marketing strategies, customer base and branding strategies. Coca Cola projects American values to its customers worldwide. Sony is reputed for the invention of new products. Johnson & Johnson, and Procter & Gamble are world renowned as the largest manufacturers of quality personal hygiene products.

2. **Enabling a corporation perform efficiently by preventing fraud and malpractices:** The Code of Best Conduct—policies and procedures governing the behaviour of individuals of a corporation—form part of corporate governance. This enables a corporation to compete more efficiently in the business environment and prevents fraud and malpractices that destroy business from inside. Failure in management of best practice within a corporation has led to crises in many instances. The Japanese banks that made loans to property developers that created the bubble economy in the early 1990s, the foreign banks which granted loans to State-owned enterprises that became insolvent after the Asian financial crisis in 1997, and the demise of Barings are examples of managements not governing the behaviour of individuals in the corporation leading to their downfall.
3. **Providing protection to shareholders' interest:** Corporate governance is a set of rules that focusses on transparency of information and management accountability. It imposes fiduciary duty on management to act in the best interests of all shareholders and properly disclose operations of the corporation. This is particularly important when ownership and management of an enterprise are in different hands, as these are in corporates.
4. **Enhancing the valuation of an enterprise:** Improved management accountability and operational transparency fulfil investors' expectations and confidence in management and corporations, and in return, increase the value of corporations. As indicated earlier, companies that have adopted corporate governance standards have invariably enhanced their market valuations.
5. **Ensuring compliance of laws and regulations:** With the development of capital markets and the increasing investment by institutional shareholders and individuals in corporations that are not controlled by particular shareholders, jurisdictions around the world have been developing comprehensive regulatory frameworks to protect investors. More rules and regulations addressing corporate governance and compliance have been and will be released. Compliance has become a key agenda in establishing good corporate governance. After all, corporate governance ensures the long-term survival of a corporation and thereby enables its shareholders long-term benefits.

CONCLUSION

Corporate governanc ensures transparency, full disclosures and accountability of companies to all its stakeholders. The latest revised OECD Principles place their thrust on six major areas of corporate governance. (i) They call upon governments to put in place an effective institutional and legal framework to support good corporate governance practices; (ii) they call for a corporate governance framework that protects and facilitates the exercise of shareholders' rights; (iii) they strongly support equitable treatment of all shareholders including minority and foreign shareholders; (iv) they recognise the importance of the role of stakeholders in corporate governance; (v) they stress the importance of timely, accurate and transparent disclosure mechanisms, and finally, (vi) they deal with Board structures, responsibilities and procedures. All issues of corporate governance, of course, emanate from and centre around these six major areas.

KEYWORDS

- Board procedures
- Board processes
- Broad perceptions
- Broader vision
- Developing countries
- Dialogue
- Disclosure
- Enabling corporations
- Enhancing valuations
- Global concerns
- Historical perspective
- Investor confidence
- Investors' preference
- Laws and regulations
- Misgovernance
- Modern ideas
- New millennium
- Perceptional differences
- Related issues
- Strategies and techniques
- Transparency

DISCUSSION QUESTIONS

1. Discuss the factors responsible for the emergence of corporate governance both in the USA and India.
2. What do you understand by the term "Corporate Governance?" While explaining the concept, discuss both the "market model" and the "control model."
3. Explain the historical model of corporate governance.
4. Discuss some of the most prominent issues of corporate governance. Discuss the relevance of these issues with particular reference to the Indian corporate sector.
5. Justify the need and the relevance of corporate governance in developing countries with particular reference to India.
6. How is corporate governance related to corporate performance? Illustrate your answer with suitable examples from the Indian corporate sector.

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Theories and Models of Corporate Governance

CHAPTER OUTLINE

- Theoretical Basis of Corporate Governance
- Agency Theory
- Stewardship Theory
- Stakeholder Theory
- Sociological Theory
- Resource Dependency Theory
- Transaction Cost Theory
- Hazard Model Theory
- Political Theory
- Ethics Theory
- Corporate Governance Mechanisms
- Corporate Governance Systems
- Anglo Saxon Model
- Japanese Model
- German Model
- Latin American Model
- Indian Model of Corporate Governance
- What is "Good" Corporate Governance?
- Obligations to Society at Large
- Obligation to Investors
- Obligation to Employees
- Obligation to Customers
- Managerial Obligation

"Corporate Governance is to conduct the business in accordance with owner or shareholders' desires, which generally will be to make as much money as possible, while conforming to the basic rules of the society embodied in law and local Customs".

— Milton Friedman, Economist and Noble Laureate.

Introduction

Though the concept of modern corporate governance is of recent origin, it was deeply rooted in the corporate history from the days the corporate form of business establishments began. As this form of business passed through several stages of its growth to the present form, corporate governance also passed through different stages to reach the present form. The subject of corporate governance is based on strong theoretical foundation derived from several disciplines as finance, economic, accounting, management, law, organisational behaviour, etc. As such it is multidisciplinary in nature. It can be observed that though legally corporate form of business have unidimensional characteristics all over the world now, the governance system prevailing in different countries are multi-dimensional in nature. Different systems of governance are followed in different countries of the world. In some countries like the UK, the USA, India, one tier board of directors system exists while in countries like Germany, France, Japan, etc., two tier board systems exist. Legal system of the country, corporate structure and shareholding pattern, cultural and value system prevailing, economic system of the country, etc., play a significant role with regards to the types of corporate governance suitable for each country. In addition to these, the theoretical base upon which the corporate governance has been developed plays a significant role in the type of corporate governance in a country. Economic system, political system and governance, path dependency, resource dependency and institutional environment also play a dominant role in corporate governance.

Theoretical base upon which the corporate governance has been developed plays a significant role in the type of corporate governance in a country. Economic system, political system and governance, path dependency, resource dependency and institutional environment also play a dominant role in corporate governance.

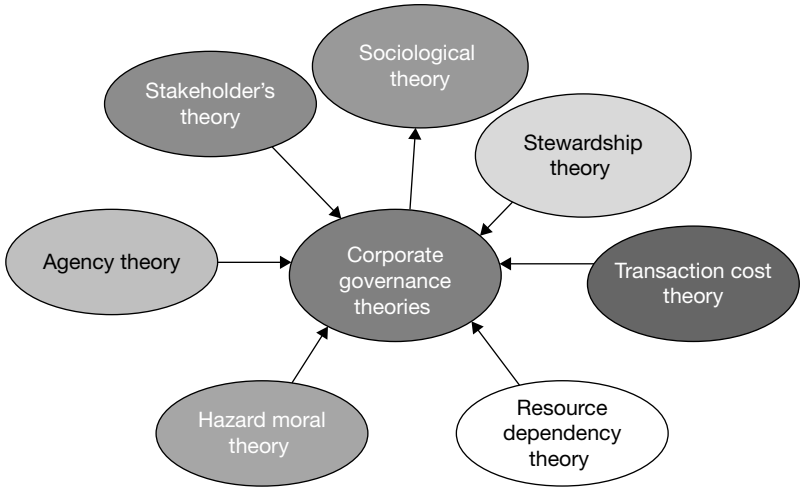
What is a Theory?

Theory is a supposition or a system of ideas intended to explain something, especially one based on general principles independent of the thing to be explained. In other words, it is a set of principles on which the practice of an activity is based or it can be defined as a set of assumptions, propositions, or accepted facts that attempts to provide a plausible or rational explanation of cause-and-effect (causal) relationships among a group of observed phenomenon.

Theories of Corporate Governance

Theories of corporate governance are rooted in the agency theory with the theory of moral hazard's implications, further developing within the stewardship theory and the stakeholder theory and evolving at resource dependence theory, transaction cost theory and political theory. Later, to these theories, the ethics theory, the information asymmetry theory or the theory of efficient markets theories were added. These theories are defined based on the causes and effects of variables such as the configuration of the board of directors, audit committee, independence of managers, the role of top management and their social relations beyond the legal regulatory framework. Effective corporate governance requires

applying a combination of existing corporate governance theories, rather than applying an individual any theory.



Agency Theory

Recent thinking about strategic management and business policy has been influenced by agency cost theory, though the roots of the theory can be traced back to Adam Smith who identified an agency problem (managerial negligence and profusion) in the joint stock company. The fundamental theoretical basis of corporate governance is *agency costs*. The shareholders are the owners of any joint stock, limited liability company, and are the principals of the same. By virtue of their ownership, the principals define the objectives of a company. The management, directly or indirectly selected by the shareholders to pursue such objectives, is the *agent*. While the principals generally assume that the agents would invariably carry out their objectives, it is often not so. In many instances, the objectives of managers are at variance with those of the shareholders. For instance, a chief executive may want to increase his managerial empire and personal stature by using the company's funds to finance an unrelated diversification, which could reduce long term shareholder value. The shareholders and other stakeholders of the company, may not be able to counteract this because of inadequate disclosure about such a decision and because the principals may be too scattered or even not motivated enough to effectively block such a move. Such mismatch of objectives is called the *agency problem*; the cost inflicted by such dissonance is the *agency cost*. The core of corporate governance is designing and putting in place disclosures, monitoring, "overseeing" and corrective systems that can align the objectives of the two sets of players as closely as possible and, hence, minimise agency costs.

In the modern corporation, where share ownership is widely held, managerial actions depart from those required to maximise shareholder returns. In the agency theory terms, the owners are the principals and the managers are the agents and there is an agency loss, which is the extent to which returns to the owners fall. Agency theory specifies mechanisms that reduce agency loss.

The main thrust of the agency theory runs like this. In the modern corporation, in which share ownership is widely held, managerial actions depart from those required to maximise shareholder returns. In the agency theory terms, the owners are principals and the managers are agents and there is an *agency loss* which is the extent to which returns to the residual claimants, the owners, fall below what they would be if the principals, the owners themselves, exercised direct control of the corporation. The agency theory specifies mechanisms which reduces agency loss. These include incentive schemes for managers which reward them financially for maximising shareholder's interests. Such schemes typically include plans whereby senior executives obtain shares, perhaps at a reduced price, thus aligning financial interests of executives with those of the

shareholders. Other similar schemes tie executive compensation and levels of benefits to shareholders, returns and have part of executive compensation deferred to the future to reward long-run value maximisation of the corporation and deter short-run executive action which harms corporate value.

Problems with the Agency Theory

Total control of management is neither feasible nor required under this theory. The underlying assumption in the trade-off that shareholders make on employing agents is that they must accept a certain level of self-interested behaviour in delegating responsibility to others. The objective of agency theory is to check the abuse in this trade-off, but its limited success raises the question of its utility as a theoretical model to promote corporate governance. Besides, in the agency theory the assumption is with the complexities of investor-board relationship in large organisations, shareholders should have correct and adequate information to wield effective control. Equity investors rarely get these and besides they rarely make clear their exact target returns, and yet delegate authority to meet the target. It is also to be understood that in terms of controls, equity investors hardly have sanctions over boards. Instead, they have to rely on self-regulation to ensure that an orderly house is maintained.

There are two broad mechanisms that help reduce agency costs and hence improve corporate performance through better governance: (i) fair and accurate financial disclosures, and (ii) efficient and independent board of directors.

There are two broad mechanisms that help reduce agency costs and hence, improve corporate performance through better governance. These are:

1. **Fair and accurate financial disclosures:** Financial and non-financial disclosures, relate to the role of the independent, statutory auditors appointed by shareholders to audit a company's accounts and present a "true and fair" view of the financial health of the corporation. Indeed, the quality and the independence of statutory auditors are fundamental to achieve the purpose. While it is the job of the management to prepare the accounts, it is the responsibility of the statutory auditors to scrutinise such accounts, raise queries and objections (if the need arises), arrive at a true and fair view of the financial position of the company, and report their independent findings to the board of directors and, through them, to the shareholders and the investors of the company.

   A company that discloses nothing can do anything. Improving the quality of financial and non-financial disclosures not only ensures corporate transparency among a wide group of investors, analysts and the informed intelligentsia, but also persuades companies to minimise the value-destroying deviant behaviour. This is precisely why law insists that companies prepare their audited annual accounts, and that these be provided to all shareholders and is deposited with the Registrar of Companies. This is also why a good deal of effort in global corporate governance reform has been directed to improving the quality and the frequency of disclosures.
2. **Efficient and independent board of directors:** A joint-stock company is owned by the shareholders, who appoint directors to supervise management and ensure that it does all that is necessary by legal and ethical means to make the business grow and maximise long-term corporate value. Directors are fiduciaries of the shareholders, not of the management. They are accountable only to the shareholders. "Independence" has of late, become a critical issue in determining the composition of any board.

Stewardship Theory

The Stewardship Theory of corporate governance discounts the possible conflicts between corporate management and owners and shows a preference for a board

of directors made up primarily of corporate insiders. This theory assumes that managers are basically trustworthy and attach significant value to their own personal reputations. The market for managers with strong personal reputations serves as the primary mechanism to control behaviour, with more reputable managers being offered higher compensation packages. Financial reporting, disclosure and auditing are still important mechanisms, but there is a fundamental presumption that these mechanisms are needed to confim managements' inherent trustworthiness.

Stewardship theory can be reduced to the following basics:

- The theory defines situations in which managers are not motivated by individual goals, but rather they are stewards whose motives are aligned with the objectives of their principles.
- Given a choice between the self-serving behaviour and the pro-organisational behaviour, a steward's behaviour will not depart from the interests of his/her organisation.
- Control can be potentially counterproductive, because it undermines the pro-organisational behaviour of the steward, by lowering his/her motivation.

The stewardship theory assumes that managers are basically trustworthy and attach significant value to their own personal reputations. It defines situations in which managers are stewards whose motives are aligned with the objectives of their principles. A steward's behaviour will not depart from the interests of his/her organisation. Control can be potentially counterproductive, because it undermines the pro-organisational behaviour of the steward by lowering his/her motivation.

This emphasis on the responsibility of the board to shareholders in the Anglo–Saxon model of corporate governance in terms of *stewardship* and *trusteeship* is nowhere better articulated than in the Canadian guidelines. It is stated therein: "Stewardship refers to the responsibility of the board to oversee the conduct of the business and to supervise management which is responsible for the day-to-day conduct of the business. In addition, as stewards of the business, the directors function as the catch-all to ensure no issue affecting the business and affairs of the company falls between cracks." Similar views, though differently told, predominate in corporate governance guidelines of many countries of the world.

The responsibility of the board to shareholders in terms of stewardship and trusteeship cannot be overemphasised. These concepts of stewardship and trusteeship are not new. The sacred scriptures, both in India and Christendom, emphasise the almost filial relationships between the rulers and the ruled. Gandhiji too elaborated the concept of trusteeship to make Indian industrialists better understand and appreciate their roles and responsibilities towards their employees.

The greatest barrier, however, to the adoption of stewardship mechanisms of governance lies in the risk propensity of principals. Risk taking owners will assume that executives are pro-organisation and favour stewardship governance mechanisms. Where the executives, the investors cannot afford to extend board power, agency costs are effective insurance against the self-interest behaviours of agents.

Of course, these concepts of stewardship and trusteeship are not new. The sacred scriptures, both in India and Christendom, emphasise the almost filial relationships between the rulers and the ruled. Gandhiji too elaborated the concept of trusteeship to make the Indian industrialists understand better and appreciate their roles and responsibilities towards their employees. It is said in many oriental societies including Japan, that an employer has been ordained by God to act as His trustee to own and administer assets for the benefit of his employees.

Though the Agency and the Stewardship Theories have something in common, there are certain basic differences. The tables set out below summarise the main differences between the two theories.[1]

Davis, Schoorman and Donaldson (1997) state that the owner-manager relationship depends on the behaviour adopted respectively by them. Managers choose to act as agents or as stewards according to certain personal characteristics and their own perceptions of particular situational factors. Principals choose to create a relationship of one type or the other depending on their perceptions of the same situational factors and of their managers' psychological mechanisms. The following tables set out these variables and the differences between the two theories.

TABLE 3.1 Behavioural differences

Agency Theory	*Stewardship Theory*
Managers act as agents	Managers act as stewards
Governance approach is materialistic	Governance approach is sociological and psychological
Behaviour pattern is • individualistic • opportunistic • self-serving	Behaviour pattern is • collectivistic • pro-organisational • trustworthy
Managers are motivated by their own objectives	Managers are motivated by the principal's objectives
Interests of the Managers and principals differ	Interests of the managers and principals converge
The role of the management is to monitor and control	The role of the management is to faclitate and empower
Owners' attitude is to avoid risks	Owners' attitude is to take risks
Principal–Manager relationship is based on control	Principal–Manager relationship is based on trust

Adapted from "Development of Corporate Governance System: Agency Theory Versus Stewardship Theory in Welsh Agrarian Coorperative Societies", by Dr. Alfonso Vargas Sanchez.

TABLE 3.2 Psychological mechanisms

Agency Theory	*Stewardship Theory*
Motivation revolves around • lower order needs • Extrinsic needs	Motivation revolves around • Higher order needs • Intrinsic needs
Social comparison is between compatriots	Social comparison is between principals
There is little attachment to the company	There is great attachment to the company
Power rests with the institution	Power rests with the personnel

Adapted from "Development of Corporate Governance System: Agency Theory Versus Stewardship Theory in Welsh Agrarian Coorperative Societies", by Dr. Alfonso Vargas Sanchez.

TABLE 3.3 Situational mechanisms

Agency Theory	*Stewardship Theory*
Management philosophy is control oriented	Management philosophy is involvement oriented
To deal with increasing uncertainty and risk, the theory advocates exercise of • greater controls • more supervisions	To deal with increasing uncertainty and risk, the theory advocates exercise of • training and empowering people • making jobs more challenging and motivating
Risk orientation is done through a system of control	Risk orientation is done through trust
Time frame is short term	Time frame is long term
The objective is cost control	The objective is improving performance
Cultural differences revolve around • individualism • large power distance	Cultural differences revolve around • collectivism • small power distance

Adapted from "Development of Corporate Governance System: Agency Theory Versus Stewardship Theory in Welsh Agrarian Coorperative Societies", by Dr. Alfonso Vargas Sanchez.

Shareholder Versus Stakeholder Approaches

While studying theories of corporate governance, it is common to distinguish between shareholder and stakeholder approaches. Shareholder approaches argue that corporations have a limited set of responsibilities, which primarily consist of obeying the law and maximising shareholder wealth. The basic argument is that corporations, by focussing on shareholder interests maximise societal utility. The logic of this position goes back to the ability of the shareholder model to maximise utility, however, is tenuous in that it is based on the assumption of perfect competition. To the extent that the conditions of perfect competition are not in place, the argument falters. More specifically, as deviations from the conditions of perfect competition increase (e.g. imperfect markets, incomplete contracts, information asymmetries), after a certain point, corporations will not be maximising societal utility by merely pursuing shareholder interests. The shareholder approach is logically most compatible with the Anglo-American model of corporate governance.

In contrast to shareholder approaches, stakeholder models of corporate governance argue that those responsible for the governance of the corporation have responsibilities to parties other than shareholders and that, any fiduciary obligations owed to shareholders to maximise profits might be subject to the constraint of respecting obligations owed to such stakeholders.

Stakeholder Theory

The stakeholder theory of corporate governance has a lengthy history that dates back to 1930s. The theory represents a synthesis of economics, behavioural science, business ethics and the stakeholder concept. The history and the range of disciplines that the theory draws upon has led to large and diverse literature on stakeholders. In essence, the theory considers the firm as an input-output model by explicitly adding all interest groups—employees, customers, dealers, government and the society at large—to the corporate mix.

The stakeholder theory is grounded in many normative, theoretical perspectives including ethics of care, the ethics of fiduciary relationships, social contract theory, theory of property rights, and so on. Stakeholder theory is often criticised, mainly because it is not applicable in practice by corporations.

The theory is grounded in many normative theoretical perspectives including the ethics of care, the ethics of fiduciary relationships, social contract theory, theory of property rights, theory of the stakeholders as investors, communitarian ethics, critical theory, etc. While it is possible to develop stakeholder analysis from a variety of theoretical perspectives, in practice much of stakeholder analysis does not firmly or explicitly root itself in a given theoretical tradition, but rather operates at the level of individual principles and norms for which it provides little formal justification. Insofar as stakeholder approaches uphold responsibilities to non-shareholder groups, they tend to be in some tension with the Anglo-American model of corporate governance, which generally emphasises the primacy of "fiduciary obligations" owed to shareholders over any stakeholder claims.

The stakeholder theory is often criticised, more often than not as "woolly minded liberalism", mainly because it is not applicable in practice by corporations. Another cause for criticism is that there is comparatively little empirical evidence to suggest a linkage between stakeholder concept and corporate performance. But there are considerable theoretical arguments favouring promotion of stakeholders' interests. Managers accomplish their organisational tasks as efficiently as possible by drawing on stakeholders as a resource. This is in effect a "contract" between the two, and one that must be equitable in order for both parties to benefit.

Criticisms of the Stakeholder Theory

The major problem with the Stakeholder Theory stems from the difficulty of defining the concept. Who really constitutes a genuine stakeholder? There is an expansive list suggested by authors of the theory, ranging from the most bizarre

to include terrorists, dogs and trees, to the least questionable such as employees and customers. Some writers have suggested that any one negatively affected by corporate actions might reasonably be included as stakeholder, and across the world this might include political prisoners, abused children, minorities and the homeless. However, a more seriously conceived and yet contested list of stakeholders would generally include employees, customers, suppliers, the government, the community, assorted activist or pressure groups, and of course, shareholders. Some writers on the theory opine that where there are too many stakeholders, "in order to clarify and ease the burden it places upon directors" it is better to categorise them as primary and secondary stakeholders. Clive Smallman in his article "Exploring Theoretical Paradigms in Corporate Governance" says: "The case for including both the serious claimants and the more flippant are rooted in business ethics, in managerial morality and in the best practice in business strategy. However, whilst the inclusion of a wide range of interested parties may be well-intentioned, in practice if directors (as agents) attempt to serve too many principals they will fail to satisfy those who have a genuine claim on an organisation."

Further, Clive Smallman points out to another problem that stems from the stakeholder theory. "Relating to the range and diversity of stakeholders, some critics also accuse stakeholder theory of being "superfluous", by which they mean that the intent of the theory is better achieved by relying on the hand of management to deliver social benefit where it is required."

In the assessment of Clive Smallman, "the stakeholder model also stands accused of opening up a path to corruption and chaos; since it offers agents the opportunity to divert wealth away from shareholders to others, and so goes against the fiduciary obligations owed to shareholders (a misappropriation of resources)".[2] Thus, the stakeholder model of corporate governance leads to corrupt practices in the hands of managements with a wide option and also to chaos, as it does not differ much from the agency model, while increasing exponentially the number of principals the agents have to tackle.

The sociological theory has focussed mostly on board composition and wealth distribution. Under this theory, board composition, financial reporting, and disclosure and auditing are of utmost importance to realise the socio-economic objectives of corporations.

Sociological Theory

The sociological approach to the study of corporate governance has focussed mostly on board composition and the implications for power and wealth distribution in society. Problems of interlocking directorships and the concentration of directorships in the hands of a privileged class are viewed as major challenges to equity and social progress. Under this theory, board composition, financial reporting, disclosure and auditing are necessary mechanisms to promote equity and fairness in society.

Resource Dependency Theory

Whilst, the stakeholder theory focuses on relationships with many groups for individual benefits, the resource dependency theory concentrates on the role of board directors in providing access to essential resources needed for an organisation through their linkages to the external environment. Resource dependency theorists provide focus on the appointment of representatives of independent organisations as a means for gaining access in resources critical to firm success. For example, outside directors who are partners to a law firm provide legal advice, either in board meetings or in private communication with the firm executives that may otherwise be more costly for the firm to secure. The provision of resources enhances organisational functioning, firm's performance and its survival. The directors bring resources to the firm, such as information, skills, access to key constituents such as suppliers, buyers, public policy makers, social groups as well as legitimacy.

Resource Dependency Theory

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- The provision of resources enhances organisational functioning, the firm's performance and its survival that directors bring resources to the firm, such as information, skills, access to key constituents such as suppliers, buyers, public policy makers, social groups as well as legitimacy.

According to the theory, the directors can be classified into four categories such as insiders, business experts, support specialists and community influential.

(a) First, the insiders are current and former executives of the firm and they provide expertise in specific areas such as finance and law on the firm itself as well as general strategy and direction.
(b) Second, the business experts are current, former senior executives and directors of other large for-profit firms and they provide expertise on business strategy, decision making and problem solving.
(c) Third, the support specialists are the lawyers, bankers, insurance company representatives and public relations experts and these specialists provide support in their individual specialized field.
(d) Finally, the community influential is the political leaders, university faculty, members of clergy, leaders of social or community organisations.

Transaction Cost Theory

Unlike the Agency Theory, the transaction cost theory explicitly uses the concept of corporate governance. This theory states that the company is a relatively efficient hierarchical structure that serves as framework to run the contractual relationships. The main concern in transaction cost theory is to explain the transactions conducted in terms of efficiency of governance structures. This theory was first initiated by Cyert and March (1963) and later it was described and exposed by Williamson (1996). The Transaction cost theory was interdisciplinary in nature covering the disciplines of law, economics and organisations. This theory attempts to view the firm as an organisation comprising people with different views and objectives.

Transaction Cost Theory

(i) The organisation and structure of a firm can determine price and production.
(ii) The unit of analysis in this theory is the transaction.
(iii) Therefore, the combination of people with transaction suggests that transaction cost.
(iv) Managers are opportunists and arrange firms' transactions to their interests.
(v) It assumes that individuals are self-interested and opportunistic in nature and they will cheat the system if they can.
(vi) The theory emphasises the need of strong legal mechanism to deal with opportunistic behaviour.

The underlying assumption of the transaction cost theory is that firms have become very large. The size of the firm in effect substitutes for the market in determining the allocation of resources. In other words, the organisation and structure of a firm can determine the price and production. The unit of analysis in this theory is the transaction. Therefore, the combination of people with transaction suggests that transaction cost theory managers are opportunists and arrange firms' transactions to their interests. It assumes that individuals are self-interested and opportunistic in nature and they will cheat the system if they can. The theory emphasizes the need of strong legal mechanism to deal opportunistic behaviour.

Hazard Moral Theory

The conflict of interest determined by the separation between the ownership and the control upon which the agency theory is founded can cause opportunistic behaviour of the managers as agents, which is not necessarily in synergy with the shareholder's interest as principals of maximizing shareholder's wealth. Thus, the managers are prone to moral hazard and opportunistic behaviour guided by their own interests. The theory of moral hazard is central within agency theory and also refers to hidden actions or opportunistic behaviour of managers. Hidden action arises as a consequence of asymmetric information held by the counterparties and opportunistic actions occur by human inclination. The result can only be extremely dramatic such as decreasing performance and even business failure.

Hazard Moral Theory

- Conflict of interest between the owners and the managers leads to opportunistic behaviour on the part of the directors.
- There is also asymmetric information availability between the directors and the owners.
- This can be overcome by appropriate remuneration policy to the directors by constituting a separate remuneration committee.

The hazard moral theory is strongly connected to the remuneration of manager policy. The concerns to define the managers' remuneration policy according to the need to develop a common interest between manager and the shareholders are current and they are the subject of various economic, financial and management researches. Regarding the manager's remuneration policy, Corporate Governance Code issued by various regulatory bodies states that "The board should establish a remuneration committee among its members to assist in formulating a remuneration policy for directors and managers and it should define the committee's internal regulations. Until a remuneration committee has been set up, the board should deal with these tasks and responsibilities at least once a year. The remuneration policy shall be subject to AGM approval." In conclusion, the way of expressing the moral hazard may result in the managers' remuneration policy and in the use of various actions such as handling financial communications in order to increase their prestige and management reputation or adopting risky decision.

Political Theory

Political theory says that the corporate governance system should be such that the task of corporate organisation is by developing voting support from shareholders, rather by purchasing voting power. Hence, having a political influence in corporate governance may direct corporate governance within the organisation. Public interest

is much reserved as the government participates in corporate decision making, taking into consideration cultural challenges. The political model highlights the allocation of corporate power, profits and privileges are determined through the governments' favour. The political model of corporate governance can have an immense influence on governance developments. Over the last decades, the government of a country has been seen to have a strong political influence on firms. As a result, there is an entrance of politics into the governance structure or firms' mechanism.

Ethics Theories and Corporate Governance

In addition to the fundamental corporate governance theories of the agency theory, the stewardship theory, the stakeholder theory, resource dependency theory, the transaction cost theory and the political theory there are other ethical theories that can be closely associated to corporate governance. These include the business ethics theory, the virtue ethics theory, the feminist ethics theory, the discourse ethics theory, the postmodern ethics theory.

Business ethics is the study of right or wrong in business. The main reasons for this are the power and the influence of business in any given society is stronger than ever before. Businesses have become a major provider to the society value, in terms of jobs, products and services. Business collapse has a greater impact on society than ever before and the demands placed by the firm's stakeholders are more complex and challenging. This has been experienced at the time of the collapse of Sathyam Computers, the Sahara issue, the Kingfisher case, etc. Only a handful of business giants have had any formal education on business ethics but there seems to be more compromises these days. Business ethics help us to identify the benefits and the problems associated with the ethical issues within the firm and business ethics is important as it gives us a new light into the present and the traditional view of ethics.

In understanding the 'right and wrongs' in business ethics, injected morality that is concerned with the norms, values and beliefs fixed in the social process which helps right and wrong for an individual or social community.

Ethics is defined as the study of morality and the application of reason which sheds light on rules and principle, which is called ethical theories that ascertain the right and wrong for a situation. Whilst business ethics theory focuses on the 'rights and wrongs' in business, feminist ethics theory emphasizes on empathy, healthy social relationship, loving care for each other and the avoidance of harm. In an organisation, to care for one another is a social concern and not merely a profit centred motive. Ethics has also to be seen in the light of the environment in which it is exercised. This is important as an organisation is a network of actions, hence influencing trans-communal levels and interactions. Disclosure ethics theory is concerned with peaceful settlement of conflicts. Discourse ethics, also called argumentation ethics, refers to a type of argument that tries to establish ethical truths by investigating the presuppositions of discours contends that such a kind of settlement would be beneficial to promote cultural rationality and cultivate openness

Corporate Governance Mechanisms

Why Corporate Governance?

Companies need to be governed as well as managed. Corporate governance is concerned with this need. The board of directors is central and its structure and processes are fundamental; so are the board's relationships with the company's shareholders, regulators, auditors, top management and other legitimate stakeholders.

As has been pointed out earlier, the joint-stock, limited liability company has become the preferred organisation for running business throughout the world. It has proved its worth in providing employment, generating wealth, and contributing to the economic and the social development. The original concept of the company,

which stems from the mid-nineteenth century, has proved immensely innovative, elegantly simple and highly successful.

In the limited liability company, the business is incorporated as an independent legal entity, separate from its owners, whose liability for its debts is limited to the amount of equity capital they have agreed to subscribe to. In law, the company has many of the rights of a legal person—to buy and sell, to own assets, to incur debts, to employ, to contract and to sue and be sued. The company has a life of its own different from those of its innumerable owners. Although this does not guarantee perpetuity, it does give the company an existence independent of the life of the proprietors, who can transfer their shares to others.

Everywhere ownership is the basis of power. The shareholders nominate and elect directors, who run the enterprise on their behalf. The directors are the stewards of the resources of the business and demonstrate their accountability to the shareholders, in the form of regular financial account and directors' reports. The shareholders also appoint independent auditors to report that these accounts show a true and fair view of the state of affairs of the company. Regular shareholders' meetings provide an opportunity for the directors to report and clarify shareholders' doubts or answer their questions.

Companies need to be governed as well as managed. Corporate governance is concerned with this need. The board of directors is central and its structure and processes are fundamental; so are the board's relationships with the company's shareholders, regulators, auditors, top management and other legitimate stakeholders.

There is no uniform scope or content of corporate governance. Some focus on the link between the shareholders and the company; some concentrate on the formal structures of the board, codes of board practice and corporate effectiveness; yet others believe the focus should be on the social responsibilities of corporations to a wider set of stakeholders. Corporate governance is a useful umbrella term to cover the exercise of power over and within the company, for the good of all concerned.

Models of Corporate Governance

What is a Model? How It Is Different from Theory?

Corporate governance provisions may differ from corporation to corporation. But conceptual aspects affect corporations in a similar way.

A model is a purposeful representation of a reality. In other words it is a physical representation of a theory. As stated earlier, a theory, on the other hand, is a set of statements that is developed through a process of abstraction. A theory is a generalized statement explaining a phenomenon. Scientific studies and discoveries come about after a well-thought-out hypothesis and thoroughly conducted experiments that produce models and theories. We may have encountered countless models and theories of famous scientists who once aimed to explain the different phenomena. Models may be produced after the formulation of theories, but there can be instances when the models are produced first before the theories. There can also be cases when models produce theories which in turn lead to the construction of another model for the verification of a theory.

It may be noted that one difference relied upon is that models are the basis of theories, while theories are the main basis for the explanation of different phenomena. Models come in the form of a verbal, visual, or mathematical representation of a prospect or scientific process of structure that should be followed by scientists in order to come up with theories and test inferences. These then can be formulated after conducting extensive observations of physical phenomena. When scientists have come up with a model showing structures of the scientific methods, repeated experiments following the model will be conducted in order to come up with acceptable theories.

Model and Theory

- Models and theories provide possible explanations for natural phenomena.
- Models can serve as the structure for the step-by-step formulation of a theory.
- Theories can be the basis of creating a model that shows the possibilities of subjects observed.
- Models can be used as a physical tool in the verification of theories.

Major corporate governance models are as follows: The corporate governance structure of a country is determined by several factors such as:

1. The legal and regulatory framework outlining the rights and the responsibilities of all parties involving broad legal system and specifically company legislation.
2. The corporate environment in the country.
3. The corporate structure and shareholding pattern of different countries.
4. Culture and value system prevailing in different countries.
5. Each corporation's articles of association.

While corporate governance provisions may differ from corporation to corporation, many conceptual aspects affect corporations in a similar way. Therefore, it is possible to outline a 'model' of corporate governance for a given country. In each country, the corporate governance structure has certain characteristics or constituent elements, which distinguish it from structures in other countries. To date, several models have been identified, they are:

1. Anglo-Saxon model
2. Japanese model
3. German model

Each model identifies the following constituent elements: key players in the corporate environment; the share ownership pattern in the given country; the composition of the board of directors (or boards, in the German model); the regulatory framework; disclosure requirements for publicly-listed stock corporations; corporate actions requiring shareholder approval and interaction among key players.

The Anglo-Saxon Model

The Anglo-Saxon model is purely based on the following assumptions.

1. Share owners are individuals, and increasingly institutional. In 1990, institutional investors held approximately 61 per cent of the shares of the UK corporations and individuals held approximately 21 per cent. (In 1981, individuals held 38 per cent.) In 1990, institutions held 53.3 per cent of the shares of the US corporations.
2. Investors not affiliated with the corporation (known as outside shareholders or **'outsiders'**).
3. A well-developed legal framework defining the rights and the responsibilities of three key players, namely the management, the directors and the shareholders.
4. A simple procedure for interaction between the shareholder and the corporation as well as among the shareholders during or outside the AGM.
5. Equity financing is a common method of raising capital for corporations.
6. Assume a free market economy,

7. Assumes the separation of ownership and control in most publicly-held corporations. This important legal distinction serves as a valuable business and social purpose; investors contribute capital and maintain ownership in the enterprise but avoid legal liability for the acts of the corporation. They entrust the task to management and paying management for acting as their agent. This cost of separation of ownership and control is defined as '**agency costs'**.
8. The interests of shareholders and management may not always coincide. Laws governing companies in countries following the Anglo-Saxon model attempt to reconcile this conflict by insisting election of a Board of Directors by the shareholders and insisting that boards act as **fiduciaries** for shareholders' interests.

The Anglo-Saxon Model
Features of companies: Widely dispersed ownership—High disclosure norms—High quality shareholders—high transparency—Sophisticated institutional investors taking active interest in companies affairs–Active private equity market—non executive majority board–Active share holders
Working: The model demands directors behave independently and take independent decisions even though they are invited by CEO to the meetings
Main features: Composition of BOD- Regulatory frame work-Disclosure requirements-Corporate actions requiring shareholders' approval-Interaction with share holders

Major Features of the Anglo-Saxon Model

Composition of the board of directors: The board of directors of most corporations that follow the Anglo-Saxon model includes both 'insiders' and 'outsiders'. An 'insider' is mostly executive director or a person who has significant business relationships with the company. An 'outsider' 'on the other hand' is a person or institution which has no direct relationship with company namely non-executive director or independent director.

Board composition and board representation remain important shareholder's concerns in the UK and the US. Perhaps this is because other corporate governance issues, such as disclosure and mechanisms for communication between corporations and shareholders, have largely been resolved. The UK and the US boards are generally smaller than the boards in Japan and Germany.

Regulatory framework: In this model a wide range of laws and regulatory codes define relationships among management, directors and shareholders. Regulatory agencies such as SEC (Securities Exchange Commission) strictly establish disclosure requirements for corporations and regulate communication between the corporations and the shareholders and among the shareholders. In comparison with other capital markets, the US has the most comprehensive disclosure requirements and a complex, well-regulated system for the shareholder communication.

The regulatory framework of corporate governance in the UK is established in Parliamentary Acts and Rules established by self-regulatory organisations, such as the Securities and Investment Board, which is responsible for overseeing of the securities market. Although the framework for disclosure and shareholder communication is well-developed, it is also remarked that self-regulation in the UK is inadequate and suggest that a government agency similar to the US SEC would be more effective. Stock exchanges also play an important role in the Anglo-US model by establishing listing, disclosure and other norms.

Disclosure requirements: The model presupposes most comprehensive and stringent disclosure requirements. US corporations are required to disclose a wide range of information such as corporate financial data on quarterly basis, its capital structure information, background information on each nominee to the board of directors, their relationship with the company, and ownership of stock in the corporation, the aggregate compensation paid to all executive officers (upper management) as well as individual compensation data for each of the five highest paid executive officers, all shareholders holding more than five per cent of the corporation's total share capital; information on proposed mergers and restructurings and names of individuals and/or companies proposed as auditors. Disclosure requirements in the UK and other countries that follow the Anglo-US model are similar. However, they generally require semi-annual reporting and less data in most categories, including financial statistics and the information provided on nominees.

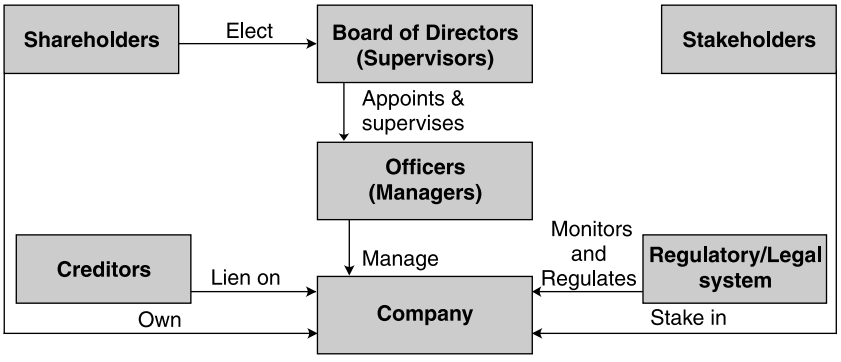
Corporate actions requiring shareholder approval: The two routine corporate actions requiring shareholder approval under the Anglo-US model are elections of directors and appointment of auditors. There is one important distinction between the US and the UK: in the US, shareholders do not have the right to vote on the dividend proposed by the board of directors. In the UK, shareholders vote on the dividend proposal. The Anglo-US model also permits shareholders to submit proposals to be included on the agenda of the AGM. The proposals known as shareholder proposals must relate to a corporation's business activity. Shareholders owning at least ten per cent of a corporation's total share capital may also convene an extraordinary general meeting (EGM) of shareholders.

Interaction among players: Shareholders may exercise their voting rights without attending the annual general meeting in person. All registered shareholders receive the agenda for the meeting by email including background information an all proposals ('proxy statement'), the corporation's annual report and a voting card. Shareholders may vote by proxy, that is, they complete the voting card and return it by mail to the corporation. By mailing the voting card back to the corporation, the shareholder authorizes the chairman of the board of directors to act as his proxy and cast his votes as indicated on the voting card. How this model works is presented in Figure 3.1.

Where is this model used? This mode is extensively used in countries where the above stated characteristics exist such as the UK, the USA, Canada, Australia.

Figure 3.1

The Anglo–American Model



The Japanese Model

The Japanese is model characterized by the following:

1. High level of stock ownership by affiliated banks and companies such as industry, financial institution network.
2. A banking system characterized by strong, long-term links between bank and corporation. Almost all Japanese corporations have a close relationship with a main bank. The bank provides its corporate client with loans as well

as services related to bond issues, equity issues, settlement accounts and related consulting services. The main bank is generally a major shareholder in the corporation.

3. A legal, public policy and industrial policy framework designed to support and promote ***' keiretsu'*** (industrial groups linked by trading relationships as well as cross-shareholdings of debt and equity).
4. Boards of directors composed almost solely of insiders. The interests of outside shareholders are marginal.
5. Equity financing is important for Japanese corporations. However, insiders and their affiliates are the major shareholders in most Japanese corporations.
6. The percentage of foreign ownership of Japanese stocks is small, but it may become an important factor in making the model more responsive to outside shareholders.
7. In the Japanese model, the key players are main bank (a major inside shareholder), affiliated company or *keiretsu* (a major inside shareholder), management and the government. Interaction among these players serves to link relationships rather than balance powers, as in the case in the Anglo-US model. But non-affiliated shareholders have little or no voice in decision making.
8. Few truly independent directors, representing outside shareholders.

Key Players in the Japanese Model

Key players in the Japanese models are:

1. The main bank (a major inside shareholder),
2. The affiliated company or *keiretsu* (a major inside shareholder),
3. The management and
4. The government. Interaction among these players serves to link relationships rather than balance powers, as in the case in the Anglo-US model. But non-affiliated shareholders have little or no voice in.

Japanese Model

- Company features: Shareholders are banks and financial institutions—large family shareholders with corporate shareholders- keiretsu form- Four key players such as Main Sponsoring Bank, Keiretsu, Management and Government. Foreign ownership stake is very small.
- The BOD and president are jointly appointed by shareholders and financial institutions. Outside independent directors are rarely seen in Japanese boards.
- Disclosure requirements in Japan are relatively stringent, but not as stringent as in the US.
- Government has great influence in developing industrial policy and has enormous regulatory control.
- Shareholders' approval is necessary for payment of dividends and allocation of reserves; election of directors; and appointment of auditors.

Composition of the board of directors: The board of directors of Japanese corporations comprise almost completely of insiders, that is, executive managers, usually the heads of major divisions of the company and its central administrative body. If a company's profits fall over an extended period, the main bank and members of the *keiretsu* may remove directors and appoint their own candidates to the company's board. Another practice common in Japan is the appointment of retiring government bureaucrats to corporate boards. Independent director

concept does not exist in Japanese model. Director's continuance in the Board depends on performance only. Japanese Boards are generally larger than the boards in the UK, the US and Germany.

Regulatory framework: In Japan, the government has great influence in developing industrial policy and has enormous regulatory control. However, in recent years, this has been weakened due to many reasons as the involvement of many departments in it, increasing internationalization of Japanese corporations, growth of Japanese capital markets. Despite all these, government agencies provide little effective, independent regulation of the Japanese securities industry.

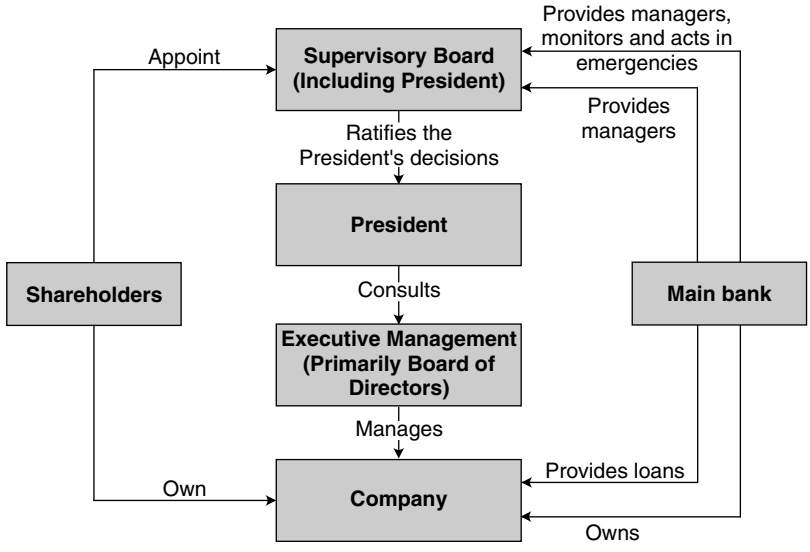
Disclosure requirements: Disclosure requirements in Japan are relatively stringent, but not as stringent as in the US. Corporations are required to disclose a wide range of information in the annual report and or agenda for the AGM. While the Japan's disclosure differs from the US in several ways such as bi-annual disclosure of financial data, compared with the quarterly disclosure in the US; the aggregate disclosure of executive and board compensation, compared with individual data on the executive compensation in the US; the disclosure of the corporation's ten largest shareholders, compared with the US requirement to disclose all shareholders holding more than five per cent of the corporation's total share capital.

Corporate actions requiring shareholder approval: In Japan, shareholders' approval is necessary for payment of dividends and allocation of reserves, the election of directors and the appointment of auditors. Other common corporate actions which also require shareholder approval include capital authorizations; amendments to the articles of association relating to change in the size and/or composition of the board of directors, payment of retirement bonuses to directors and auditors; and increase of the aggregate compensation ceilings for directors and auditors takeovers and restructurings.

Interaction among players in the Japanese model: One of the fundamental characteristics of Japanese model is the high interaction between different players to strengthen relationship. Japanese corporations prefer long-term, preferably affiliated shareholders. Outside shareholders represent a small constituency and are largely excluded from the process. Annual reports and materials related to the AGM are available to all shareholders. Shareholders may attend the annual general meeting, vote by proxy or vote by mail. In theory, the system is simple; however, the mechanical system of voting is more complicated for non-Japanese shareholders. Corporations mostly discourage dissent in AGM. Shareholder activism is also restricted. The working of the model is represented in Figure 3.2.

Figure 3.2

The Japanese Model



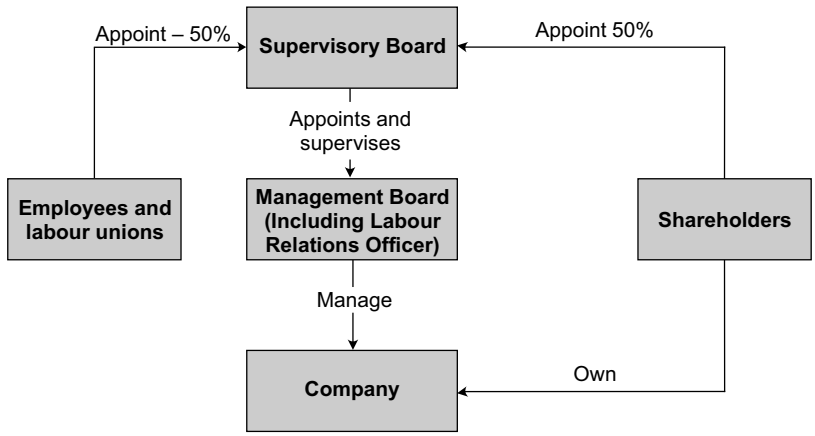
The German model: This model has the following features.

1. Theoretically, the German model is based on stakeholder theory of corporate governance.

2. The German corporations have traditionally preferred bank financing to equity financing.
3. The German banks and corporate shareholders are the key players in the German model.
4. The German stock market capitalization is small in relation to the size of the German economy.
5. The level of individual stock ownership in Germany is low, reflecting Germans' conservative investment strategy.
6. The corporate governance structure is focused on preserving relationships between the key players, namely banks and corporations.
7. It is ambivalent towards minority shareholders.
8. The percentage of foreign ownership of German equity is significant since 1990, it was 19 per cent.

Figure 3.3

The German Model



The model: The German corporate governance model is different from the Japanese model and the Anglo-Saxon model. The unique elements of the German model that distinguish it from the other models are related to the board composition and the shareholders' rights.

Share holding pattern: German corporations hold 41 per cent of the German equity market, 27 per cent is held by institutional owners (primarily banks), individuals and pension funds hold 7 per cent and foreign investors hold 19 per cent shares.

German Model

Company features: Major shareholders are banks and financial institutions. German corporations have traditionally preferred bank financing to equity financing.

1. Supervisory board
2. Management board

Shareholders can appoint only 50 per cent of supervisory board members and the rest by employees and trade unions.

Size of the supervisory board is set by law and cannot be changed by shareholders. Voting rights of a shareholder is restricted to a certain percentage of the corporation's total share capital legally regardless of share ownership position. Mandatory to include employee representatives in the supervisory board.

1. The corporate governance structure is focused on preserving relationships between the key players, namely banks and corporations.
2. It is ambivalent towards minority shareholders.

Germany, Italy, Holland, France, follow this model.

Composition of the Management Supervisory Board

The German model has a two-tiered board structure consisting of a **management board** (composed entirely of insiders, that is, executives of the corporation) and a **supervisory board** (composed of labour/employee representatives and shareholder representatives). These two boards are completely distinct. Secondly, the size of the supervisory board is set by law and cannot be changed by shareholders. Thirdly, in Germany and other countries following this model, voting rights of a shareholder is restricted legally to a certain percentage of the corporation's total share capital regardless of share ownership position. Fourthly it is mandatory to include employee representatives in the supervisory board

The supervisory board contains no 'insiders', it is composed of labour/employee representatives and shareholder representatives. The supervisory board appoints and dismisses the management board, approves major management decisions; and advises the management board. The supervisory board usually meets once a month. The management board is responsible for daily management of the company. It is composed solely of 'insiders', or executives. The numbers of members of the supervisory board is set by law. In small corporations shareholders elect the entire supervisory board. In medium-size corporations employees elect one-third of a nine member supervisory board. In larger corporations, employees elect one-half of a 20-member supervisory board.

Regulatory framework: Germany has a strong federal tradition; both Federal and State law influence corporate governance. Federal laws include the Stock Corporation Law, Stock Exchange Law and Commercial Law. Regulation of Germany's stock exchanges is, however, the mandate of State.

Disclosure requirements: Stringent disclosure requirements are recommended in German model, they are required to disclose a wide range of information in the annual report and/or agenda for the AGM, including: corporate financial data; data on the capital structure; limited information on each supervisory board aggregate data for compensation of the management board and supervisory board; any substantial shareholder holding more than 5 per cent of the corporation's total share capital; information on proposed mergers and restructurings. German corporations are required to disclose shareholder's details holding more than 25 per cent of the total share capital.

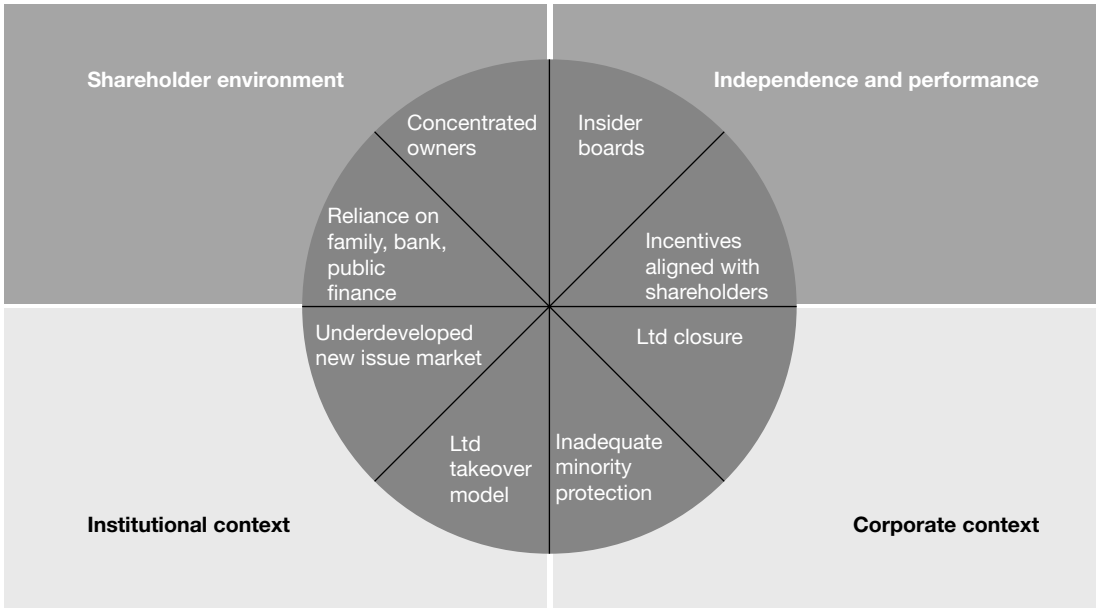
Corporate Actions Requiring Shareholder Approval

The German model demands shareholders' approval for allocation of net income (payment of dividends and allocation to reserves); ratification of the acts of the management board for the previous fiscal year; ratification of the acts of the supervisory board for the previous fiscal year; election of the supervisory board and appointment of auditors. Shareholders have no authority to alter the size or composition of the supervisory board. These are determined by law.

Interaction among players: The German legal and public-policy framework is designed to include the interests of labour, corporations, banks and shareholders in the corporate governance system. The multi-faceted role of banks has been described above. On the whole, the system is geared towards the interests of the key players. There is, nevertheless, some scope for participation by minority shareholders, such as the above-mentioned provisions concerning shareholder proposals.

Control model or the Latin American model: This model is characterized by the following.

1. Concentrated share holding pattern.
2. Heavy reliance on family, bank and public finance by companies.
3. Primary capital markets are not much developed.
4. Limited external holding hence the chance of hostile takeovers are limited.



The control model: The control corporate governance model is different from the Anglo-Saxon model. The unique elements of the Control Model that distinguish it from the other model are related to board composition, shareholders' rights. Minority interest protection is inadequate in control model.

Board composition: Unlike in the Anglo Saxon mode in control model the board is concentrated with insiders. Only few outsiders will be on the board. Core shareholders are given incentives.

Disclosure pattern: In this model only limited disclosure is made. Stringent disclosure requirements are not recommended by this model, unlike in the German model which stipulates the disclosure of a wide range of information in the annual report and/or agenda for the AGM. Only limited information such as financial data, capital structure data, list of major shareholders, dividend policy are disclosed in annual reports.

Regulatory framework: Regulatory framework is very weak in the Latin American countries and some of the Asian countries where control model is used.

Indian model: India having been a British colony for centuries, the British system of political and economic administration was followed during the British rule and early years of Independence also. Like the British, since Independence India also followed the democratic system of political governance in the economic administration we followed mixed economic system. Our legal system is based on the British common law. Most of the Indian laws including the company law were

in the similar line with the British company law. Regarding corporate structure during the pre-independence lot of similarity existed between the Indian and the British corporate structure. But during the post-independence period India followed a different structure with emphasis on the public sector. The major corporate characteristics of India are as follows:

- In India almost 90 per cent of the companies are private limited companies. Only 10 per cent are public limited companies.
- Of the 10 per cent public limited companies 8 per cent are family owned unlisted public limited companies. One per cent was companies limited by guarantee and other forms of companies.
- Listed companies raising capital from public are only 1 per cent of the total numbering approximately 7000 companies in India. Even in the listed category promoters holding is approximately 51 per cent followed by FII's holding 25 per cent and Domestic Institutional Investors holding another 20 per cent shares.
- In the UK and the USA dispersed ownership pattern exists, whereas in India exists concentrated shareholding pattern with promoter group, multinational corporations and government holding of substantial part of the share capital.
- Another characteristic of the Indian corporate structure is that the State is the major shareholder in corporate form of ventures as the government in the post-independence period started several companies in the core sectors of the country, followed by selected few business families.
- Capital market is not developed like that of the US or the UK. But recently the government has taken several initiatives to develop the Indian capital market on the same line of the capital markets of the developed countries.
- Regulatory framework was not developed in the professional line at the beginning. But during the post liberalization era considerable improvement has taken place in the regulatory framework of corporate governance in India.
- Though India corporate governance is based on the shareholders theory, due emphasis is also given to protect other stakeholder's interest.

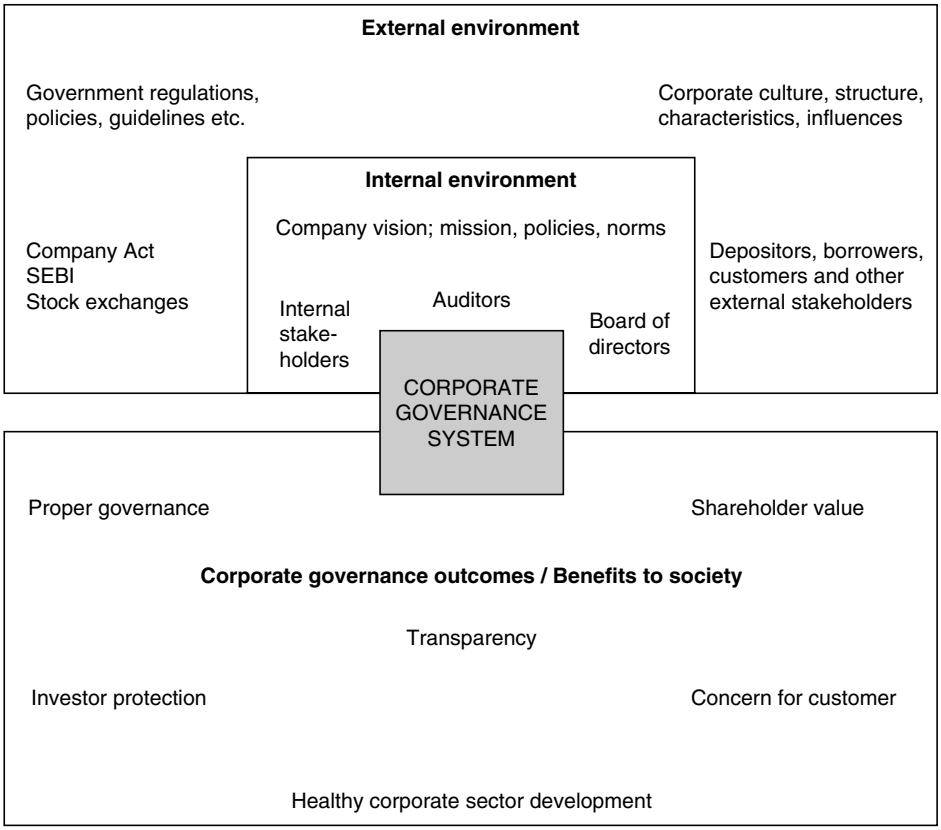
Indian model of corporate governance: Since Indian corporate structure is a mixture of private companies (Majority shares held by family), public companies (majority share held by outsiders) and the public sector (majority shares held by government) corporate governance model is also a mixture of the Anglo-American model and the German model. In the family controled business the German model is used, whereas in the public companies and government companies the Anglo-American model is used. Figure 3.4 illustrates how the corporate governance system works in India.

Indian Model

- The model of corporate governance found in India is a mixture of the Anglo-American and the German model as we have three types of corporations– Purely private companies (Family business) – public companies (Majority outside equity) – Government companies.
- In the first category companies the German model is used.
- In the Second and the third category companies the Anglo American model is used.

Figure 3.4

Indian Corporate Governance Model



Available literature on corporate governance and the way companies are structured and run indicates that India shares many features of the German/ the Japanese model, but of late, recommendations of various committees and consequent legislative measures are driving the country to adopt increasingly the Anglo-American model. In terms of the legislative mechanisms, Indian government and industry constituted three committees to study corporate governance practices in the country and suggest measures for improvement based on what has globally recognised as "best practices". Significantly, most of the recommendations of the three committees—the SEBI-appointed Kumar Mangalam Birla Committee (2000), the government-appointed Naresh Chandra Committee(2003) and the SEBI's Narayana Murthy Committee are remarkably similar to those of England's Cadbury Committee and America's Sarbanes–Oxley Act, in terms of their approaches and recommendations.

The thrust of the legislative reforms, suggested by these committees and subsequent legislative actions adopted, centre around the strengthening of external governance mechanisms. "A key area here includes greater transparency and independent scrutiny of corporate accounts that are made available to investors. This is in line with the Anglo-American model where shareholder influence through the exit option which is contingent upon reliable and accurate information provided by companies. Institutional reforms, including a strengthening of overseeing committees and the development of a serious fraud office, are further evidence of the drive to seek external monitoring of corporate affairs. "In terms of reforms to internal mechanisms such as boards of directors, it is notable that again the recommendations are centred on the Anglo-American practice, namely, a greater role for non-executive directors (NEDs) and the curtailment of interlocking directorates."[3]

Further, experts point out that India has adopted the key tenets of the Anglo-American external and internal control mechanisms, in the wake of economic liberalisation and its integration into the global economy. "This is evident especially in the realm of the legislative framework where Indian policy-makers have taken their cue from the UK and the US committees and their recommendations. Furthermore, a small, *albeit* high profile group of companies, have voluntarily adopted the Anglo-American protocols in their bid to successfully raise capital from international markets."[4] Thus corporate governance developments in India in recent years show a paradigm shift from the German/the Japanese model to the Anglo-American model.

There are primary distinctions among the three broad models of corporate governance, and within them the actual practices adopted by companies vary considerably. There is not a single preferred model or a set of corporate governance mechanisms. Moreover, ideas and practices are evolving fast in many countries. Indeed, given the high calibre directors with relevant experience, appropriate Board leadership and a shared vision for the company's future, each of the models can prove effective, provided they are consistent with the overall corporate governance infrastructures in the countries concerned.

These various governance systems form a package of overall corporate control in each company law jurisdiction. It is vital to see the package as a whole. There has to be an integrated harmony between state legislation and regulatory infrastructure, stock market regulation and corporate self-regulation. Moreover, the overall corporate governance package has to be consistent with the way the business is done and the reality of relationships in that culture.

What is "Good" Corporate Governance?

Recently the terms "governance" and "good governance" are being increasingly used in development literature. Bad governance is being recognised now as one of the root causes of corrupt practices in our societies. Major donors, institutional investors and international financial institutions provide their aid and loans on the condition that reforms that ensure "good governance" are put in place by the recipient nations. As with nations, corporations too are expected to provide good governance to benefit all their stakeholders. At the same time, good corporates are not born, but are made by the combined efforts of all stakeholders, which include shareholders, board of directors, employees, customers, dealers, government and the society at large. Law and regulation alone cannot bring about changes in corporates to behave better to benefit all concerned. Directors and management, as goaded by stakeholders and inspired by societal values, have a very important role to play. The company and its officers, who, *inter alia*, include the board of directors and the officials, especially the senior management, should strictly follow a code of conduct, which should have the following desiderata:

Bad governance is being recognised now as one of the root causes of corrupt practices in our societies. Institutional investors and international financial institutions provide their aid and loans on the condition that reforms that ensure good governance are put in place by recipients. Good corporates are not born, but are made by the combined efforts of all stakeholders, board of directors, government and the society at large.

Obligation to Society at Large

A corporation is a creation of law as an association of persons forming part of the society in which it operates. Its activities are bound to impact the society as the society's values would have an impact on the corporation. Therefore, they have mutual rights and obligations to discharge for the benefit of one another.

1. **National interest:** A company (and its management) should be committed in all its actions to benefit the economic development of the country in which it operates and should not engage in any activity that would militate against

A corporation is a creation of law, as an association of persons forming part of the society in which it operates. Its activities are bound to impact the society as the society's values would have an impact on the corporation. Therefore, they have mutual rights and obligations to discharge for the benefit of each other: national interest, legal compliances, honest and ethical conduct.

TABLE 3.4 Corporate governance practices—An international comparison

Sl. No.	*Feature*	*Anglo-American corporate governance*	*German corporate governance*	*Japanese corporate governance*	*Indian corporate governance*
1.	Corporate objective	Shareholder value	Long-term corporate value	Long-term corporate value	Shareholder value
2.	Shareholding	Diffused institutional investors, significant block holders.	Banks, Promoter families, other corporates	Financial, non-financial corporates	Directors and relatives. Other corporates, foreign investors, govt.-term lending institutions, foreign investors.
3.	Governance focus	Capital market	Corporate body	Keiretsu or business network	Maximise surplus
4.	Measure of success	Return on financial capital	Return on human capital	Return on social capital	Return on financial capital
5.	Decision-making	Checks and balances between voice and exit options. Outside stake-holders excluded	Within the network of stake-holders including employees, local community	Within the network — includes business associates and banks as stakeholders	Management, outside stake-holders excluded.
6.	Control of corporates	Separated from ownership	Linked with ownership	Linked with ownership	Linked with ownership
7.	Orientation	Short-term, driven by stock market prices	Long-term	Long-term	Short-term gains
8.	Long-term investment in	Physical capital, R & D, human capital	Plant and equipment, employee training	R&D, employee training	Physical capital
9.	Capital market: (Primary)	Liquid	Less important, due to close ties with banks	Less important, because of close ties with banks	Less important due to institutional funding.
10.	Capital market: (Secondary)	Important, frequent hostile takeovers possible.	Not important, hostile takeovers rare.	Not important, hostile takeovers rare.	Not important, hostile takeovers rare.
11.	Investor commitment	Low	High, important in difficult times	High, important in difficult times	Low; improving
12.	Major investors	Institutional shareholders; Individual shareholders; Business network; Employees; Government and banks	Banks; Business network; Employees; Government; Individual shareholders and Institutional shareholders	Business network; Main bank; Government; Institutional shareholders; Individual share-holders and Employees	Directors and relatives; Other corporates; Foreign Investors; Govt. term lending institutions; Public shareholding; and Institutional Investors (UTI)
13.	Board composition	Executive and non-executive directors.	Two-tier boards, upper tier-supervisory board, lower tier-management board	Executive and non-executive directors (representing outside finance institutions)	Executive and non-executive Directors
14.	Goal of the board	To promote shareholder wealth	To promote long-term organisational health	To promote long-term organisational health	Short-term gains.
15.	Board independence over management	Little	High	Little formally, more informally	Little
16.	Executive compensation	High	Moderate	Low	Moderate, subject to govt. approval
17.	Dividend	High	Low	Low	Low, uncertain
18.	Strength	Dynamic, market-based; liquid capital; internalisation non- problematic	Long-term industrial strategy; Stable capital; Strong overseas investment, governance procedures	Long-term industrial strategy; stable capital	Recent government and organisational activism (CII) towards corporate governance practices.
19.	Weakness	Instability; short-termism	Internationalisation difficult; vul-nerable to global capital market	Secretive, corrupt practices; growth in institutional activism and financial speculation in recent times.	Lack of proper disclosures; Secretive corrupt practices; Instabilities

such an objective. A company should not undertake any project or activity detrimental to the nation's interest or those that will have an adverse impact on the social and cultural life patterns of its citizens. A company should conduct its business in consonance with the economic development of the country and the objectives and priorities of the nation's government and must strive to make a positive contribution to the realisation of its goals.

2. **Political non-alignment:** A company should be committed to and support a functioning democratic constitution and system with a transparent and fair electoral system and should not support directly or indirectly any specific political party or candidate for political office. The company should not offer or give any of its funds or property as donations directly or indirectly to any specific political party candidate or campaign.
3. **Legal compliances:** The management of a company should comply with all applicable government laws, rules and regulations. The employees and the directors should acquire appropriate knowledge of the legal requirements relating to their duties sufficient to recognise potential dangers. Violations of applicable governmental laws, rules and regulations may subject them to individual criminal or civil liability as well as disciplinary action by the company apart from subjecting the company itself to civil or criminal liability or even the loss of business.

   Legal compliance will also mean that corporations should abide by the tax laws of the nations in which they operate such as corporate tax, income tax, excise duties, sales tax, cesses and other levies imposed by the respective governments. These should be paid on time and as per the required amount.
4. **Rule of law:** Good governance requires fair, legal frameworks that are enforced impartially. It also requires full protection of rights, particularly those of minority shareholders. Impartial enforcement of laws require an independent judiciary and regulatory authorities.
5. **Honest and ethical conduct:** Every officer of the company including its directors, executive and non executive directors, managing director, CEO, CFO and CCO should deal on behalf of the company with professionalism, honesty, commitment and sincerity as well as high moral and ethical standards. Such conduct must be fair and transparent and should be perceived as such by third parties as well.The officers are also expected to act in accordance with the highest standards of personal and professional integrity and ethical conduct at their place of work or while working on offsite locations where the company's business are located or in social events or in any other place where they represent the company. Honest conduct is a conduct that is free from fraud or deception. Ethical conduct is an ethical handling of actual or apparent conflicts between the personal and the professional relationship.
6. **Corporate citizenship:** A corporation should be committed to be a good corporate citizen not only in compliance with all relevant laws and regulations, but also by actively assisting in the improvement of the quality of life of the people in the communities in which it operates with the objective of making them self-reliant and enjoy a better quality of life.

   Such social commitment consists of initiating and supporting community initiatives in the field of public health and family welfare, water management, vocational training, education and literacy and encourages application of modern scientific and managerial techniques and expertise. The company should review its policy, in this respect, periodically in consonance with national and regional priorities. The company should strive to incorporate them as an integral part of its business plan and not treat them as optional and something to be dispensed with when it is inconvenient. It should encourage volunteering amongst its employees and help them to work in the

An ideal corporation has certain obligations to society such as corporate citizenship, ethical behaviour, environment-friendliness, observing correctly the rule of law and being politically non-aligned.

communities. The company should develop social accounting systems and carry out social audit of its operations towards the community, the employees and the shareholders.

7. **Ethical behaviour:** Corporations have a responsibility to set exemplary standards of ethical behaviour, both internally within the organisation, as well as in their external relationships. Unethical behaviour corrupts organisational culture and undermines stakeholder value. The board of directors have a great moral responsibility to ensure that the organisation does not derail from an upright path to make short-term gains.
8. **Social concerns:** Corporations exist beyond time and space. So they have to set an example to their employees and shareholders. New paradigm is that the company should not only think about its shareholders but also think about its stakeholders and their benefit. A corporation should not give undue importance to shareholders at the cost of small investors. They should treat all of them equally and equitably. The company should have concerns towards the society. It can help the needy people and show its concern by not polluting the water, air and land. The waste disposal should not affect any human or other living creatures.
9. **Corporate social responsibility:** Accountability to stakeholders is a continuing topic of divergent views in corporate governance debates. In line with the developing trends towards an integrated model of governance toward the creation of an ideal corporate, the emphasis should be laid on corporate social responsiveness and ethical business practices seeking what might well turn out to be not only the first small steps for better governance on this front but also the promise of a more transparent and internationally respected corporates of the future**.**
10. **Environment-friendliness:** Corporations tend to be intervening in altering and transforming nature. For corporations engaged in commodity manufacturing, profit comes from converting raw materials into saleable products and vendible commodities. Metals from the ground are converted into consumer durables. Trees are converted into boards, houses, and furniture and paper products. Oil is converted into energy. In all such activities, a piece of nature is taken from where it belongs to and processed into a new form. So companies have a moral responsibility to save and protect the environment. All the pollution standards have to be followed meticulously and organisations should develop a culture having more concern towards environment.
11. **Healthy and safe working environment:** A company should be able to provide a safe and healthy working environment and comply with the conduct of its business affairs with all regulations regarding the preservation of environment of the territory it operates in. It should be committed to prevent the wasteful use of natural resources and minimise the hazardous impact of the development, production, use and disposal of any of its products and services on the ecological environment.

An ideal corporate should also exhibit social concern and adequate social responsibility besides ensuring healthy and safe working environment. Corporations should uphold the fair name of the country.

12. **Competition:** A company should play its role in the establishment and support a competitive, open market economy and co-operate to promote the progressive and judicious liberalisation of trade and investment by a country. It should not covertly or overtly engage in activities, which lead to or support the formation of monopolies, dominant market positions, cartels and similar unfair trade practices.

    A company should market its products and services on its own merits and should not resort to unethical advertisements or include unfair and misleading pronouncements on competitors' products and services. Any collection of competitive information shall be made only in the normal course

of business and shall be obtained only through legally permitted sources and means.

13. **Trusteeship:** Corporates have both a social purpose and an economic purpose. They represent a coalition of interests, namely, those of the shareholders, other providers of capital, business associates and employees. This belief, therefore, casts a responsibility of trusteeship on the company's board of directors. They are to act as trustees to protect and enhance shareholder value, as well as to ensure that the company fulfills its obligations and responsibilities to its other stakeholders. Inherent in the concept of trusteeship is the responsibility to ensure equity, namely, that the rights of all shareholders, large or small, foreign or local, majority or minority, are equally protected.
14. **Accountability:** Accountability is a key requirement of good governance. Not only governmental institutions but also the private sector and civil society organisations must be accountable to the public and to their institutional stakeholders. Who is accountable to whom varies depending on whether decisions or actions taken are internal or external to an organisation or institution. In general, an organisation or an institution is accountable to those who will be affected by its decisions or actions. Accountability cannot be enforced without transparency and the rule of law.
15. **Effectiveness and efficiency:** Good governance means that processes and institutions produce results that meet the needs of society while making the best use of resources at their disposal. The concept of efficiency in the context of good governance also covers the sustainable use of natural resources and the protection of the environment.
16. **Timely responsiveness:** Good governance requires that institutions and processes try to serve all stakeholders within a reasonable timeframe. They should also address the concerns of all stakeholders and the society at large.
17. **Corporations should uphold the fair name of the country**: When companies export their products or services, they should ensure that these are qualitatively good and are delivered in time. They have to ensure that the nation's reputation is not sullied abroad during their deals, either as exporters or importers. They have to ensure maintenance of the quality of their products, which should be the brand ambassadors for the country.

Obligation to Investors

That the investors as shareholders and providers of capital are of paramount importance to a corporation is such an accepted fact that it need not be overstressed here. A company has the following obligations to investors:

A company ideally has the following obligations to investors: promoting transparency and informed shareholder participation. In the context of enhanced awareness of better governance practices, an ideal corporate should address these issues and ensure meaningful and transparent accounting and reporting, so that there is better harmony in the workplace.

1. **Towards shareholders:** A company should be committed to enhance shareholder value and comply with all regulations and laws that govern shareholder's rights. The board of directors of the company shall inform its shareholders about all relevant aspects of the company's business and disclose such information in accordance with the respective regulations and agreements. Every employee shall strive for the implementation of and compliance with this in his professional environment. Failure to adhere to the code could attract the most severe consequence including termination of employment or directorship as the case may be.
2. **Measures promoting transparency and informed shareholder participation:** A related issue of equal importance is the need to bring about greater levels of

informed attendance and meaningful participation by shareholders in matters relating to their companies without, however, such freedom being abused to interfere with management decision. An ideal corporate should address this issue and relate it to more meaningful and transparent accounting and reporting.

3. **Transparency:** Transparency means that decisions taken and their enforcement are done in a manner that follows rules and regulations. It also means that information is freely available and directly accessible to those who will be affected by such decisions and their enforcement. It also means that enough information is provided and that it is provided in easily understandable forms and media.
4. **Financial reporting and records:** A company should prepare and maintain accounts of its business affairs fairly and accurately in accordance with the accounting and financial reporting standards, laws and regulations of the country in which the company conducts its business affairs.

Likewise, internal accounting and audit procedures shall fairly and accurately reflect all of the company's business transactions and disposition of assets. All required information shall be accessible to the company's auditors, non-executive and independent directors on the board and other authorised parties and government agencies. There shall be no wilful omissions of any transaction from the books and records, no advance income recognition and no hidden bank account and funds.

Such wilful material misrepresentation of and/or misinformation on the financial accounts and reports shall be regarded as a violation of the firm's ethical conduct and also will invite appropriate civil or criminal action under the relevant laws of the land.

Obligation to Employees

For too long, corporations in free societies had been adopting a "Hire and Fire" policy in the employment of men and women in their work places and hardly treated them humanely taking advantage of the fact that workers were a commodity, namely, labour that was highly perishable with little bargaining power. But in the context of enhanced awareness of better governance practices, managements should realise that they have their obligations towards their workers too.

1. **Fair employment practices**: An ideal corporate should commit itself to fair employment practices, and should have a policy against all forms of illegal discrimination. By providing equal access and fair treatment to all employees on the basis of merit, the success of the company will be improved while enhancing the progress of individuals and communities. The applicable labour and employment laws should be followed scrupulously wherever it operates. That includes observing those laws that pertain to freedom of association, privacy, and recognition of the right to engage in collective bargaining, the prohibition of forced, compulsory and child labour, and also laws that pertain to the elimination of any improper employment discrimination.
2. **Equal opportunities employer:** A company should provide equal opportunities to all its employees and all qualified applicants for employment irrespective of their race, caste, religion, colour, ancestry, marital status, sex, age, nationality, disability and veteran status. Its employees should be treated with dignity and in accordance with a policy to maintain a conducive work environment free of sexual harassment, whether physical, verbal or psychological. Employee

By providing equal access and fair treatment to all employees on the basis of merit, the success of the company will be improved while enhancing the progress of individuals and communities.

policies and practices should be administered in a manner that ensure that in all matters equal opportunity is provided to those eligible and the decisions are merit-based.

3. **Encouraging whistle blowing:** It is generally felt that if whistle blower concerns have been addressed to some of the recent disasters could have been avoided, and that in order to prevent future misconduct, whistle blowers should be encouraged to come forward. So an ideal corporate is one that deals pro-actively with the whistle blowers and to make sure employees have comfortable reporting channels and are confident that they will be protected from any form of retribution. Such an approach will enhance the company's chances to become aware of, and to appropriately deal with, a concern before an illegal act has been committed rather than after the damage has been done. If reporting is delayed, the company's reputation can be seriously harmed and it can face a serious risk of prosecution with all its disastrous consequences. An ideal Whistle Blower Policy would mean:
   (a) Personnel who observe an unethical or improper practice (not necessarily a violation of law) shall be able to approach the CEO or the audit committee without necessarily informing their supervisors.
   (b) The company shall take measures to ensure that this right of access is communicated to all employees through means of internal circulars, etc. The employment and other personnel policies of the company should contain provisions protecting "whistle blowers" from unfair termination and other prejudicial employment practices.
   (c) The appointment, the removal and the terms of remuneration of the chief internal auditor shall be subject to review by the audit committee.
4. **Humane treatment:** Now corporations are viewed like humans and similar kind of behaviour is expected from them like a man with good sense. Companies should treat their employees as their first customers and above all as human. They have to meet the basic needs of all employees in the organisation. There should be a friendly, healthy and competitive environment for the workers to prove their ability.
5. **Participation:** Participation by both men and women is a key cornerstone of good governance. Participation could be either direct or through legitimate intermediate institutions or representatives. Participation needs to be informed and organised. This means freedom of association and expression on the one hand and an organised civil society on the other.
6. **Empowerment:** Empowerment is an essential concomitant of any company's principle of governance that management must have the freedom to drive the enterprise forward. Empowerment is a process of actualising the potential of its employees. Empowerment unleashes creativity and innovation throughout the organisation by truly vesting decision-making powers in the most appropriate levels in the organisational hierarchy.
7. **Equity and inclusiveness:** A corporation is a miniature of a society whose well being depends on ensuring that all its employees feel that they have a stake in it and do not feel excluded from the mainstream. This requires all groups, particularly the most vulnerable, have opportunities to improve or maintain their well being.
8. **Participative and collaborative environment:** There should not be any form of human exploitation in the company. There should be equal opportunities for all levels of management in any decision-making. The management should cultivate the culture where employees should feel they are secure and are being well taken care of. Collaborative environment would bring

peace and harmony between the working community and the management, which in turn, brings higher productivity, higher profits and higher market share.

Obligation to Customers

A company's existence cannot be justified without its catering to the needs of its customers. The companies have an obligation to its employees, without whose assistance they cannot realise their objectives. They have to ensure quality of products and services; products at affordable prices; unwavering commitment to customer satisfaction. All these steps will earn for the company customers' good will to stay long in the business.

A corporation's existence cannot be justified without its being useful to its customers. Its success in the marketplace, its profitability and its being beneficial to its shareholders by paying dividends depends entirely on how it builds and maintains fruitful relationships with its customers.

1. **Quality of products and services:** The company should be committed to supply goods and services of the highest quality standards, backed by efficient after sales service consistent with the requirements of the customers to ensure their total satisfaction. The quality standards of the company's goods and services should meet not only the required national standards but also should endeavour to achieve international standards.
2. **Products at affordable prices:** Companies should ensure that they make available to their customers quality goods at affordable prices. While making normal profit is justifiable, profiteering and fattening on the miseries of the poor consumers is unacceptable. Companies should constantly endeavour to update their expertise, technology and skills of manpower to cut down costs and pass on such benefits to customers. They should not create a scare in the midst of scarcity or by themselves create an artificial scarcity to make undue profits.
3. **Unwavering commitment to customer satisfaction:** Companies should be fully committed to satisfy their customers and earn their goodwill to stay long in the business. They should respect in letter and spirit warranties and guarantees given on their products and call back from markets, goods found to be sub- standard or harmful and replace them with good ones.

Managerial Obligation

A manager's obligation to a corporation includes protecting company's assets cordial behaviour towards government agencies, having control and being consensus oriented.

1. **Protecting company's assets:** The assets of the company should not be dissipated or misused but invested for the purpose of conducting the business for which they are duly authorised. These include tangible assets such as equipment and machinery, systems, facilities, resources as well as intangible assets such as proprietary information, relationships with customers and suppliers, etc.
2. **Behaviour towards government agencies:** A company's employees should not offer or give any of the firm's funds or property as donation to any government agencies or their representatives directly or through intermediaries in order to obtain any favourable performance of official duties.
3. **Control:** Control is a necessary principle of governance that the freedom of management should be exercised within a framework of appropriate checks and balances. Control should prevent misuse of power, facilitate timely management response to change, and ensure that business risks are pre-emptively and effectively managed.

4. **Consensus-oriented:** Good governance requires mediation of the different interests in society to reach a broad consensus on what is in the best interest of the whole community and how this can be achieved. It also requires a broad and long-term perspective on what is needed for sustainable human development and how to achieve the goals of such development. This can only result from an understanding of the historical, cultural and social contexts of a given society or community.
5. **Gifts and donations:** The company's employees should neither receive nor make directly or indirectly any illegal payments, remuneration, gifts, donations or comparable benefits, which are intended to or perceived to obtain business or uncompetitive favours for the conduct of its business. However, the company and its employees may accept and offer nominal gifts, which are customarily given and are of a commemorative nature for special events provided the same is disclosed on time to the management.
6. **Role and responsibilities of corporate board and directors:** The role of the corporate board of directors as stewards of their stakeholders has gained significant importance in recent decades. Successive corporate failures, scams, debacles and other disasters have strengthened the demand for more transparency and accountability on the part of corporations. In the discharge of these onerous responsibilities, the corporate board has come to be regarded as the principal arbiter ensuring, on the one hand, that the executive management creates wealth competently and through legitimate means, and on the other hand, such created wealth is equitably distributed to all shareholders after meeting the due aspirations of, and obligations to, other stakeholders.

   An ideal corporate calls for a greater role and influence for non-executive independent directors, a tighter delineation of independence criteria and minimisation of interest-conflict potential and some stringent punitive punishments for executive directors of companies failing to comply with listing and other requirements.
7. **Direction and management must be distinguished:** It is necessary to distinguish the nature of the two basic components of governance in terms of policymaking and overseeing responsibilities of the board of directors and the executive and implementation responsibilities of corporate management comprising the managing director and his or her team of executives including functional directors. Executives who are also on the board as directors of the company in effect wear two hats, one as part of the board, and the other as part of the management. Directors derive their authority only when acting collectively as the board or when the board delegates specifically authorities to be exercised as in the case of managing directors. Managers in the broadest sense of the term have the responsibility to execute the policies under the supervision of the board and for this purpose have the necessary authority to ensure compliance and implementation. An ideal corporate highlights this critical distinction particularly in the context of fixing responsibility for failure and the consequential liabilities that follow.
8. **Managing and whole-time directors:** Managing and other whole-time directors are required to devote whole or substantially whole of their time to the affairs of the company. And yet many of them serve as non-executive directors on several other boards. An ideal corporate affords the shareholders and stakeholders of the company the benefit of having their chosen executives' full attention in the matters of the company. An ideal corporate must necessarily limit the nature and the number of their other non-executive directorships.

CONCLUSION

The analysis of the duties, the responsibilities and the obligations of different management groups illustrates the complexities involved in the administration of modern corporations. Gone are the days when the society looked at corporations as forms of business enterprises working exclusively for the material benefit of its shareholders. With the broadening vision of modern thinkers and opinion makers and enhanced and heightened social values, it is now an unacceptable proposition that corporations exist purely for the profit of those who constituted it. They are expected to be transparent, accountable and even beneficial to the larger society. Their employees, consumers of their products, and associates in their business such as dealers and stockists, the communities surrounding their facilities and workstations are as important as those who contributed their capital. Corporates cannot any more ignore the concerns of the society such as of the environment and ecology. And these concerns are no more community-based or country-specific. In a global village such as the one all of us are moving into, if a corporate has to survive, grow and wants to be counted, its vision should focus on the ways and means of becoming a responsible and responsive corporate citizen, and its mission could no more be myopic as it used to be in the distant past. The values, concerns, duties and responsibilities the society casts on the corporates are exemplified in the following beautifully formulated and well-articulated Credo of Johnson & Johnson.

Our Credo

We believe our first responsibility is to the doctors, nurses and patients,
to mothers and fathers and all others who use our products and services.
In meeting their needs everything we do must be of high quality.
We must constantly strive to reduce our costs
in order to maintain reasonable prices.
Customers' orders must be serviced promptly and accurately.
Our suppliers and distributors must have an opportunity
to make a fair profit.

We are responsible to our employees,
the men and women who work with us throughout the world.
Everyone must be considered as an individual.
We must respect their dignity and recognise their merit.
They must have a sense of security in their jobs.
Compensation must be fair and adequate,
and working conditions clean, orderly and safe.
We must be mindful of ways to help our employees fulfil
their family responsibilities.

Employees must feel free to make suggestions and complaints.
There must be equal opportunity for employment, development
and advancement for those qualified.
We must provide competent management,
and their actions must be just and ethical.

We are responsible to the communities in which we live and work
and to the world community as well.
We must be good citizens — support good works and charities
and bear our fair share of taxes.
We must encourage civic improvements and better health and education.
We must maintain in good order
the property we are privileged to use,
protecting the environment and natural resources.

Our final responsibility is to our stockholders.
Business must make a sound profit.
We must experiment with new ideas.
Research must be carried on, innovative programme developed
and mistakes paid for.
New equipment must be purchased, new facilities provided
and new products launched.
Reserves must be created to provide for adverse times.
When we operate according to these principles,
the stockholders should realise a fair return.

Johnson & Johnson

In the modern financial and business world, good corporate governance is not an optional extra. Good corporate governance is fundamental to raising capital, satisfying investors and running successful businesses in increasingly global markets. Good corporate governance is essential to all other stakeholders in the firm—employees, suppliers, customers, and bankers as well as to the local and national society for the provision of employment, the creation of wealth and the building of a modern state. Good corporate governance also encourages the levels of transparency, accountability and corporate social responsibility that is increasingly necessary for a modern nation.

KEYWORDS

- Agency Theory
- Concepts of governance
- Contemporary situation
- Credo
- Ethics Theory
- Governance mechanisms
- Governance practices
- Hazard Model Theory
- International comparison
- Managerial obligations
- Obligation to customers
- Obligation to employees
- Obligation to investors
- Obligation to society
- Political Theory
- Resource Depending Theory
- Societal responses
- Sociological Theory
- Stakeholder
- Stewardship Theory
- Transaction Cost Theory

DISCUSSION QUESTIONS

1. Discuss briefly the Agency Theory relating to public corporations. What are the major criticisms against the theory?
2. What is meant by "agency costs"? While doing so, discuss the two broad mechanisms that help reduce agency costs with a view to improving corporate performance through better governance.
3. Explain briefly the Agency Theory and the Stewardship Theory. Compare and contrast these theories as means to achieve better corporate governance.
4. Define the corporate governance system. Also differentiate between the German model and the Anglo-American model of corporate governance.
5. Explain the Indian model of corporate governance. Would you agree with the view that there is a paradigm shift in recent years in India from the German/the Japanese model to the Anglo-American model?
6. Enumerate the various features of good corporate governance with suitable examples from the Indian corporate sector.

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Initiatives in Corporate Governance: Global and National

CHAPTER OUTLINE

- Introduction
- Corporate Governance Committees
- Cadbury Committee
- Paul Ruthman Committee
- Greenbury Committee
- Hampel Committee
- Turnbull Committees
- Blue Ribbon Committees
- World Bank on Corporate Governance
- OECD Principles
- McKinsey Survey on Corporate Governance
- Sarbanes–Oxley Act, 2002
- Kings Committee
- Indian Committees and Guidelines
- Working Group on the Companies Act, 1996
- Indian Companies Act 2013
- The Confederation of Indian Industry's Initiative
- SEBI'S Initiatives
- Naresh Chandra Committee Report, 2002
- Narayana Murthy Committee Report, 2003
- Dr. J. J. Irani Committee Report on Company Law, 2005
- Uday Kotak Committiees 2017

Introduction

The emergence of corporate governance has been a fairly recent phenomenon. There has been a perceptible change in people's minds as to the objective of a corporation—from one which was intended to exclusively benefit the shareholders to one which is expected to benefit all its stakeholders.

The emergence of corporate governance as a fair and transparent mechanism to run and administer corporations in a manner that would result in long term shareholder value and benefits to the entire society has been fairly a recent phenomenon. There has been a perceptible change in people's minds as to the objective of a corporation—from one which was intended to benefit exclusively the shareholders to one which is expected to benefit all its stakeholders. Besides, the corporate scams and frauds that came to light have brought about a change in the thinking of advocates of free enterprise that the system was not self-regulatory and needed substantial external regulations. These regulations should penalise the wrongdoers while those who abide by the rules of the game are to be amply rewarded by the market forces. The society's response to these frauds reflected in the legislative and regulatory changes brought out by governments, shareholder activism, insistence of mutual funds and large institutional investors, that corporates they invested in adopt better governance practices, and in the formation of several committees to study the issues in depth and make recommendations, codes and guidelines on corporate governance that are to be put in practice. All these measures have brought about a metamorphosis in corporates that realised that the society, especially the investing public are pretty serious about corporate governance and started internalising these values and later adopting them *albeit* selectively and sporadically.

Developments in the US

Corporate governance gained importance after the Watergate scandal in the US. Investigations highlighted control failures that had allowed several major corporations to make illegal political contributions and to bribe government officials. This led to the development of the Foreign and Corrupt Practices Act of 1977. This was followed in 1979 by the Securities and Exchange Commission's proposals for mandatory reporting on internal financial controls.

Corporate governance gained importance with the occurrence of the Watergate scandal in the United States. Thereafter, as a result of subsequent investigations, US regulatory and legislative bodies were able to highlight control failures that had allowed several major corporations to make illegal political contributions and to bribe government officials. This led to the development of the Foreign and Corrupt Practices Act of 1977 that contained specific provisions regarding the establishment, maintenance and review of systems of internal control. This was followed in 1979 by the Securities and Exchange Commission's proposals for mandatory reporting on internal financial controls. In 1985, following a series of high profile business failures in the US, the most notable one of which being the savings and loan collapse, the Treadway Commission was formed to identify the main causes of misrepresentation in financial reports and to recommend ways of reducing incidence thereof. The Treadway Report published in 1987 highlighted the need for a proper control environment, independent audit committees and an objective internal audit function and called for published reports on the effectiveness of internal control. The Commission also requested the sponsoring organisations to develop an integrated set of internal control criteria to enable companies to improve their controls.

Developments in the UK

In England, the seeds of modern corporate governance were probably sown by the Bank of Credit and Commerce International (BCCI) scandal. The BCCI was a global bank, made up of multiplying layers of entities, related to one another through an impenetrable series of holding companies, affiliates, subsidiaries, banks-within-banks, insider dealings and shareholder (nominee) relationships. With this corporate structure of BCCI and shoddy record keeping, regulatory review and audits, the complex BCCI family of entities was able to evade

ordinary legal restrictions on the movement of capital and goods as a matter of daily practice and routine. Since BCCI was a vehicle fundamentally free of government control, it was an ideal mechanism for facilitating illicit activity by others, including such activity by officials of many of the governments whose laws BCCI was breaking.

Another landmark that heightened people's awareness and sensitivity on the issue and the resolve that something ought to be done to stem the rot of corporate misdeeds, was the failure of Barings Bank. Barings was Britain's oldest merchant bank. It had financed the Napoleonic wars, the Louisiana Purchase, and the Erie Canal. Barings was the Queen's bank. What really grabbed the world's attention was the fact that its failure was caused by the actions of a single trader based at a small office in Singapore, Nick Leeson. He was posted as a trader in Singapore on behalf of Barings Bank. The cardinal principle in trading is to separate the front office from the back office. But Nick Leeson was posted in charge of the back office operations of Barings Bank as well. He started trading on behalf of the Bank, whereas he was supposed to trade only on behalf of the customers. Eventually when his strategy failed because of an earthquake in Japan, Barings Bank had already lost $1.4 billion and it had to shut office.

These are just a couple of examples of corporate failure due to absence of a proper structure and objectives in the top management. Corporate governance assumed more importance in the light of these corporate failures, which was affecting the shareholders and other interested parties.

As a result of these failures and lack of regulatory measures from authorities as an adequate response to check them in future, the Committee of Sponsoring Organisations (COSO) was born. The report produced by it in 1992 suggested a control framework, and was endorsed and refined in the four subsequent UK reports: Cadbury, Ruthman, Hampel and Turnbull. While developments in the United States stimulated debate in the UK, a spate of scandals and collapses in that country in the late 1980s and early 1990s led shareholders and banks to worry about their investments. These also led the government in the UK to recognise that the then existing legislation and self-regulation were not working. Companies such as Polly Peck, British & Commonwealth and Robert Maxwell's Mirror Group News International were all victims of the boom-to-bust decade of the 1980s. Several companies, which saw explosive growth in earnings, ended the decade in a memorably disastrous manner. Such spectacular corporate failures arose primarily out of poorly managed business practices.

The publication of a series of reports consolidated into the Combined Code on Corporate Governance (The Hampel Report) in 1998 resulted in major changes in the area of corporate governance in the United Kingdom. The corporate governance committees of the last decade have analysed the problems and crises besetting the corporate sector and the markets and have sought to provide guidelines for corporate management. Studying the subject matter of the corporate codes and the reports produced by various committees highlight the key practical issues and concerns driving the development of corporate governance over the last decade.

In England, the seeds of modern corporate governance were sown by the BCCI scandal. Another landmark that heightened people's awareness and sensitivity on the issue was the failure of Barings Bank. These are just a couple of examples of corporate failure due to absence of a proper structure and objectives in the top management that affect the shareholders and other interested parties.

Corporate Governance Committees

A series of corporate failures across the globe such as Maxwell Communication Corporation, Barings Bank, BCCI and of late Enron Corporation, World Com, AIG International, Lehman Brothers created ripples across the world. As a sequel to these developments, India also witnessed big corporate failures triggering panic among the stakeholders. The prominent of them are Tata Finance, Satyam Computers; Kingfisher Airlines, etc., getting international attention. This situation even raised the question of Capitalism at crossroads. In order to overcome this

situation a series of initiatives in the form of expert committees for formulating codes of corporate governance at different levels had taken place internationally and nationally. Some of the prominent initiatives are discussed below.

Global Level Initiatives

At the global level the following committees have been constituted to study the issues of corporate governance and report the recommendations for improving the corporate governance across the world.

- The Cadbury Committee on Corporate Governance–1992
- The Greenbury Committee–1995
- The Hampel Committee–1998
- The Combined Code–1998
- The Blue Ribbon Committee–1998
- The Turnbull Committee–1999
- The World Bank Initiative on Corporate Governance
- The OECD Principal on Corporate Governance
- The McKinsey Survey on Corporate Governance
- The Sarbanes-Oxley Act–2002
  - The King Committee (I)–1993, The King Committee (II)–2003, The King Committee (III)–2006, The King Committee (IV)–2016

National Level Initiative

During this period, similar initiatives have taken place at national level also in order to mitigate corporate failures and ensure good governance and to bring transparency in operations. The prominent among them are listed below.

- The Working Group on Companies Act 1996
- The CII Efforts 1996
- The Kumaramangalam Birla Committee 1999
- The Naresh Chandra Committee 2002
- The Narayanamoorthy Committee 2003
- The JJ Irani Committee 2005
- Uday Kotak committee on corporate governance 2017

Cadbury Committee on Corporate Governance, 1992

The Committee (UK) was set up in May 1991 by the Financial Reporting Council, the Stock Exchange and the accountancy profession in response to the concern about the standards of financial reporting and accountability, particularly in the light of Maxwell case and other cases. The committee was chaired by Sir Adrian Cadbury and decided to review those aspects of corporate governance relating to financial reporting and accountability. The final report 'The Financial Aspects of Corporate Governance' (usually known as the Cadbury Report) was published in December 1992 and it contained a number of recommendations to raise standards in corporate governance.

The Background of the Appointment of the Committee

The immediate reason for the appointment of the committee on corporate governance by the Financial Reporting Council, UK was the failure of one of

the top communication companies in the UK called Maxwell Communications Company and the death of Robert Maxwell in 1990 after missing from his office. The Company was established in 1964 when Hazell Sun merged with Purnell & Sons to form the British Printing Corporation. In 1967 the British Printing Corporation merged its magazines into Haymarket Group. In July 1981, Robert Maxwell acquired a stake of 29 per cent of the company. The Next year he secured full control of it. He changed the name of the Company to British Printing & Communications Corporation in March 1982 and to Maxwell Communication Corporation in October 1987.

The company was registered and control exercised in the UK but most of its assets were situated in the US. It made a series of risky acquisitions in the mid-80s that led the company into high debts, which was being financed by diverting resources from the pension funds of his companies. Robert Maxwell disappeared from England and after his disappearance, it emerged that the Mirror Group's debts (one of Maxwell's companies) vastly outweighed its assets, while £440 million (GBP) were missing from the company's pension funds. Despite the suspicion of manipulation of the pension schemes, there was a widespread feeling in London that no action was taken by the UK or the US regulators against the Maxwell Communications. Eventually, in 1992 Maxwell's companies filed for bankruptcy protection in the UK and the US. Around the same time the Bank of Credit and Commerce International (BCCI) went burst and lost billions of dollars for its depositors, shareholders and employees. Another company, Polly Peck, reported healthy profits one year while declaring bankruptcy the next year. (For details refer to the case at the end of the book)

The Cadbury Committee – Objectives

- To uplift the low level of confidence both in financial reporting and in the ability of auditors to provide safeguards.
- To review the structure, the rights and the role of BOD, the shareholders and the auditors by making them more effective.
- To address various aspects of accounting profession.
- To raise the standard of corporate governance.

General principles of C.G developed by the Cadbury committee

- Rights and equitable treatment of shareholders–Minority Vs. Majority
- Recognition and protection of other stakeholder's interest.
- Role and responsibilities of BOD–Size, independence, commitment, skills.
- Integrity and ethical behaviour of auditor.
- Disclosure and transparency–Timing, facts, etc.

The major aspects of the Cadbury Committee recommendations are as follows:

1. The committee's sponsors were concerned at the perceived low level of confidence both in the financial reporting and in the ability of auditors to provide the safeguards which the users of company reports sought and expected. The underlying factors were seen as the slackness of accounting standards, the absence of a clear framework for ensuring that directors kept under review the controls in their business and competitive pressures both on the companies and on the auditors which made it difficult for the auditors to stand up to the demanding boards.
2. The Committee's objective is to help to raise the standards of corporate governance and the level of confidence in financial reporting and auditing by setting out clearly what it sees as the respective responsibilities of those involved and what it believes is expected of them.

3. The committee looked in to three broad aspects of corporate governance such as (i) the structure role and the responsibilities of board of directors (ii) the role of auditors and the responsibility of accounting profession and (iii) the rights and the responsibilities of shareholders in a company as investors.
4. The basic approach of the committee was that compliance with a voluntary code coupled with disclosure will be more efficient than a statutory code of corporate governance. Hence the committee' emphasis on 'Comply or explain' principle. All the listed companies in the London Stock Exchange are bound to comply with and give reason for non-compliance of any aspects.
5. The committee focused on the control and the reporting functions of the board and the role of auditors related to financial reporting and accounting.
6. The committee's recommendations are a code of best practices designed to achieve a high standard of corporate behaviour.
7. All the proposals of the committee are aimed to strengthened the unitary board system and enhance its efficiency and effectiveness.

Major Recommendations of the Committee

(a) **Board performance:** Of the three main aspects considered by the Committee the first was the board of director's performance, board composition, board structure, role of independent directors, internal control system, board committees, chairman's role, Secretary's role, training to board of directors etc. In this area the Cadbury Committee made the following recommendations:

1. The board must compose of an optimum number of executive and non-executive directors. The executive directors must have good knowledge of business and the non-executive directors have a broader view about the activities of the company and the environment in which the company is working.
2. The executive and the non-executive directors must work together with one objective of maximizing the shareholder's wealth.
3. All board members will have equal responsibility in the actions of company board.
4. Non-executive directors will have additional responsibilities of reviewing the performance of executive directors in addition to reviewing the performance of the board as such and must take a lead when a potential conflict of interest arises.
5. Chairman is primarily responsible for the working of the board and also ensuring that all the executive and the non-executive directors are encouraged to play their full role.
6. The Non-executive directors should bring an independent judgment on issues of strategy formulation, performance, resource use and fixing the standard of performance.
7. There should be a formal selection process of the non-executive directors to ensure the independence the independence of them through a nomination committee.
8. The independent directors must be appointed for a specific period and the formal appointment letter must be given clearly mentioning their rights, duties terms of appointment and responsibilities.

9. The independent directors must be allowed to seek outside professional advice on issues related to the company at company's cost whereever necessary.
10. Sufficient training must be given to directors for improving their performance.
11. The board should recognize the importance of the finance function by making it the designated responsibility of a non-executive director who should be a signatory of the annual report and accounts on behalf of the board.
12. There must be a board committees such as audit committee, nomination committee, remuneration committee, etc. for the effective functioning of these activities.
13. Audit committees should be formally constituted to ensure that they have a clear relationship with the board to whom they are answerable and to whom they should report regularly. They should be given written terms of reference which deal adequately with their membership, authority and duties, and they should normally meet at least twice a year.
14. The audit committee must have three independent directors only.
15. The Company Secretary has a key role in ensuring that the bard procedures are strictly followed.
16. The remuneration of both the executive and the non-executive directors must be clearly disclosed in the annual report.
17. Financial report should be presented in a balanced and understandable manner to the shareholders and should ensure the highest level of disclosure. The Financial Reporting Council must develop a format for this purpose and all listed companies must follow it.
18. The director's service contracts should not exceed 3 years without the approval of the shareholders.
19. The nomination committee should have a majority of non-executive directors on it and be chaired either by the chairman or a non-executive director.
20. Directors need in practice to maintain a system of internal control over the financial management of the company, including procedures designed to minimize the risk of fraud. There is, therefore, already an implicit requirement on the directors to ensure that a proper system of internal control is in place.

(b) **External auditor and their responsibilities:** Enhancing objectivity and effectiveness of external auditing is one of the main recommendations of the Committee with regards to external audit. Other specific recommendations in this area are as follows:

1. The external auditors should be present at the board meeting when the annual report and accounts are approved and preferably when the half-yearly report is considered as well.
2. The auditor should have a duty to report fraud to the appropriate authorities. The auditor's duty is normally to report fraud to the senior management. Where, however, if he/she no longer has confidence that the senior management will deal adequately with the matter, he is encouraged by professional guidance to report fraud to the proper authorities.
3. In order to ensure transparency the fee paid to the external auditor for audit work and other non-audit work if any should be specified separately in the annual report.

4. Professional objectivity must be ensured to the external auditor.
5. Auditor rotation system must be introduced and strictly adhered to.
6. Auditors while discharging their duties must ensure that accounting standards are strictly followed.
7. Auditors owe a legal duty of care to the company and to the shareholders collectively, but not to the shareholders as individuals nor to the third parties
8. Companies' statements of compliance should be reviewed by the auditors before publication. The review should cover only those parts of the compliance statement which relate to provisions of the Code where compliance can be objectively verified. The Auditing Practices Board should consider guidance for auditors accordingly.
9. Directors should report on the effectiveness of their system of internal control, and the auditors should report on their statement. The accountancy profession together with representatives of preparers of accounts should draw up criteria for assessing effective systems of internal control and guidance for companies and auditors.
10. The government should consider introducing legislation to extend to the auditors of all companies the statutory protection already available to auditors in the regulated sector (banks, building societies, insurance, and investment business) so that they can report reasonable suspicions of fraud freely to the appropriate investigatory authorities.
11. The accounting profession should continue its efforts to improve its standards and procedures so as to strengthen the standing and independence of auditors.

(c) The Shareholders:

1. All parties concerned with corporate governance should use their influence to encourage compliance with the code, institutional shareholders in particular, with the backing of the institutional shareholders' Committee.
2. Institutional investors should disclose their policies on the use of their voting rights.
3. If long-term relationships are to be developed, it is important that companies should communicate its strategies to their major shareholders and that the shareholders should understand them. It is equally important that the shareholders should play their part in the Communication process.
4. The board must ensure that any significant statement concerning their companies is made publicly and hence equally available to all shareholders.

Source: Cadbury code 1992.

The Paul Ruthman Committee

This committee was constituted later to deal with the said controversial point of Cadbury Report. It watered down the proposal on the grounds of practicality. It restricted the reporting requirement to internal financial controls only as against "the effectiveness of the company's system of internal control" as stipulated by the Code of Best Practices contained in the Cadbury Report.

The final report submitted by the committee chaired by Ron Hampel had some important and progressive elements notably the extension of directors' responsibilities to "all relevant control objectives including business risk assessment and minimising the risk of fraud...".

The Greenbury Committee Report

During the early years of 1990's a series of public utilities in England were privatized and large pay increase was subjected to the directors and senior executives of these companies. Huge share options were also given to these executives. This was followed by staff reduction, pay restrictions to other lower level staff and price increase for products and services. All these actions invited huge public and shareholder criticism about large listed companies. The issue of director's remuneration was also debated in the administration and corporate circles in England. As a consequence to these deliberations in January 1995 a study group on director's remuneration was set up with Sir Richard Greenbury, Chairman of Marks and Spencer's as chairman of the committee.

The terms of reference to the committee was "to identify good practices in determining director's remuneration and prepare a code of such practices for use by public limited companies in the UK". The committee focused the deliberations on remuneration policy, service conditions and compensation of directors, functioning of a remuneration committee, disclosure of director's compensation and code of best practices in this respect.

The terms of reference to the committee was to identify good practices in determining director's remuneration and prepare a code of such practices for use by public limited companies in the UK. Though the committee's work is focused on big public limited companies directors, it is equally applicable to other senior executives in public limited companies and directors of small listed and unlisted companies. The committee focused the deliberations on remuneration policy, service conditions and compensation of directors, functioning of a remuneration committee, disclosure of director's compensation and code of best practices in this respect. The committee made the following recommendations:

The Greenbury Code of Corporate Governance

(A) The remuneration committee

- To avoid potential conflicts of interest, the Board of Directors should set up remuneration committees of Non-Executive Directors to determine on their behalf, and on behalf of the shareholders, within agreed terms of reference the company's policy on executive remuneration and specific remuneration, packages for each of the Executive Directors, including pension rights and any compensation payments.
- Remuneration committees should consist exclusively of the Non-Executive Directors with no personal financial interest other than as shareholders in the matters to be decided, no potential conflicts of interest arising from cross directorships and no day-to-day involvement in running the business.
- Remuneration committee Chairmen should account directly to the shareholders through the means specified in the Code for the decisions their committees reach. Where necessary, companies' Articles of Association should be amended to enable remuneration committees to discharge these functions on behalf of the Board.
- The members of the remuneration committee should be listed each year in the committee's report to shareholders. When they stand for re-election, the proxy cards should indicate their membership of the committee.

- The Board itself should determine the remuneration of the Non-Executive Directors, including members of the remuneration committee, within the limits set in the Articles of Association.
- Remuneration committees should consult the company Chairman and/ or Chief Executive about their proposals and have access to professional advice inside and outside the company.
- The remuneration committee Chairman should attend the company's Annual General Meeting (AGM) to answer shareholders' questions about Directors' remuneration and should ensure that the company maintains contact as required with its principal shareholders about remuneration in the same way as for other matters.
- The committee's annual report to the shareholders should not be a standard item of agenda for AGMs. But the committee should consider each year which the circumstances are such that the AGM should be invited to approve the policy set out in their report and should minute their conclusions.

(B) Disclosure and approval provisions

- The remuneration committee should make a report each year to the shareholders on behalf of the Board. The report should form part of, or be annexed to, the company's Annual Report and Accounts. It should be the main vehicle through which the company accounts to the shareholders for Directors' remuneration are communicated.
- The report should set out the Company's policy on executive remuneration, including levels, and Individual components. Performance criteria and measurement, pension provision, contracts of service and compensation commitments on early termination must also be specified.
- The report should state that, in framing its remuneration policy, the committee shall give full consideration to the best practice provisions set out in the report. The report should also include full details of all elements in the remuneration package of each individual Director by name, such as basic salary, benefits in kind, annual bonuses and long-term incentive schemes including share options.
- Information on share options should be given to each Director in accordance with the recommendations of the Accounting Standards Board's Urgent Issues Task Force Abstract 10 and its successors.
- If grants under executive share option or other long-term incentive schemes are awarded in one large block rather than phased, the report should explain and justify. Also the report should specify pension entitlements earned by each individual Director during the year, calculated on a basis of be recommended by the Faculty of Actuaries and the Institute of Actuaries If annual bonuses or benefits in kind are pensionable the report should explain and justify, the amounts received by, and commitments made to, each Director.
- Any service contracts which provide for, or imply notice periods in excess of one year (or any provisions for predetermined compensation on termination which exceed one year's salary and benefits) should be disclosed and the reasons for the longer notice periods explained.
- Shareholdings and other relevant business interests and activities of the Directors should continue to be disclosed as required in the Companies Acts and the London Stock Exchange Listing Rules.
- Shareholders should be invited specifically to approve all new long-term incentive schemes (including share option schemes) whether payable in

cash or shares in which Directors or senior executives will participate which potentially commit shareholders' funds over more than one year or dilute the equity.

(C) Remuneration policy

- Remuneration committees must provide the packages needed to attract, retain and motivate Directors of the quality required but should avoid paying more than what is necessary for this purpose.
- Remuneration committees should bench mark their company relative to other companies. They should be aware what other comparable companies are paying and should take account of relative performance.
- Remuneration committees should be sensitive to the wider scene, including pay and employment conditions elsewhere in the company, especially when determining annual salary increases.
- The performance-related elements of remuneration should be designed to align the interests of Directors and shareholders and to give Directors keen incentives to perform at the highest levels.
- Remuneration committees should consider whether their Directors should be eligible for annual bonuses. If so, performance conditions should be relevant, stretching and designed to enhance the business. Upper limits should always be considered.
- Remuneration committees should consider whether their Directors should be eligible for benefits under long-term incentive schemes. Traditional share option schemes should be weighed against other kinds of long-term incentive scheme.
- Any new long-term incentive schemes which are proposed should preferably replace existing schemes or at least form part of a well-considered overall plan, incorporating existing schemes which should be approved as a whole by the shareholders. The total rewards potentially available should not be excessive.
- Grants under incentive schemes, including new grants under existing share option schemes, should be subject to challenging performance criteria reflecting the company's objectives. Consideration should be given for criteria which result the company's performance relative to a group of companies in some key variables such as total shareholder return.
- Grants under executive share option and other long-term incentive schemes should normally be phased rather than awarded in one large block.
- Executive share options should never be issued at a discount.
- Remuneration committees should consider the pension consequences and associated costs to the company of basic salary increases, especially for Directors close to retirement.
- In general, neither annual bonuses nor benefits in kind should be pensionable.

(D) Service contracts and compensation

- Remuneration committees should consider what compensation commitments their Directors' contracts of service, if any, would entail in the event of early termination, particularly for unsatisfactory performance.
- There is a strong case for setting notice or contract periods at, or reducing them to, each year. Remuneration committees should, however, be sensitive and flexible, especially over timing. In some cases notice or contract periods of upto two years may be acceptable. Longer periods should be avoided wherever possible.

- If it is necessary to offer longer notice or contract periods, such as three years, to new Directors recruited from outside, such periods should reduce after the initial period.
- Within the legal constraints, remuneration committees should tailor their approach in individual early termination cases to the wide variety of circumstances. The broad aim should be to avoid rewarding poor performance while dealing fairly with cases where departure is not due to poor performance.
- Remuneration committees should take a robust line on payment of compensation where performance has been unsatisfactory and on reducing compensation to reflect departing Directors' obligations to mitigate damages by earning money elsewhere.
- Where appropriate, and in particular where notice or contract periods exceed one year, companies should consider paying all or part of compensation in instalments rather than in lump sum and reducing or stopping payment when the former Director takes on new employment.

Source: Greenbury code 1995.

Compliance:

- The committee also recommended that all listed companies registered in the UK should comply with the Code to the fullest extent practicable and include a statement about their compliance in the annual reports to shareholders by their remuneration committees or elsewhere in their annual reports and accounts. Any areas of non-compliance should be explained and justified.
- The committee further recommends that the London Stock Exchange should introduce the following continuing obligations for the listed companies: (1) an obligation to include in their annual remuneration committee reports to the shareholders or their annual reports a general statement about their compliance with section A of the Code which should also explain and justify any areas of non-compliance; (2) a specific obligation to comply with the provisions in section B of the Code which are not already covered by existing obligations, and with provisions of the Code, subject to any changes of working which may be desirable for legal or technical reasons.

The Hampel Committee, 1995

The Hampel Committee was set up in November 1995 to promote high standards of corporate governance both to protect investors and preserve and enhance the standing of companies listed on the London Stock Exchange.[1]

The Committee

- Developed the Cadbury Report.
- Recommended that
  - the auditors should report on internal control privately to the directors.
  - the directors maintain and review all (and not just financial) controls.
  - companies that do not already have an internal audit function, should from time to time, review their need for one.
- Introduced the Combined Code that consolidated the recommendations of earlier corporate governance reports (Cadbury and Greenbury).

The Combined Code, 1998

The Combined Code[2] was subsequently derived from Ron Hampel Committee's Final Report, Cadbury Report and the Greenbury Report. (Greenbury Report, which was submitted in 1995, addressed the issue of directors' remuneration.) The Combined Code is appended to the listing rules of the London Stock Exchange. As such, compliance of the code is mandatory for all listed companies in the United Kingdom.

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The stipulations contained in the Combined Code require, among other things, that the boards should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets. The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control covering all controls, including financial, operational, and compliance and risk management, and report to the shareholders that they have done so.

It was observed that the one common denominator behind the past failures in the corporate world was the lack of effective risk management. As a result, risk management subsequently grew in importance and is now seen as highly crucial to the achievement of business objectives by the corporates.

It was clear, therefore, that the boards of directors were not only responsible but also needed guidance in not just reviewing the effectiveness of internal controls but also for providing assurance that all the significant risks had been reviewed. Furthermore, assurance was also required that the risks had been managed and an embedded risk management process was in place. In many companies, this challenge was being passed on to the internal audit function.

The Turnbull Committee, 1999

The Turnbull Committee was set up by the Institute of Chartered Accountants in England and Wales (ICAEW) in 1999 to provide guidance to assist companies in implementing the requirements of the Combined Code relating to internal control.

The Committee

- Provided guidance to assist companies in implementing the requirements of the Combined Code relating to internal control.
- Recommended that where companies do not have an internal audit function, the board should consider the need for carrying out an internal audit annually.
- Recommended that the boards of directors confirm the existence of procedures for evaluating and managing key risks.

Corporate governance is constantly evolving to reflect the current corporate, economic and legal environment. To be effective, corporate governance practices need to be tailored to the particular needs, objectives and risk management structure of an organisation. Corporate governance is not a static concept, in fact it is dynamic, and thus needs to be altered with the changes that occur in the business environment.

The Blue Ribbon Committee (1999)

Background: Financial reporting of misstatement appears to be a growing problem in the US. The number of class action securities suits filed has grown steadily since the passage of the 1995 Private Securities Litigation Act, and allegations of

accounting manipulation have replaced disclosure-based allegations as the primary grounds of complaint. To overcome this problem and improve in the quality of financial reporting by strengthening the effectiveness of audit committee the Securities Exchange Commission, US has set up the Blue Ribbon Committee under the chairmanship of Levitt in 1998. In February 1999, the Committee published the Report on Improving the Effectiveness of Corporate Audit Committees (the Blue Ribbon Report). The recommendations of the committee include the role of audit committee, the independence of audit committee, minimum size, financial expertise of members in the committee. The BRC also made several recommendations related to audit committee charters and communications with the external auditor and with the shareholders. The recommendations of the Blue Ribbon Committee were adopted and declared to be mandatory by the NYSE, the American Stock Exchange (Amex), Nasdaq and the American Institute of Certified Public Accountants (AICPA). However, the recommendations are not mandatory for foreign issuers.

"Qualified, committed independent and tough-minded audit committees represent the most reliable guardians of the public interest" Chairman Blue Ribbon Committee Levitt.

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Major Recommendations

1. **Audit committee and its member's independence:** The BRC recommends that all listed companies over a certain size have audit committees composed entirely of independent directors. Independence is defined to exclude current and former employees, relatives of management, persons receiving compensation from the company (except directors' fees) or controlling for-profit organisations receiving from or paying the corporation significant sums, and compensation committee interlocking directorships.
2. **Financial experts and minimum committee members**: Except for small firms, a minimum of three audit committee directors, each of whom is financially literate and at least one of whom has accounting or related financial management expertise. Financial literacy is the ability to read and understand fundamental financial statements and accounting expertise may be demonstrated by employment experience in finance or accounting, a CPA certification or comparable experience, including a position as CEO or other senior officer with financial oversight responsibilities.
3. **Need of a formal charter for audit committee:** The audit committee must have a formal charter and to disclose the status of the charter and whether the audit committee has fulfilled its designated responsibilities during the proxy statement period.
4. **Responsibilities and activities of the audit committee**: BRC recommends that audit committee must be active in the selection and the retention of the statutory auditor, regularly evaluate auditor's independence, regularly discuss accounting quality with the auditor and to hold similar discussions with the management and the auditor interim reviews and discussion of these review-related issues with the auditor.

World Bank on Corporate Governance

The World Bank, both as an international development bank and as an institution, interested and involved in equitable and sustainable economic development worldwide, was one of the earliest international organisations to study the issue of corporate governance and suggest certain guidelines.

The World Bank Report on corporate governance recognises the complexity of the very concept of corporate governance and focusses on the principles on which it is based. These principles such as transparency, accountability, fairness and responsibility are universal in their applications. The way they are put into practice has to be determined by those with the responsibility for implementing them. What is needed is a combination of statutory and self-regulation; the mix will vary around the world, but nowhere can statutory regulation alone promote effective governance. The stronger the partnership between the public and private sectors, the more soundly based will be their governance structures. Equally, as the report emphasises, governance initiatives win most support when driven from the bottom up rather than from the top down.

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It could be argued that international investors and capital markets are bringing about a degree of convergence over governance practices worldwide. But the standards that they are setting apply primarily to those corporations in which they invest or to which they lend. These standards set the target but it is one which, at present, is out of reach for the majority of enterprises across the world. In the past, these standards might have become diffused by a gradual process of economic osmosis. However, the pace of change today is such that to leave the raising of governance standards to natural forces might put parts of the world, where funds could be put to best use, at a competitive disadvantage in attracting them. Adoption of the report's proposals offers enterprises everywhere the chance to gain their share of the potentially available funds for investment.

Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society. The incentive to corporations and to those who own and manage them to adopt internationally accepted governance standards is that they will help them to achieve their corporate aims and to attract investment. The incentive for their adoption by states is that they will strengthen their economies and discourage fraud and mismanagement. The foundation of any structure of corporate governance is disclosure. Openness is the basis of public confidence in the corporate system and funds will flow to those centres of economic activity, which inspire trust. This report points the way to the establishment of trust and the encouragement of enterprise. It marks an important milestone in the development of corporate governance.

OECD Principles

The Organisation for Economic Cooperation and Development (OECD) was one of the earliest non-governmental organisations to work on and spell out principles and practices that should govern corporates in their goal to attain long-term shareholder value.[3] The OECD Principles were oft-quoted and have won universal acclaim, especially of the authorities on the subject of corporate governance. Because of the ubiquitous approval, the OECD Principles are as much trend-setters as the Codes of Best Practices associated to the Cadbury Report. A useful first step in creating or reforming the corporate governance system is to look at the principles laid out by the OECD and adopted by its member governments. In summary, they include the following elements:

The OECD was one of the earliest non-governmental organisations to work on and spell out principles and practices that should govern corporates in their goal to attain long-term shareholder value. In summary, they include the following aspects of corporate governance: the rights of shareholders; equitable treatment of all shareholders; the role of stakeholders in corporate governace; disclosure and transparency and the responsibilities of the board.

1. **The rights of shareholders:** The rights of shareholders include a set of rights to secure ownership of their shares, the right to full disclosure of information, voting rights, participation in decisions on sale or modification of corporate assets, mergers and new share issues. The guidelines go on to specify a host of other issues connected to the basic concern of protecting the value of the corporation.
2. **Equitable treatment of shareholders:** The OECD is concerned with protecting minority shareholders' rights by setting up systems that keep insiders, including managers and directors, from taking advantage of their roles. Insider trading, for example, is explicitly prohibited and directors should disclose any material interest regarding transactions.
3. **The role of stakeholders in corporate governance:** The OECD recognises that there are other stakeholders in companies in addition to shareholders. Banks, bondholders and workers, for example, are important stakeholders in the way in which companies perform and make decisions. The OECD guidelines lay out several general provisions for protecting stakeholder's interests.
4. **Disclosure and transparency:** The OECD lays down a number of provisions for the disclosure and communication of key facts about the company ranging from financial details to governance structures including the board of directors and their remuneration. The guidelines also specify that independent auditors in accordance with high quality standards should perform annual audits.
5. **The responsibilities of the board:** The OECD guidelines provide a great deal of details about the functions of the board in protecting the company and its shareholders. These include concerns about corporate strategy, risk management, executive compensation and performance as well as accounting and reporting systems.

The OECD guidelines are somewhat general and both the Anglo–American system and the Continental European (or German) system would be quite consistent with them. However, there is a growing pressure to put more enforcement mechanisms into those guidelines. The challenge will be to do this in a way consistent with market-oriented systems by creating self-enforcing procedures that do not impose large new costs on firms. The following are some ways to introduce more explicit standards:

- Countries should be required to establish independent share registries. All too often, newly privatised or partially privatised firms dilute stock or simply fail to register shares purchased through foreign direct investment
- Standards for transparency and reporting of the sales of underlying assets need to be spelled out along with enforcement mechanisms and procedures by which investors can seek to recover damages
- The discussion of stakeholder participation in the OECD guidelines needs to be balanced by discussion of conflict of interest and insider trading issues. Standards or guidelines are needed in both areas
- Property rights and their protection
- Internationally accepted accounting standards should be explicitly required and national standards should be brought into alignment with international standards
- Internal company audit functions and the inclusion of outside directors on audit committees need to be made explicit. The best practice would be to require that only outside, independent directors be allowed to serve on audit committees

These standards seem to be too heavily influenced by the Anglo–American tradition and may really be necessary in most countries. A study by the Center for European Policy Studies noted that the wider the distribution of shareholding the greater is the role of the market in the exercise of corporate control. Hence there

is a greater need for corporate governance procedures in this type of economy than in one where shareholding is relatively concentrated. The report went on to note, however, that financial market liberalisation increased privatisation and the growing use of funded system to support pension rules driving European countries toward more explicit and more comprehensive rules on corporate governance. In short, globalisation is forcing convergence of different systems into an open and internationally accepted set of standards.

The reason why it is important to take note of the trends toward convergence is that many people have cited the European experience as proof that corporate governance issues only apply to countries that follow an Anglo–American tradition, such as India, for instance. Recent history would seem to show that without sound corporate governance procedures, including the larger institutional features mentioned earlier, economic crises in developing countries are likely to become more frequent. Many developing countries face rather stark choices: either create the type of governance procedures needed to participate in and take advantage of globalisation, run risk of severe (and frequent) economic crises or seek to build defensive walls around the economy. It should be noted that the last option usually entails the risk of keeping out investors and new technologies, and lower growth rates dramatically.

Another consideration in the debate over corporate governance system is the risk that individual firms face. Unless a company is able to build the kind of governance mechanisms that attract capital and technology, they run the risk of simply becoming suppliers and vendors to the multinationals.

McKinsey Survey on Corporate Governance

There has been a continuing debate among those who hold divergent positions on corporate governance practices whether there is any quantifiable connection between good corporate governance and the market valuation of the company. In this regard, McKinsey, the international management consultant organisation conducted a survey with a sample size of 188 companies from 6 emerging markets (India, Malaysia, Mexico, South Korea, Taiwan and Turkey), to determine the correlation between good corporate governance and the market valuation of the company. The results of the survey pointed out to a positive correlation between the two. In short, good corporate governance increases market valuation in the following ways:

McKinsey, the international management consultant organisation, conducted a survey with a sample size of 188 companies from 6 emerging markets (India, Malaysia, Mexico, South Korea, Taiwan and Turkey) to determine the correlation between good corporate governance and the market valuation of the company.

- Increasing financial performance.
- Transparency of dealing, thereby reducing the risk that boards will serve their own self-interest.
- Increasing investor confidence.

McKinsey rated the performance on corporate governance of each company based on the following parameters:

- *Accountability:* transparent ownership, board size, board accountability, ownership neutrality.
- *Disclosure and transparency of the board:* timely and accurate disclosure, independent directors.
- *Shareholder equality:* one share-one vote.

Through the survey, McKinsey found that companies with good corporate governance practices have high price-to-book values indicating that investors are willing to pay a premium for the shares of a well-managed and governed company. Additionally, the survey revealed that investors are willing to pay a premium of as much as 28 per cent for shares of such a corporate governance based company.

Companies in emerging markets often claim that Western corporate governance standards do not apply to them. However, the survey revealed that studies of the six emerging markets show that investors the world over look for high standards of good governance. Additionally, they are willing to pay a high premium for shares in companies that meet their requirements of good corporate governance.

Sarbanes–Oxley Act, 2002

Corporate America has been blotted with many scandals in recent times. The Sarbanes–Oxley Act which codifies certain standards of good governance is meant to prevent these. The Act calls for protection to those who have the courage to bring frauds to the attention of those who have to handle frauds. It ensures that such things are not left to the individuals who may or may not choose to reveal them. The SOX Act is a sincere attempt to address all the issues associated with corporate failures to achieve quality governance and to restore investor's confidence.

"Corporate America has been blotted with many scandals in the recent times. Despite the fact that there have been differences between the recent scandals and the earlier ones, there is a common thread running in between them. The common thread is that governance matters, that is, good governance promotes good corporate decision-making. The recent Sarbanes–Oxley Act is a step in this direction, which codifies certain standards of good governance as specific requirements. The Act calls for protection to those who have the courage to bring frauds to the attention of those who have to handle frauds. But it ensures that such things are not left to the individuals who may or may not choose to reveal them, it is better for the corporations to appoint an officer with the responsibility to oversee compliance and ethical issues. Unless corporate governance is integrated with strategic planning and shareholders are really willing to bear the additional expenses that may be required, effective corporate governance cannot be achieved."

The Sarbanes–Oxley Act (SOX Act), 2002 is a sincere attempt to address all the issues associated with corporate failures to achieve quality governance and to restore investor's confidence. The Act was formulated to protect investors by improving the accuracy and reliability of corporate disclosures, made precious to the securities laws and for other purposes. The Act contains a number of provisions that dramatically change the reporting and corporate director's governance obligations of public companies, the directors and officers.

Important provisions contained in SOX Act are briefly given below:

Establishment of Public Company Accounting Oversight Board (PCAOB): The SOX Act creates a new board consisting of five members of whom two will be certified public accountants. All accounting firms will have to register themselves with this Board and submit among other details, particulars of fees received from public company clients for audit and non-audit services, financial information about the firm, list of firms' staff who participate in audits, quality control policies, information on civil, criminal and disciplinary proceedings against the firm or any of the staff. The Board will conduct annual inspections of firms, which audit more than 100 public companies, and once in 3 years in other cases. The board will establish rules governing audit quality control, ethics, independence and other standards. It can conduct investigations and disciplinary proceedings and can impose sanctions on auditors.

The Board reports to the SEC. The Board is required to send its report to the SEC annually, which will then be forwarded by the SEC to the Congress. The new board replaces the old one, which was funded by fees collected from public companies based on their market capitalisation.

Audit committee: The SOX Act provides for a "new improved" audit committee. The members of the committee are drawn from among the directors of the board of the company but all are independent directors as defined in the Act.

The audit committee is responsible for appointment, fixing fees and oversight of the work of independent auditors. The committee is also responsible for establishing and reviewing the procedures for the receipt, treatment of accounts, internal control and audit complaints received by the company from the interested or affected parties.

The SOX Act requires that registered public accounting firms should report directly to the audit committee on all critical accounting policies and practices and other related matters.

Conflict of interest: Public accounting firms should not perform any audit service for a publicly traded company if the CEO, CFO, CAO, controller, or any person serving in an equivalent position was employed by such firm and participated in any capacity in the audit of that company during the one year period preceding the date of initiation of the audit.

Audit partner rotation: The SOX Act provides for mandatory rotation of the lead auditor, co-ordinating partner and the partner reviewing audit once every 5 years.

Improper influence on conduct of audits: It will be unlawful for any executive or director of the firm to take any action to fraudulently influence, coerce, manipulate or mislead any auditor engaged in the performance of an audit with the view to rendering the financial statements materially misleading.

Prohibition of non-audit services: Under the SOX Act, auditors are prohibited from providing non-audit services concurrently with audit financial review services. Non-audit services include: (i) book-keeping or other services related to the accounting records or financial statements of the client; (ii) financial information system, design and implementation; (iii) appraisal or valuation services, fair opinions; (iv) acturial services; (v) internal audit outsourcing services; (vi) management functions or human resources; (vii) broker or dealer, investment adviser or investment banking services; (viii) legal services or expert services unrelated to the audit and (ix) any other service that the board determines, by regulation, is impermissible. However, the board has the power to grant exemptions. The Act also allows an accounting firm to "engage in any non-audit service including tax services", if it has been pre-approved by the audit committee of the firm concerned.

CEOs and CFOs required to affirm financials: Chief executive officers and chief finance officers are required to certify the reports filed with the Securities and Exchange Commission. If the financials are required to be restated due to material non-compliance "as a result of misconduct" of the CEO or CFO, then such CEO or CFO will have to return bonus and any other incentives received by him back to the company. This applies to equity-based compensation received during the first 12 months after initial public offering. False and/or improper certification can attract fine ranging from $1 million to $5 million or imprisonment upto 10 years or both.

Loans to directors: The SOX Act prohibits US and foreign companies with securities traded within the US from making or arranging from third parties any type of personal loan to directors. It appears that the existing loans are not affected but material modifications or renewal of loans and arrangements of existing loans are banned.

Attorneys: The attorneys dealing with the publicly traded companies are required to report evidence of material violation of securities law or breach of fiduciary duty or similar violations by the company or any agent of the company to the Chief Counsel or CEO and if the Counsel or CEO does not appropriately respond to the evidence, the attorney must report the evidence to the audit committee or the Board of Directors.

Securities analysts: The SOX Act has a provision under which brokers and dealers of securities should not retaliate or threaten to retaliate an analyst employed by the broker or dealer for any adverse, negative or unfavourable research report on a public company. The Act further provides for disclosure of conflict of interest by the securities analysts and brokers or dealers whether

(a) The analyst has investments or debt in the company he is reporting on.
(b) Any compensation received by the broker dealer or analyst is "appropriate in the public interest and consistent with the protection of investors".
(c) The company (issuer) has been a client of the broker or dealer.
(d) The analyst received compensation with respect to a research report based on investment banking revenues.

Penalties: The penalties prescribed under SOX Act for any wrongdoing are very stiff. Penalties for wilful violations are even stiffer. Any CEO or CFO providing a certificate knowing that it does not meet with the criteria stated may be fined upto $1 million and/or imprisonment upto 10 years. However, those who "wilfully" provide certification knowing that it does not meet the required criteria can be punished with a fine of $5 million and/or with prison term upto 20 years. These heavy penalties are bound to be a deterrent for wrongdoers.

Very importantly, the SOX Act provides for studies to be conducted by the Securities and Exchange Commission or the Government Accounting Office in the following areas:

(i) Auditor's rotation.
(ii) Off-balance sheet transactions.
(iii) Consolidation of accounting firms and its impact on the accounting industry.
(iv) Role of Credit Rating Agencies.
(v) Study of violators and violations during the years 1998–2001.
(vi) SEC enforcement actions over the past 5 years.
(vii) Role of investment banks and financial advisers.
(viii) "Principle-based" accounting.

The SOX Act would certainly enhance accountability levels for directors, officers, auditors, security analysts and legal counsel involved in the financial markets. It would have far reaching implications worldwide particularly in areas of audit. The Act targets specifically publicly traded companies and does not distinguish between the US and non-US companies. It applies to all companies with a listing in the US.

But the most important aspect of the SOX Act is that it makes it clear that a company's senior officers are responsible for the corporate culture they create, and must be faithful to the same rules they set out for other employees. The CEO, for example, must be ultimately responsible for the company's disclosure, controls and financial reporting.

The King's Committee on Corporate Governance

The King's Committee report on corporate governance is basically a South African based corporate governance framework which is a requirement for Johannesburg Stock Exchange listed companies. In July 1993, the Institute of Directors in South Africa asked retired South African Supreme Court Judge Mervyn King to chair a committee on corporate governance with Phillip Armstrong, Nigel Payne, and Richard Wilkinson members to prepare guidelines for the governance structures and operation of companies in South Africa. The committee came out with three reports first in 1994 (King I), second in 2002 (King II), third in 2009 (King III) and fourth in 2017 (King IV). This report is cited as the most effective summary of the best international practices in corporate governance.

Unlike other corporate governance codes such as Sarbanes-Oxley, this Code is non-legislative and is based on principles and practices. It also espouses 'an apply or explain approach'. The philosophy of the Code consists of the three key elements

such as (1) leadership, (2) sustainability and (3) good corporate citizenship. It views good governance as essentially being effective, ethical leadership. King believes that the leaders should direct the company to achieve sustainable economic, social and environmental performance. It views sustainability as the primary moral and economic imperative of this century; the code's view on corporate citizenship flows from a company's standing as a juristic person under the South African constitution and should operate in a sustainable manner.

Kings I

In 1994, the first King reports on corporate governance (King I) was published which form the first corporate governance code for South Africa. It recommended standards of conduct for boards and directors of listed companies, banks, and certain state-owned enterprises. It included not only financial and regulatory aspects, but also advocated an integrated approach that involved all stakeholders.

It was applicable to all companies listed on the main board of the Johannesburg Stock Exchange, large public entities as defined by the Public Entities Act of South Africa; banks, financial and insurance companies as defined by the Financial Services Acts of South Africa; and large unlisted companies. It defined 'large' as companies with shareholder equity over ₹50 million, but encouraged all companies to adopt the code.

The key principles from the first King report covered:

- Board of directors makeup and mandate, including the role of non-executive directors and guidance on the categories of people who should make up the non-executive directors.
- Appointments to the board and guidance on the maximum term for executive directors.
- Determination and disclosure of executive and non-executive director's remuneration.
- Board meeting frequency
- Balanced annual reporting
- The requirement for effective auditing
- Affirmative action programs
- The company's code of ethics

Kings II

In 2002, when the Earth Submit was held in Johannesburg, King pushed for a revision of the report (King II), including new sections on the role of the corporate board on sustainability and risk management. This revised code of governance was applicable from March 2002.

In addition to those types of organisations listed in King I, it was applicable to departments of State or national, provincial or local government administration falling under the Local Government: Municipal Finance Management Act, and public institution or functionary exercising a power or performing a function in terms of the constitution, or exercising a public power or performing a public function in terms of any legislation, excluding courts or judicial officers. As before, it encourages all companies to adopt the applicable principles from the code.

The key principles from the second King report covered the following areas:

- Directors and their responsibility
- Risk management
- Internal audit
- Integrated sustainability reporting
- Accounting and auditing

Kings III

Realizing the fact that the King II report was wrong to suggest sustainability as a separate chapter to leading companies to report on it separately from other factors. The 2009 King III report on governance, strategy and sustainability were integrated, recommended that organisations produce an integrated report in place of an annual financial report and a separate sustainability report and that companies create sustainability reports according to the Global Reporting Initiative's Sustainability Reporting Guidelines.

In contrast to the earlier versions, King III is applicable to all entities, public, private and non-profit. King encourages all entities to adopt the King III principles and explain how these have been applied or are not applicable. The code of governance was applicable from March 2010.

The report incorporated a number of global emerging governance trends such as:

- Alternative dispute resolution
- Risk-based internal audit
- Shareholder approval of non-executive directors' remuneration
- Evaluation of board and directors' performance[4]

It also incorporated a number of new principles to address elements not previously included in the King reports:

- IT governance
- Business rescue
- Fundamental and affected transactions in terms of director's responsibilities during mergers, acquisitions and amalgamations.

Again, the code of corporate governance is not enforced through legislation. However, due to evolutions in the South African law, many of the principles put forward in King II are now embodied as law in the Companies Act of South Africa of 2008. In addition to the Companies Act, there are additional applicable statutes that encapsulate some of the principles of King III such as the Public Finance Management Act and the Promotion of Access to Information Act.

Kings IV

There have been significant corporate governance and regulatory developments, locally and internationally, since King III was issued in 2009 which need to be taken into account. The other consideration is that whilst listed companies are generally applying King III, non-profit organisations, private companies and entities in the public sector have experienced challenges in interpreting and adapting King III to their particular circumstances. The enhancement will aim to make King IV more accessible to all types of entities across sectors.

Due to the consultative process to be followed, King IV will only be completed in the second half of 2017. Providing for a 2-year period in respect of the drafting process and another year grace period to allow organisations to implement, King IV will probably become effective from middle 2017.

Indian Committees and Guidelines

The corporate world in India could not remain indifferent to the developments that were taking place in the UK. In fact, the developments in the UK had tremendous influence in India too. They triggered the thinking process in the country, which finally led to the government and the regulators laying down the ground rules on corporate governance. As a result of the interest generated in the corporate

sector by the Cadbury Committee's report, the issue of corporate governance was studied in depth and dealt with by the Confederation of Indian Industry (CII), the Associated Chambers of Commerce and the Securities and Exchange Board of India (SEBI). Though some of the studies did touch upon shareholders' right to "vote by ballot" and a few other issues of general nature, none can claim to be wider than the Cadbury report.

The developments in the UK had tremendous influence on India. Corporate failures and the reports of various committees starting with Cadbury's had a great impact on Indian corporate sector. They triggered the thinking process in the country, which finally led to the government and regulators laying down the ground rules on corporate governance.

Working Group on the Companies Act, 1996

Over the years, it has been felt necessary to re-write completely the Companies Act in the light of the modern-day requirements of the corporate sector, the aspirations of investors, globalisation of the economy, liberalisation etc. The government accordingly set up a Working Group in August 1996 for this purpose.

The Working Group on the Companies Act has recommended a number of changes and also prepared a working draft of the Companies Bill 1997. The Bill was introduced in the Rajya Sabha on 14 August 1997, containing the following recommendations:

Financial disclosures recommended by the Working Group on the Companies Act were as follows:

Over the years, it has been felt necessary to re-write completely the Companies Act in the light of the present-day requirements of the corporate sector, the aspirations of investors, globalisation of the process, economy, liberalisation etc. The government accordingly set up a Working Group on the Companies Act in August 1996 for this purpose.

- A tabular form containing details of each director's remuneration and commission should form a part of the directors' report in addition to the usual practice of having it as a note to the profit and loss account.
- Costs incurred in using the services of a group resource company must be clearly and separately disclosed in the financial statement of the user company.
- A listed company must give certain key information on its divisions or business segments as a part of the directors' report in the annual report. This should comprise: (i) the share in total turnover, (ii) a review of operations during the year in question, (iii) market conditions and (iv) future prospects. For the present, the cut-off may be 10 per cent of the total turnover.
- Where a company has raised funds from the public by issuing shares, debentures or other securities, it would have to give a separate statement showing the end-use of such funds, namely: how it was utilised in the project up to the end of the financial year; and where the residual funds are, if any, invested and in what form. This disclosure would be in the balance sheet of the company as a separate note forming a part of accounts.
- The disclosure on debt exposure of the company should be strengthened.
- In addition to the existing level of disclosure on foreign exchange earning and outflow, there should also be a note containing separate data on foreign currency transactions that are germane in the present context: (i) foreign holding in the share capital of the company and (ii) loans, debentures or other securities raised by the company in foreign exchange.
- The difference between financial statements pertaining to fixed assets and long term liabilities (including share capital and liabilities which are not to be liquidated within a year) as at the end of the financial year and the date on which the board approves the balance sheet and the profit and loss account should be disclosed.
- If any fixed asset acquired through or given out on lease is not reported under appropriate subheads, then full disclosure would need to be made as a note to the balance sheet. This should give details of the type of asset, its total value and the future obligations of the company under the lease agreement.

- Any inappropriate treatment of an item in the balance sheet or the profit and loss account should not be allowed to be explained away either through disclosure of accounting policies or through notes forming a part of accounts but should be dealt with in the directors' report.

All other things being equal, greater the quality of disclosure, the more loyal are a company's shareholders.

Non-financial disclosures recommended by the Working Group on Companies Act were the following:

- A comprehensive report on the relatives of directors—either as employees or board members—to be an integral part of the directors' report of all listed companies.
- Companies have to maintain a register, which discloses interests of directors in any contract or arrangement of the company. The existence of such a register and the fact that it is open for inspection by any shareholder of the company should be explicitly stated in the notice of the AGM of all listed companies.
- Likewise, the existence of the directors' shareholding register and the fact that members in any AGM can inspect it should be explicitly stated in the notice of the AGM of all listed companies.
- Details of loans to directors should be disclosed as an annex to the directors' report in addition to being a part of schedules of the financial statements. Such loans should be limited to only three categories—housing, medical assistance and education for family members—and be available only to full-time directors. The detailed terms of loan would need shareholders' approval in a general meeting.
- Appointment of sole selling agents for India will require prior approval of a special resolution in a general meeting of shareholders. The board may approve the appointment of sole selling agents in the foreign markets, but the information must be divulged to shareholders as a part of the directors' report accompanying the annual audited accounts. In either case, if the sole selling agent is related to any director or director having interest, this fact has not only to be stated in the special resolution but also divulged as a separate item in the directors' report.
- Subject to certain exceptions there should be a Secretarial Compliance Certificate forming a part of the annual returns that is filed with the Registrar of Companies.
- The Compliance Certificate should certify in prescribed format that the secretarial requirements under the Companies Act have all been adhered to.

Deficiencies of the Companies' 1956 Act

The Companies Act, 1956, was rooted in an environment of License and Permit Raj. Though the Act has been amended more than two dozen times to take cognisance of the changing and liberalised environment, it has been felt by many authorities on the subject that the Act has long outlived its usefulness. The provisions of the Act were insufficient to tackle the present-day corporate frauds and their enforcement was weak and inefficient.

The Companies Act, 1956 was rooted in an environment of License and Permit Raj. Though the Act has been amended on more than two dozen times to take cognisance of the changing and liberalised environment, it has been felt by many authorities on the subject that the Act has long outlived its usefulness. The relevance of a large number of provisions to private companies, which are often not more than mere family enterprises has been justifiably questioned. Though the Indian Companies Act 1956 provides the formal structure of corporate governance, it does not address adequately the governance problems. Some of the main deficiencies found in the provisions of the Act with regard to the basic issues of corporate governance are given below:

- Though non-executive directors can play a significant role in providing independent and objective opinion in discussions on many strategic areas in board deliberations, the Act does not assign them any formal role for the

executive and the non-executive directors, so far as their roles and responsibilities are concerned, the effective control in practice is in the hands of executive, whole time and managing directors.

- In actual practice, the non-executive directors have only ornamental value. They also lack a sense of commitment as the Act allows them to be on the boards of as many as 20 companies.
- With regard to financial reporting, the provisions of the Act make it more rule-based and ritualistic, rather than being transparent.
- The Act does not prescribe any formal qualification for a director of a company, with the result even an incompetent and mediocre person can become a member of the board.
- Though the Act formally provides for the appointment of auditors by shareholders, in practice they work more closely with the company management. The shareholders hardly have a chance to interact with the auditors. Corporate malpractices are often the result of the collusion between the management and the auditors.
- A large number of companies hardly provide any service to the investors, particularly with regard to redressal of grievances, delay in share transfers, dispatch of dividend warrants and share certificates.

The Indian Companies Act 2013

The new Companies Act of 2013 overcame most of the deficiencies in the Indian Companies Act 1956. This is considered to be a major reform in independent India to bring about good governance in Indian Corporate sector. This Act simplified and liberalized the formation and administration of company and set norms for its governance. Corporate Governance under the new companies' Act 2013 has broadened its meaning and scope. The Act set a complete module for fixing liability on the corporate entity. It is prescriptive to the companies rather recommendatory in nature. The major provisions relating to corporate governance introduced in the new company law can be broadly grouped in to eight groups namely:

1. Increased reporting standards
2. Higher auditing accountability
3. Risk management
4. Emphasis on investor protection
5. Composition of director board members and their responsibilities
6. Board committees
7. Inclusive Corporate Social Responsibility
8. Compulsory whistle-blower mechanism
(Details are given in Chapter 5)

The Confederation of Indian Industry's Initiative

In 1996, the Confederation of Indian Industry (CII) took a special initiative on corporate governance, the first ever institutional initiative in Indian industry. This initiative by the CII flowed from the public concerns regarding the protection of investors' interest, especially of the small investor; the promotion of transparency within business and industry; the need to move towards international standards in terms of disclosure of information by the corporate sector and, through all of this, to develop a high level of public confidence in business and industry. The objective of the effort was to develop and promote a code of corporate governance

In 1996, CII took a special initiative on corporate governance. The initiative flowed from public concerns regarding the protection of investors' interest, especially of the small investor, the promotion of transparency within business and industry, the need to move towards international standards in terms of disclosure of information by the corporate sector and, through all of this, to develop a high level of public confidence in business and industry.

to be adopted and followed by Indian companies, be they in the private sector or in the public sector, banks or financial institutions, all of which are mostly corporate entities.

A National Task Force that was set up with Rahul Bajaj (past President of the CII) as the Chairman, and had members drawn from industry, the legal profession, media and academia, presented the draft guidelines and the Code of Corporate Governance in April 1997 at the National Conference and Annual Session of CII. This draft was then publicly debated in workshops and seminars and a number of suggestions were received for the consideration of the Task Force. The Task Force finalised the Code for Desirable Corporate Governance, subsequently.[5]

The Task Force opined that although the concept of corporate governance still remained an ambiguous and misunderstood phrase, two aspects were becoming evident:

(i) As India gets integrated in the world market, Indian as well as international investors will demand greater disclosure, more transparent explanation for major decisions and better shareholder value. Indian companies, banks and financial institutions (FIs) can no longer afford to ignore better corporate practices.

(ii) The governance features such as quantity, quality and frequency of financial and managerial disclosure, the extent to which the board of directors exercise their fiduciary responsibilities towards shareholders, the quality of information that managements share with their boards and the commitment to run transparent companies that maximise long term shareholder value, cannot be legislated at any level of detail.

To survive international competition, the Indian companies have to attract low cost capital from across the globe. For this, the Indian companies have to gear themselves to meet the increasingly demanding standards of international disclosures and corporate governance.

The CII has pioneered the concept of corporate governance in India and has been internationally recognised as one of the best in the world. Corporate India has started recognising the pivotal role that disclosures play in creating corporate value in the increasingly market oriented environment.

When the CII adopted the Code of Corporate Governance from the recommendations of the Task Force, there was very little difference between the recommendations of the Task Force and the final outcome. These are as follows:

Recommendations of the CII'S Code of Corporate Governance

1. A single board, if it performs well, can maximise long-term shareholder value. The board should meet at least six times a year, preferably at intervals of 2 months.
2. A listed company with a turnover of ₹100 crores and above should have professionally competent and recognised independent non-executive directors who should constitute
   - At least 30 per cent of the board, if the chairman of the company is a non-executive director or
   - At least 50 per cent of the board, if the chairman and managing director is the same person.
3. A person should not hold directorships in more than 10 listed companies.
4. For the non-executive directors to play a significant role in corporate decision making and maximising long term shareholder value, they need to
   - become active participants in boards and not just passive advisors.
   - have clearly defined responsibilities within the board such as the audit committee, and

- know how to read a balance sheet, profit and loss account, cash flow statements and financial ratios and have some knowledge of various company laws. This, of course, excludes those who are invited to join boards as experts in other fields such as science and technology.

5. To secure better effort from the non-executive directors, companies should
   - pay a commission over and above the sitting fees for the use of the professional inputs. Commissions are rewards on current profits.
   - consider offering stock options, so as to relate rewards to performance. Stock options are rewards contingent upon future appreciation of corporate value.
6. While re-appointing the members of the board, companies should give the attendance record of the concerned directors. If a director has not been present (absent with or without leave) for 50 per cent or more meetings, then this should be explicitly stated in the resolution that is put to vote. One should not re-appoint any director who has not had the time to attend even 50 per cent of the meetings.
7. Key information that must be reported to, and placed before the board, must contain the following:
   - Annual operating plans and budgets, together with up-dated long term plans.
   - Capital budgets, manpower and overhead budgets.
   - Internal audit reports including cases of theft and dishonesty of a material nature.
   - Fatal or serious accidents, dangerous occurrence, and any effluent or pollution problems.
   - Default in payment of interest or non-payment of the principal on any public deposit and/or to any secured creditor or financial institution.
   - Defaults such as non-payments of the principal on any company or materially substantial non-payments for goods sold by the company.
   - Details of any joint venture or collaboration agreement.
   - Transactions that involve substantial payment towards goodwill, brand equity or intellectual property.
   - Recruitment and remuneration of senior officers just below the board level, including appointment or removal of the chief financial officer and the company secretary.
   - Labour problems and their proposed solutions.
   - Quarterly details of foreign exchange exposure and the steps taken by management to limit the risks of adverse exchange rate movement.
8. For all companies with a paid-up capital of ₹ 20 crores or more, the quality and quantity of disclosure that accompanies a GDR issue should be the norm for any domestic issue.
9. Under "Additional Shareholder's Information", listed companies should give data on the following:
   - High and low monthly averages of share prices in a major stock exchange where the company is listed for the reporting year.
   - Greater detail on business segments up to 10 per cent of turnover, giving share in sales revenue, review of operations, analysis of markets and future prospects.
10. Companies that default on the fixed deposits should not be permitted to accept further deposits and make inter-corporate loans or investments or declare dividends until the default is made good.
11. Major Indian stock exchanges should insist upon a compliance certificate, signed by the CEO and the CFO which should clearly state the following:
    - The company will continue in business in the course of the following year.
    - The accounting policies and principles conform to the standard practice.

- The management is responsible for the preparation, integrity and fair presentation of financial statements and other information contained in the annual report.
- The board has overseen the company's system of internal accounting and administrative controls either directly or through its audit committee.

SEBI's Initiatives

SEBI appointed a committee on corporate governance on 7 May 1999, with 18 members under the chairmanship of Kumar Mangalam Birla with a view to promoting and raising the standards of corporate governance. The Kumar Mangalam Birla Committee's Report is indeed a veritable landmark in the evolution of corporate governance in India.

The Securities and Exchange Board of India appointed a committee on corporate governance on 7 May 1999, with 18 members under the chairmanship of Kumar Mangalam Birla with a view to promoting and raising the standards of corporate governance. The committee's terms of reference were: (a) to suggest suitable amendments to the listing agreement (LA) executed by the stock exchanges with the companies and any other measures to improve the standards of corporate governance in the listed companies in areas such as continuous disclosure of material information, both financial and non-financial, manner and frequency of such disclosures, responsibilities of independent and outside directors (b) to draft a code of corporate best practices and (c) to suggest safeguards to be instituted within the companies to deal with insider information and insider trading.

The committee submitted its famous and oft-quoted report to SEBI in March 2000 after several sittings of debates and deliberations.[6] The Kumar Mangalam Birla Committee's Report is indeed a veritable landmark in the evolution of corporate governance in India.

The Kumar Mangalam Birla Committee, 1999

The Birla Committee's recommendations consist of both mandatory recommendations, and non-mandatory recommendations.

Mandatory Recommendations

1. **Applicability:** These are applicable to all listed companies with a paid-up share capital of ₹3 crore and above.
2. **Board of directors:** The board of directors of a company must have an optimum combination of executive and non-executive directors. The number of independent directors should be at least one-third in case the company has a non-executive chairman and at least half of the board in case the company has an executive chairman.

   Kumar Mangalam Birla Committee defines independent directors as directors who apart from receiving directors' remuneration do not have any material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the judgment of the board, may affect independent judgment of the directors.
3. **Audit committee:** A qualified and independent audit committee should be set up to enhance the credibility of the financial disclosures and to promote transparency.

   The audit committee should have a minimum of three members, all being non-executive directors with a majority being independent and at least one director having financial and accounting knowledge. In addition to this, the following stipulations will have to be met:
   - The company will continue business in the course of the following year.
   - The accounting policies and principles conform to standard practice.

- The management is responsible for the preparation, the integrity and fair presentation of financial statements and other information contained in the annual report. Besides, the chairman should be an independent director and must be present at the annual general meeting to answer shareholders' queries.

  The audit committee should invite such executives as it considers appropriate (and particularly the head of the finance function) in addition to the head of internal audit when required and a representative of the external auditor should be present as an invitee for the meetings of the committee.

  The audit committee should meet at least thrice a year with a gap of not more than 6 months with one meeting necessarily before the finalisation of annual accounts. The quorum should be either two members or one-third whichever is higher with a minimum of two independent directors.

  The audit committee specifically should function as the bridge between the board, the statutory auditors and internal auditors.

4. **Remuneration committee of the board:** The board of directors should decide the remuneration of non-executive directors.

   Full disclosure of the remuneration package of all the directors covering salary benefits, bonuses, stock options, pension-fixed component, performance-linked incentives along with the performance criteria, service contracts, notice period, severance fees etc., is to be made in the section on corporate governance of the annual report.

5. **Board procedures:** The board meeting should be held at least four times a year with a maximum time gap of four months between any two meetings. Minimum information on annual operating plans and capital budgets, quarterly results, minutes of meetings of audit committee and other committees, information on recruitment and remuneration of senior officers, significant labour problems, material default in financial obligations, statutory compliance etc. should be placed before the board.

   In order to ensure total commitment to the board meetings, a director should not be a member in more than ten committees and act as chairman of more than five committees across all companies in which he is a director.

6. **Management:** Management discussions and analysts' report covering industry structure, opportunities and threats, segment-wise or product-wise performance outlook, risks, internal control systems etc. are to form a part of directors' report or as an addition thereto.

   Besides, the management must make disclosure to the board relating to all material, financial and commercial transactions where they have personal interest that may have a potential conflict with the interest of the company.

7. **Shareholders:** In case of appointment of a new director or re-appointment of existing director, information containing a brief resume, nature of expertise in specific functional areas and companies in which the person holds directorship and committee membership, must be provided to the benefit of the shareholders.

   There is also a specific recommendation of sharing information of quarterly results presentation made by the company to analysts, through company's website.

   In addition, a board committee under the chairmanship of a non-executive director is to be formed to specifically look into the redressing of shareholder complaints of declared dividends etc.

   In order to expedite the process of share transfers, the board should delegate the power of share transfer to an officer or a committee or to the registrar and share transfer agents with a direction to the delegated authority to attend to share transfer formalities at least once in a fortnight.

8. **Manner of implementations:** A separate section on corporate governance in the annual reports is to be introduced covering a brief statement on company's philosophy on code of governance, board of directors, audit committee, remuneration committee, shareholders' committee, general body meeting, disclosures etc. Non-compliance of any of the mandatory recommendations with reasons thereof and the extent of adoption of non-mandatory recommendations should be highlighted to enable the shareholders and securities market to assess for themselves the standards of corporate governance followed by the company.

Non-mandatory Recommendations

1. **Chairman of the board:** The chairman's role should in principle be different from that of the chief executive, though the same executive can perform both the roles.

   In view of the importance of the chairman's role, the committee recommended that a non-executive chairman should be entitled to maintain a chairman's office at the company's expense and also allowed reimbursement of expenses incurred in the performance of his duties, to enable him to discharge his responsibilities effectively.

2. **Remuneration committee:** A company must have a credible and transparent policy in determining and accounting for the remuneration of the directors. The remuneration package should be good enough to attract, retain and motivate the executive directors of the quality required.

   The board of directors should set up a remuneration committee to determine on their behalf and on behalf of the shareholders with agreed terms of reference, the company's policy on specific remuneration packages for executive directors including pension rights and any other compensation payment.

   The committee should comprise at least three directors all of whom should be non-executive directors, the chairman being an independent director. All the members must be present at the meeting for the purpose of quorum as it is not necessary for the meeting to be held very often. The chairman should be present at the annual general meeting to answer the shareholders' queries.

3. **Shareholders' rights:** Half-yearly declaration of financial performance including summary of the significant events in 6 months should be sent to each of the shareholders.

4. **Postal ballot:** Although the formality of holding the general meeting is gone through in actual practice, only a small fraction of the shareholders of a company do or can really participate therein. This virtually makes the concept of corporate democracy illusory. It is imperative that this situation, which has lasted too long, needs an early correction. In this context, for shareholders who are unable to attend the meeting, there should be a requirement, which will enable them to vote by postal ballot on key issues. Some of the critical matters, which should be decided by postal ballot, are the following:
   - Matters relating to alteration in the Memorandum of Association of the company such as changes in name, objects, address of registered office etc.
   - Sale of whole or substantially the whole of the undertaking.
   - Sale of investments in the companies, where the shareholding or the voting rights of the company exceeds 25 per cent.
   - Making a further issue of shares through preferential allotment or private placement basis.
   - Corporate restructuring.
   - Entering a new business area not germane to the existing business of the company.
   - Variation in rights attached to class of securities.
   - Matters relating to change in management.

There are many corporate governance structures available in the developed world, but all of them have their merits as well as defects. There is no "One Size Fits All" structure for corporate governance. The committee's recommendations, therefore, are not based on any one model, but are designed for the Indian environment. The Birla Committee believed that its recommendations would go a long way in raising the standards of corporate governance in Indian firms and make them attractive destinations for local and global investments. These recommendations could also form the base for further evolution of the structure of corporate governance in consonance with the rapidly changing economic and industrial environment of the country.

SEBI's Response

SEBI considered and adopted in its meeting held on 25 January 2000, the recommendations of the committee on corporate governance appointed by it under the chairmanship of Kumar Mangalam Birla.

In accordance with the guidelines provided by the SEBI, the stock exchanges in India have modified the listing requirements by incorporating in them a new clause (Clause 49), so that proper disclosure for ensuring corporate governance is made by the companies in the following areas:

SEBI considered and adopted in its meeting held on 25 January 2000, the recommendations of the Kumar Mangalam Birla Committee on corporate governance appointed by it. In accordance with the guidelines provided by SEBI, the stock exchanges in India have modified the listing requirements by incorporating in them a new clause (Clause 49), so that proper disclosure for ensuring corporate governance is made by companies.

- Board of directors
- Audit committee
- Remuneration of directors
- Board procedure
- Management
- Shareholders
- Report on corporate governance
- Compliance certificate from auditors.

The above amendments to the listing agreement were to be implemented in a time-bound manner and to be completed by all entities seeking listing for the first time at the time of listing.

SEBI's Code of Corporate Governance requires that the following information be placed by a company before the board of directors periodically:

- Annual operating plans and budgets and any updates thereon.
- Capital budgets and any updates thereon.
- Quarterly results for the company and its operating divisions or business segments.
- Minutes of audit committee meetings.
- Information on recruitment and remuneration of senior officers just below the board level.
- Material communications from government bodies.
- Fatal or serious accidents, dangerous occurrences, or any material effluent pollution problems.
- Details of any joint venture or collaboration agreement.
- Labour relations.
- Material transactions which are not in the ordinary course of business.
- Disclosures by the management on material transactions, if any, with potential for conflict of interest.
- Quarterly details of foreign exchange exposures and risk management strategies.
- Compliance with all regulatory and statutory requirements.

A separate section on corporate governance in the annual reports should be introduced covering a brief statement on the company philosophy on code

of governance, board of directors, audit committee, remuneration committee, shareholders' committee, general body meeting, disclosures, means of communication and general shareholders information. In addition, companies have been asked to adopt non-mandatory requirements relating to the chairman of the board, remuneration committee, shareholders' rights and postal ballot.

Non-compliance of any of the mandatory recommendations, which is part of the listing agreement with reasons thereof, and the extent to which the non-mandatory requirements have been adopted, are to be specifically highlighted.

The Naresh Chandra Committee Report, 2002

While the SEBI was making efforts to introduce corporate governance standards among Indian corporates, the Department of Company Affairs took another initiative in this direction.

The Naresh Chandra Committee was appointed as a high-level committee to examine various corporate governance issues by the Department of Company Affairs on 21 August 2002. Naresh Chandra Committee report on 'Corporate Audit & Governance' has taken forward the recommendations of the Kumar Mangalam Birla Committee on corporate governance which was set up by the Securities and Exchange Board of India.

The Naresh Chandra Committee was appointed as a high level committee to examine various corporate governance issues by the Department of Company Affairs on 21 August, 2002. The committee's recommendations mainly concerned: (i) the auditor–company relationship, (ii) disqualifications for audit assignments, (iii) list of prohibited non-audit services, (iv) independence standards for consulting, (v) compulsory audit partner rotation, (vi) auditor's disclosure of contingent liabilities, (vii) auditor's disclosure of qualifications and consequent action, (viii) managements' certification in the event of auditor's replacement, (ix) auditor's annual certification of independence, (x) appointment of auditors, (xi) certification of annual audited accounts by the CEO and the CFO, (xii) auditing the auditors, (xiii) setting up of the independent quality review board (xiv) proposed disciplinary mechanism for auditors (xv) independent directors (xvi) audit committee charter, (xvii) exempting non-executive directors from certain liabilities, (xvii) training of independent directors (xix) establishment of corporate serious fraud office, (xx) the SEBI and subordinate legislation, and so on. Naresh Chandra Committee report on 'Corporate Audit & Governance' has taken forward the recommendations of the Kumar Mangalam Brila Committee on corporate governance which was set up by the Securities and Exchange Board of India (SEBI) on the following two counts:

- Representation of independent directors on a company's board.
- The composition of the audit committee.

The Naresh Chandra Committee has made no distinction between a board with an executive chairman and that with a non-executive chairman. It has recommended that all boards need to have at least half of its members as independent directors. As regards the audit committee, the Kumar Mangalam Birla Committee had said that it should have non-executive directors as its members with at least two independent directors, but the Naresh Chandra Committee has recommended that all audit committee members should be independent directors.

The Naresh Chandra Committee has laid down stringent guidelines defining the relationship between auditors and their clients. In a move that could impact small audit firms, the committee has recommended that along with its subsidiary, associates or affiliated entities, an audit firm should not derive more than 25 per cent of its business from a single corporate client. This committee opined that it would improve the independence of audit firms. While turning down the proposal for a compulsory rotation of audit firms, the committee stressed that the partners and at least 50 per cent of the audit team working on the accounts of a company, need to be rotated by the audit firm once every 5 years.

While the Committee has said that it has no objection to an audit firm having subsidiaries or associate companies engaged in consulting or other specialised businesses, it has drawn up a list of prohibited non-audit services. It has said that nominees of institutions (FIs) cannot be counted as independent directors.

The Committee has further recommended the following:

(a) The auditors should be asked to make an array of disclosures.
(b) Calling upon the CEOs and the CFOs of all listed companies to certify their companies' annual accounts, besides suggesting.
(c) Setting up of quality review boards by the Institute of Chartered Accountants of India (ICAI), Institute of Company Secretaries of India and the Institute of Cost and Works Accountants of India, instead of a Public Oversight Board similar to the one in the United States.

At a time when people are shy of accepting the post of an independent director in a company because of the liabilities that might follow, the Naresh Chandra Committee has come up with recommendations that will help remove their fears. To attract quality independent directors on the board of directors of a company, the committee has recommended that these directors should be exempt from criminal and civil liabilities under the Companies Act, the Negotiable Instruments Act, the Provident Fund Act, the ESIS Act, the Factories Act, the Industrial Disputes Act and the Electricity Supply Act. However, unlisted public companies that do not have more than 50 shareholders and carry no debt from the public, banks or financial institutions and unlisted subsidiaries of listed companies have been exempted from these recommendations.

SEBI's Follow-up on Birla Committee Report

In the wake of the SEBI's instruction to the companies that they should comply with the Birla Committee's recommendations in the manner dictated by the market regulator, compliance reports on corporate governance received in respect of 1,026 and 595 listed companies, for the Mumbai and National Stock Exchanges respectively, showed some progress in that direction. On the basis of the analysis from the data submitted by them, the SEBI observed that the compliance with the requirements in Clause 49 of the Listing Agreement is by and large satisfactory. However, an analysis of the financial statements of companies and the reports on corporate governance disclosed that their quality was not uniform. The SEBI also observed that there was a considerable variance in the extent and quality of disclosures made by companies in their annual reports.

Rationale for a Review of the Birla Code

In the perception of the SEBI, there was a need to appoint a committee as a follow-up of the Birla Committee's report and the experience gained from the analysis of compliance reports. The SEBI then believed that there should be on-going efforts to build up on the corporate governance structure already put in place. This is because governance standards are themselves evolving in keeping with the market dynamics. Recent developments worldwide, especially in the US, have renewed the emphasis on corporate governance. These developments have highlighted once again the need for ethical governance and management and for looking beyond mere systems and procedures. Further attempts were called for in the perception of the SEBI, to ensure compliance with corporate governance codes both in the letter and spirit. Another loophole in the existing governance standards was the lack of investor's protection. The SEBI wanted to strengthen the means through which the individual investor could be protected.

The SEBI, therefore, set out to form another committee with the twin perspectives: to evaluate the adequacy of the existing practices, and to further improve them. This committee on corporate governance was constituted under the chairmanship of N. R. Narayana Murthy, the Chairman and the Chief Mentor

of Infosys Technologies Ltd., and comprised representatives from stock exchanges, chambers of commerce, investors' associations and professional bodies.

The Narayana Murthy Committee Report, 2003

Under the committee on corporate governance set up by SEBI under N. R. Narayana Murthy, the terms of reference were (i) to review the performance of corporate governance and (ii) to determine the role of companies in responding to rumour and other price-sensitive information circulating in the market in order to enhance the transparency and integrity of the market.

The Committee on Corporate Governance, headed by Shri Narayanamurthy was constituted by SEBI, in 2003 to evaluate the existing corporate governance practices and to improve these practices as the standards themselves were evolving with the market dynamics. After the Birla committee report (1999), the SEBI has introduced a comprehensive code of corporate governance incorporating most of the recommendations of Birla committee report by amending the clause 49 of the listing rules and appropriate sections in the companies act in 1999. A review of the implementation of various provisions, revealed that a majority of the companies has implemented a number of mandatory recommendations such as board composition, board procedure, audit committee, etc. In order to review it comprehensively and improve it, the SEBI thought of the need of constituting another committee on corporate governance consisting of representatives from the stock exchanges, chambers of commerce, investor associations and Professional bodies and constituted it under the Chairmanship of Shri N. R. Narayanamurthy, the Chairman and Chief Mentor of Infosys Technologies Limited.

The terms of reference to the committee were (1) to review the performance of corporate governance and (2) to determine the role of companies in responding to rumour and other price sensitive information circulating in the market, in order to enhance the transparency and the integrity of the market.

C.G. Philosophy of the Committee

The committee recognized the fact a corporation is an integration of various stakeholders, such as customers, employees, investors, vendor partners, government and society, and capital is flowing from various persons staying in different parts of the world. Hence, it is essential that the business must be conducted ethically and be governed in a fair and transparent manner protecting the interest of all stakeholders. It is a key element in improving economic efficiency of the firm. Further the committee views corporate governance not in a strict legal point of view but from the point of view of mind set and culture of the management. The committee is of the view that good corporate governance brings credibility to the company and investors attach superior value and vice versa for bad governance. Again the committee emphasizes that one of the goals of good corporate governance is investor protection.

Approach

The approach of the Committee was that the regulations are made not for regulations but for its effective implementation and achieving the goal. Hence, the Committee felt that regulators' should clearly define regulations and be able to effectively enforce it. It should be as few as possible and the role of the regulator should primarily be that of a catalyst in enforcement. The deliberations were focused primarily on issues related to audit committees, audit reports, independent directors, related parties, risk management, directorships and director compensation, codes of conduct and financial disclosures. Suggestions were invited from all stakeholders and each suggestion was evaluated on the basis of seven parameters such as:

Importance – *How important is the recommendation to the member?*

Fairness – *Does the recommendation enhance fairness to all stakeholders, by minimizing asymmetry of benefits?*

Accountability –*Does the recommendation make corporate management more accountable?*

Transparency – *Does the recommendation enhance transparency?*

Ease of implementation – *Is the recommendation easy to implement?*

Verification – *Is the recommendation objectively verifiable?*

Enforcement – *Can the recommendation be effectively enforced?*

Mandatory Recommendations

Audit committee:

1. Audit committees of publicly listed companies should be required to review the following information mandatorily. (1) Financial statements and draft audit report, including quarterly/half-yearly financial information; (2) Management discussion and analysis of financial condition and results of operations; (3) Reports relating to compliance with laws and to risk management; (4) Management letters/letters of internal control weaknesses issued by statutory/internal auditors; (5) Records of related party transactions.
2. All audit committee members should be 'financially literate' and at least one member should have accounting or related financial management expertise. The term 'financially literate' means the ability to read and understand basic financial statements, i.e., balance sheet, profit and loss account and statement of cash flows**.**

Audit report and audit qualification:

3. In case a company has followed a treatment different from that prescribed in an accounting standard, the management should justify why they believe such alternative treatment is more representative of the underlying business transaction. Management should also clearly explain the alternative accounting treatment.

Related party transactions:

4. A statement of all transactions with related parties including their bases should be placed before the independent audit committee for formal approval/ ratification. If any transaction is not on an arm's length basis, the management should provide an explanation to the audit committee justifying the same. The term 'related party' shall have the same meaning as contained in Accounting Standard 18, Related Party Transactions issued by the Institute of Chartered Accountants of India.

Risk Management:

5. There must be a mechanism to inform the Board members about the risk assessment and the minimization procedures. These procedures should be periodically reviewed to ensure that the executive management controls risk through means of a properly defined framework. Management should place a report before the entire board of directors every quarter documenting the business risks faced by the company, measures to address and minimize such risks and any limitations to the risk taking capacity of the corporation. This document should be formally approved by the board.

Proceeds from IPO:

6. Companies raising money through an Initial Public Offering ('IPO') should disclose to the Audit Committee, the uses/applications of funds by major category (capital expenditure, sales and marketing, working capital, etc.), on a quarterly basis. On an annual basis, the company shall prepare a statement of funds utilized for purposes other than those stated in the offer document/

prospectus. This statement should be certified by the independent auditors of the company. The audit committee should make appropriate recommendations to the Board to take up steps in this matter.

Code of conduct:

7. It should be obligatory for the Board of a company to lay down the code of conduct for all board members and senior management of a company. This code of conduct shall be posted on the website of the company. All board members and senior management personnel shall affirm compliance with the code on an annual basis. The annual report of the company shall contain a declaration to this effect signed off by the CEO and the COO.

Exclusion of nominee director from the definition of independent director:

8. As far as possible there shall be no nominee director. Where an institution wishes to appoint a director on the Board, such appointment should be made by the shareholders. An institutional director, so appointed, shall have the same responsibilities and shall be subject to the same liabilities as any other director. Nominee of the government on public sector companies shall be similarly elected and shall be subject to the same responsibilities and liabilities as other directors.

Limits on compensation paid to independent directors:

9. All compensation paid to non-executive directors may be fixed by the board of directors and should be approved by shareholders in general meeting. Limits should be set for the maximum number of stock options that can be granted to the non-executive directors in any financial year and in aggregate. The stock options granted to the non-executive directors shall vest after a period of at least one year from the date such non-executive directors have retired from the Board of the Company. Companies should publish their compensation philosophy and statement of entitled compensation in respect of non-executive directors in their annual report. Alternatively, this may be put up on the company's website and reference drawn thereto in the annual report. Companies should disclose on an annual basis, details of shares held by non-executive directors, including on an 'if-converted' basis. Non-executive directors should be required to disclose their stock holding (both own or held by/for other persons on a beneficial basis) in the listed company in which they are proposed to be appointed as directors, prior to their appointment. These details should accompany their notice of appointment.

Internal policy on access to audit committee:

10. Personnel who observe an unethical or improper practice (not necessarily a violation of law) should be able to approach the audit committee without necessarily informing their supervisors. Companies shall take measures to ensure that this right of access is communicated to all employees through means of internal circulars, etc. The employment and other personnel policies of the company shall contain provisions protecting 'whistle blowers' from unfair termination and other unfair prejudicial employment practices.

Whistle blowing policy:

11. Companies shall annually affirm that they have not denied any personnel access to the audit committee of the company (in respect of matters involving alleged misconduct) and that they have provided protection to 'whistle blowers' from unfair termination and other unfair or prejudicial employment practices. The appointment, removal and terms of remuneration of the chief

internal auditor must be subject to review by the Audit Committee. Such an affirmation shall form a part of the Board report on Corporate Governance that is required to be prepared and submitted together with the annual report.

Extension of provisions relating to the non-executive director, the independent director and the audit committee to subsidiary companies:

12. The provisions relating to the composition of the Board of Directors of the holding company should be made applicable to the composition of the Board of Directors of subsidiary companies. At least one independent director on the Board of Directors of the parent company shall be a director on the Board of Directors of the subsidiary company. The Audit Committee of the parent company shall also review the financial statements, in particular the investments made by the subsidiary company. The minutes of the Board meetings of the subsidiary company shall be placed for review at the Board meeting of the parent company. The Board report of the parent company should state that they have reviewed the affairs of the subsidiary company also.

Disclosure in reports issued by security analyst:

13. The SEBI should make rules for the disclosure in the report issued by a security analyst whether the company that is being written about is a client of the analyst's employer or an associate of the analyst's employer, and the nature of services rendered to such company, if any; and disclosure in the report issued by a security analyst whether the analyst or the analyst's employer or an associate of the analyst's employer hold or held (in the 12 months immediately preceding the date of the report) or intend to hold any debt or equity instrument in the issuer company that is the subject matter of the report of the analyst.

In addition to the above, the committee also recommended making it mandatory the following recommendations made by the Naresh Chandra Committee report:

14. Disclosure of Contingent Liabilities.
15. Certification by the CEO (either the Executive Chairman or the Managing Director) and the CFO (whole-time Finance Director or other person discharging this function) which should state that, to the best of their knowledge and belief.
16. Independence of Audit Committee.
17. All audit committee members shall be non-executive directors.

Dr. J. J. Irani Committee Report on Company Law, 2005

The Government of India constituted an expert committee on company law on 2 December 2004 under the chairmanship of Dr. J. J. Irani to make recommendations on (i) responses received from various stakeholders on the concept paper; (ii) issues arising from the revision of the Companies Act, 1956; (iii) bringing about compactness by reducing the size of the Act and removing redundant provisions; (iv) enabling easy and unambiguous interpretation by recasting the provisions of the law; (v) providing greater flexibility in rule making to enable timely response to ever-evolving business models; (vi) protecting the interests of the stakeholders and investors, including small investors; and (vii) any other issue related, or incidental, to the above.

The Government of India constituted an expert committee on Company Law on 2 December 2004, under the chairmanship of Dr. J. J. Irani. Set up to structurally evaluate the views of several stakeholders in the development of company law in India in respect of the concept paper promulgated by the Union Ministry of Company Affairs, the J. J. Irani Committee has come out with suggestions that will go a long way in laying sound base for corporate growth in the coming years.

Set up to structurally evaluate the views of several stakeholders in the development of company law in India in respect of the concept paper promulgated by the Union Ministry of Company Affairs, the J. J. Irani Committee has come out with suggestions that will go far in laying sound base for corporate growth in the coming years.[7] There has been a movement for some years now in many countries to create better frameworks of corporate governance. This has happened along with a trend towards global alignment of laws governing companies. Drawing from developments in countries such as the UK, Australia, New Zealand and Canada, the Irani Committee report has made suggestions to reform and update the basic corporate legal framework essential for sustainable economic reform.

The expert committee comprised experts drawn from trade and industry associations, professional bodies and institutes, chambers of commerce, leading senior advocates and auditors. Representatives of government departments, regulatory bodies and other organisations were included as special invitees. The committee deliberated on various issues on company law requiring a review on the basis of comments and suggestions received in response to the concept paper, opinions expressed by experts, professional bodies etc. The committee submitted its report to the Government of India on 31 May 2004.

The committee's report is a balanced and well-rounded document and attempts to equate the pulls and pressures of modern business and those of shareholder democracy. It is a step toward providing a growth-oriented modern company law, with the thrust on stakeholder democracy and self-regulation. The report has taken a pragmatic approach keeping in view the ground realities, and has sought to address the concerns of all the stakeholders to enable the adoption of internationally accepted best practices.

Independent Directors in Listed Companies

The SEBI had in the revised Clause 49 of the Listing Agreement mandated that at least 50 per cent of the board of a listed company comprise independent directors. The capital market regulator has made it clear that the corporate India should comply with revised Clause 49 by 31 December 2005.

Taking a position that is at variance with that of the Securities and Exchange Board of India, the J. J. Irani Committee has recommended that one-third of the board of a listed company should comprise independent directors.

Pyramidal Structures

The committee has also suggested that corporates should be allowed to maintain pyramidal corporate structures, that is, a company which is a subsidiary of a holding company could itself be a holding company. "We suggest that pyramidal structures should be allowed because it is in the interest of corporate sector, especially when many companies are making acquisitions abroad. Although the committee started its deliberations under the presumption that only one layer should be allowed, we later decided against it," Dr. Irani commented.

Power to Shareholders

The main thrust of the committee's recommendations were to give full liberty to the shareholders and the owners of the company to operate in a transparent manner. The committee calls for a significant shift from a government approval regime to a "shareholder approval and disclosures" regime. The report thus gives more power to the shareholders, allowing them rather than the company law administration to decide on certain crucial matters. Mergers between willing companies will be quicker. They will not be subject to the vagaries of the legal

system any more. Ratification by the shareholders will be enough. To protect the rights of minority shareholders and also to ensure investor protection, the committee has aptly suggested that the new company law should recognise principles such as 'class actions' and 'derivative action'.

The capital market got plenty of attention from the committee. There are proposals to devise an exit option for shareholders who have stayed with a company and not participated in a buy back scheme implemented earlier.

Single Person Company

The committee has also mooted the concept of single-person company. Introducing the concept of One Person Company (OPC) as against the current stipulation of at least two persons to form a company, the Committee has pitched for entrepreneurship in individuals. "The whole idea is that if there is an entrepreneur who wants to form his own company, he should not be bound down by company law to find other partners," according to Dr. Irani.

Self-regulation

One distinctive approach of the Committee was to allow corporates to self-regulate their affairs. This is a much-needed orientation for corporate growth in an overall policy regime being provided by the government.

Stringent Penalties

In order to strengthen the deterrent provisions in the present framework, the report has mandated the publication of information relating to convictions for criminal breaches of the Companies Act on the part of the company or its officers in the annual report. The suggestions to provide stringent penalties will certainly help the regulator to curb fraudulent behaviour of companies.

Accounts and Audits

According to the Committee, "Proper and accurate compilation of financial information of a corporate and its disclosure in a manner that is standardised and understood by stakeholders is central to the credibility of the corporates and soundness of investment decisions by the investors. The preparation of financial information and its audit, therefore, needs to be regulated through law with stringent penalties for non-observance". The Committee took note of the contributions made by the Institute of Charatered Accountants of India and the National Advisory Committee on Accounting Standards and favoured the continuance of the existing institutional mechanism for formulating and notifying Accounting Standards.

Governance Standards

Those who believed that the Irani Committee would make corporate law and governance standards less stringent point to its advocacy of a smaller number of independent directors (just one-third of a company's board) compared to the much higher proportion (one half specified by the Securities and Exchange Board of India) under Clause 49 of the listing agreement.

There are other points of difference too between the committee and the SEBI. But it is not correct to look at an expert committee's report purely from the points of its departure from current developments in those areas.

It is too early to interpret the Irani committee, but its thrust is reminiscent of attempts in the US and elsewhere to tone down the rigours of the emerging law. At the same time, it is hoped that the Committee's report would give a new thrust and fresh perspective to the government on company law.

Uday Kotak Report on Corporate Governance 2017

The 25 member committee comprising of bureaucrats, executives, lawyers and academics, was set up in June 2017 by SEBI under the chairmanship of Mr. Uday Kotak for studying the problems of corporate governance and improving the governance practices of corporate India, ensuring higher degree disclosure of related party transactions, improving effectiveness of board evaluation practices etc. The following were the terms of references of the committee.[8]

Terms of Reference of the Committee

SEBI on June 2017 set up a committee under the chairmanship of Mr. Uday Kotak for studying the problems of corporate governance and improving the governance practices of corporate India, ensuring higher degree disclosure of related party transactions, improving of board evaluation practices, etc.

1. Ensuring independence in the spirit of Independent Directors and their active participation in functioning of the company.
2. Improving safeguards and disclosures pertaining to related party transactions.
3. Issues in accounting and auditing practices by listed companies.
4. Improving effectiveness of board evaluation practices.
5. Addressing issues faced by investors on voting and participation in general meetings.
6. Disclosure and transparency related issues, if any.
7. Any other matter, as the Committee deems fit pertaining to corporate governance in India.

The Uday Kotak-led SEBI committee on corporate governance submitted its report to the regulator(SEBI) on 5 October 2017, recommending a member of changes in corporate governance norms. They are mainly grouped into 10 broad categories, namely

1. **Composition and role of board of directors:** In the first chapter of the report specific recommendations relating to minimum number of board of directors, gender diversity of the board, attendance of directors, disclosure of expertise/ skills of directors, minimum number of board meetings, updating of knowledge of board members, quorum of board of directors meetings, separation of the role of non-executive chairman with managing director, maximum number of directorship, matrix reporting structure, and disclosure of board evaluation are given.
2. **Institution of independent directors:** The independent directors always have a problem in the corporate governance all over the world. This aspect is discussed in chapter two of the report specifying the minimum number of independent directors, eligibility criteria for independent directors, minimum compensation of independent directors, disclosure of resignation of independent directors, directors and officers insurance for independent directors, induction and training of independent directors, alternative directors for independent directors, exclusive meetings of independent directors, filling of casual vacancy of independent directors, etc.
3. **Board committee:** The role of audit committee, minimum number of committee meetings, composition of nomination and remuneration committee, their role, composition and role of stake holders relationship committee, quorum for committee meetings, role of risk management and IT committee are discussed under this head.
4. **Enhanced monitoring of group entities:** The obligation of board of directors of listed entities with respective subsidiaries, group companies and secretarial audit are specified in Chapter 8.

5. **Related party transactions:** Promoter shareholders and related party transactions has always been a major issue in the corporate governance sector. Such issues like sharing of information with controlling shareholders, with nominee directors, disclosure of related party transactions, approval of related party transactions, royalty or brand payment to related parties remuneration to non-executive directors and materiality policy are specified in Chapter 8.
6. **Disclosure and transparency:** The corporate policy relating to submission of annual reports, disclosure of credit ratings, harmonization of disclosure, format for disclosure, disclosure related to institutional investors/analysts meetings, disclosure relating to changes in key financial indicators, utilization of proceeds from preferential issues, disclosure in websites, disclosure of long term and medium term strategy, views of committees not accepted by BOD, and risk disclosure are specified.
7. **Accounting and audited related issues:** Corporate governance issues like auditors' qualifications, independent external opinion of auditors, group audit, audit quality indicators, disclosure of resignation of directors and the reason as specified, IND As adoption and disclosure of credentials and audit fee of auditors are recommended in Chapter 8.
8. **Investor participation in meetings of listed entities:** Recommendations relating to E-voting, web casting of the minutes of the meetings of BOD, general body, stewardship code, etc., are also given by the committee.
9. **Public sector corporate governance:** With regards to public sector undertakings the committee acknowledged that the PSUs face unique challenges that make their governance more complex than in the private sector, given that (i) most PSEs pursue multiple and diverse objectives in line with their broader social welfare objectives (unlike private enterprises which may focus on value maximization for their shareholders); (ii) the PSUs may also have certain structural issues arising due to conflicts of interest that are inherent in cases where the same entity is both the owner and regulator; (iii) protracted decision making in the PSUs owing to accountability at multiple levels. Nonetheless, there is a need for moving to enhanced governance standards. Hence the committee recommended that the above key guiding principles must be kept in mind for such assessment on this subject.
10. **Leniency mechanism:** This refers to the right of the central government on the basis of the SEBI recommendation to give immunity for prosecution and imposing penalty for violation of the provisions of the SEBI Act and the Security Contract Act. At present the SEBI has no power to grant leniency by way of reduction/waiver of penalty and prosecution of whistleblower who violate the relevant laws. In these aspects, the committee has also made specific recommendations enhancing the power of the regulator.

Listed below are some of the major recommendations made by the committee.

1. **Chairman of the board cannot be the MD or the CEO of a company:** The chairman of the board cannot play eithers of the roles as an MD or CEO of the company. In fact, this situation will impact a lot of companies who have the same person holding the posts of both Chairman and MD. The companies having a CMD or Chairman and CEO will now have to chose between retaining the person in either role and finding another to fill the vacancy. Industry experts have suggested that companies might opt to appoint a non-executive chairman and retain the incumbent chairman as the MD or the CEO. To be sure, a person cannot be Chairman and MD or CEO at the same time. He/she could, however, be MD and the CEO at the same time without being Chairman. Listed companies with more than 40% public shareholding should separate the roles of chairperson and the MD or the CEO from 1 April 2020, said the committee. Sebi may consider extending the requirement to all listed entities by 1 April 2022.

2. **Board of directors to have at least one woman independent director:** This suggestion is in addition to the existing requirement of having at least one woman director on the board. This suggestion insists that from among the independent directors one women director must be selected.
3. **Board of directors to have a minimum of six directors:** The board of directors of a company must have at least six directors. It is actually double the previous requirement of having at least three directors on the board of a public company.
4. **Independent directors to make up 50 per cent of the board:** At least half of the directors on the board will have to be independent directors to ensure better governance. The panel has recommended a minimum remuneration of ₹5 lakh per year for independent directors and a sitting fee of ₹20,000 to ₹50,000 for each board meeting. It has also recommended that for the top 500 companies by market capitalisation, it should be compulsory to undertake Directors and Officers Insurance for their independent directors.
5. **Audit committee to review use of loans or investment of more than ₹100 crore by a holding company in a subsidiary:** The audit committee of any parent or holding company that has invested or lent ₹100 crore or more to a subsidiary will be responsible to review the use of those funds by the subsidiary. This is to ensure more transparency on the use of funds and to keep an eye on any round-tripping of funds.
6. **SEBI to penalize auditors if any lapses are found:** The SEBI will have the right to pull up auditors for any lapses in corporate governance norms and penalize them for the same. This will ensure diligent auditing of company processes and funds.
7. **Directorship in listed entities to be limited to 8 per person:** A director in a listed company can be a director on the board for only 7 other companies. In addition to these, the committee also recommended that a formal induction be made compulsory for every new independent director on the board, and that no person be appointed as an alternate director for an independent director of a listed company. The number of board meetings a year shall be increased from one in every quarter to five in a year.
8. The committee proposed stricter rules and disclosures for related party transactions. ‚All material related party transactions shall require approval of the shareholders through resolution and no related parties shall vote to approve such resolutions whether the entity is a related party to the particular transaction or not,' Further, the committee also recommends that, ‚All entities falling under the definition of related parties shall not vote to approve the relevant transaction irrespective of whether the entity is a party or not.'
9. **Minimum remuneration:** The Independent directors must get minimum remuneration of ₹5 lakh per annum and sitting fee of ₹20,000–50,000 for each board meeting. It should be mandatory for firms to seek the public shareholders' approval for annual remuneration of the executive directors from promoter family if the amount is ₹5 crore or 2.5% of the firm's net profit. In case of more than one such director, the same condition should apply for aggregate annual remuneration exceeding 5% of the net profit. The approval of the shareholders must be required every year in which annual remuneration payable to single non-executive director exceeds 50% of total remuneration payable to all non-executive directors.
10. **Risk management and IT committee:** The top 500 listed companies should have risk management committee of boards for cyber security. In addition to this, the listed entity must constitute an information technology committee that will focus on digital technology.

11. Regarding public sector governance the committee suggested (a) the need for establishing a transparent mandate for PSUs and disclose its objectives and obligations. The government, as owner, must set clear objectives and mandates for the PSUs and where there are non-commercial objectives, these should be clearly articulated, quantified and transparently disclosed to the shareholders on a regular basis so that the investors can take informed investment decisions. (b) The government should aim at ensuring independence of the PSUs from the administrative ministry to ensure speedy decision making, functional and operational autonomy in pursuit of their stated objectives, for better commercial goals and to attract talent in a competitive market place and (c) Consolidate the Government stake in the listed PSUs under holding entity structure(s). As a sustainable and optimal solution for minimizing conflicts arising from the ownership and regulatory dichotomy in PSUs, the government should consider consolidating its ownership and monitoring of PSUs into independent holding entity structure(s) by 1 April 2020. An independent board with diversified skill set of the holding entity(s) would also facilitate operationalizing a consistent and high quality process on significant issues such as strategy, performance monitoring, mergers and acquisitions, and recruitment of best talent.

    The Committee recommends that the listed PSUs fully comply with the provisions of the SEBI regulations and the same be suitably enforced. Additionally, the government should assess and examine the broader issues such as concerning ownership structure for the government stake, removal of conflicts and creating a more autonomous environment for PSU'S to function in the best interest of all stakeholders.
12. In contrast to leniency mechanism, the Kotak committee recommends that SEBI must be empowered to give lenient treatment and protection against victimization for persons who come forward and disclose in violation or infringement of any law. It is also recommended that the whistleblower must be given adequate protection for the disclosure. Literally, it is very important to recall in the context of the killing of Daphne Caruana Galizia, a journalist, who acted as a whistleblower in the Panama Paper scandal in a car bomb explosion in Malta.
13. Companies should disclose and update all ratings.
14. Public sector companies to be governed by listing requirements.
15. Creation of a formal channel for sharing information with promoters
16. Mandate minimum qualification to independent directors and disclose their relevant skills.
17. Disclose medium and long term strategies in annual reports.

Apart from making these recommendations to the SEBI, the Uday Kotak-led panel also said that the regulator is level understaffed and recommended increasing employee capacity at the regulator to ensure better governance and enforcement of the norms. The committee also recommended imposing more checks and balances on royalty and brand payments, related party transactions and sharing of information between the company management and entities that are not a part of the board, and the creation of an independent shareholding structure for listed public sector undertakings so as to reduce their dependency on administrative ministries.

The creation of a formal channel to facilitate the sharing of information between promoters and the company, disclosure of all rating actions by companies, and mandating a minimum qualification for the independent directors were some of the other recommendations made by the committee.[9]

CONCLUSION

The foregoing analysis of the emergence of corporate governance traces the chequered history through which governance issues have been highlighted, shaped and refined, and the long road it has to traverse to acquire some degree of perfection. The worldwide movement for better corporate governance practices progressed between 1985 and 1997. The harbinger of the initiatives in this direction was the oft-quoted Cadbury Committee Report in the United Kingdom in 1992. Such initiatives being few and far between, most companies, be they global or Indian, knew little of what the phrase "corporate governance" meant and cared even less for its implications. More recently, the first major stimulus for corporate governance reforms came after the Southeast Asian crisis of 1997–98 followed by the Enron debacle of 2001, which brought home the necessity of ensuring better corporate governance practices, culminating in the enactment of the hard-hitting Sarbanes–Oxley Act of 2002 in the United States.

Although India has been fortunate in not having to go through the massive corporate failures such as Enron and Worldcom, it has not been wanting in its resolve to incorporate better governance practices in the country's corporates emulating stringent international standards. Surprisingly, the initial drive for better corporate governance and disclosure—perhaps as a result of the 1992 stock market scam and the fast emerging international competition consequent on the liberalisation of the economy that began in 1991—came from the Confederation of Indian Industry and the Department of Corporate Affairs. Various committees were constituted that recommended stringent guidelines for corporate governance, most of which have been accepted by the government and the market regulator. However, as the Naresh Chandra Committee on corporate audit and governance pointed out: "There is scope for improvement. For one, while India may have excellent rules and regulations, regulatory authorities are inadequately staffed and lack sufficient number of skilled people. This has led to less than credible enforcement. Delays in courts compound the problem. For another, India has had its fair share of corporate scams and stock market scandals that has shaken investor confidence. Much can be done to improve the situation."

KEYWORDS

- Blue Ribbon Committee
- Cadbury Committee
- Greenbury Committee
- Guidelines
- Hampel Committee
- Kings Committee
- Mandatory recommendations
- McKinsey
- Non-mandatory recommendations
- OECD
- Public company
- Rationale for a review
- SEBI's initiatives
- Turnbull Committee
- Uday Kotak Committee
- World Bank

DISCUSSION QUESTIONS

1. Why is it considered that the Cadbury Committee's Report is the landmark in the evolution of corporate governance both as a concept and practice?
2. What was the objective behind the setting up of the Cadbury Committee? Explain briefly The Cadbury Code of Best Practices.
3. Explain in detail the OECD Principles of Corporate Governance.
4. Discuss critically The Sarbanes–Oxley Act of 2002. Did it have the desired impact on the management of the corporate bodies both in the USA and elsewhere?
5. Outline briefly the Indian Companies Act 1956. What were the pitfalls of the said Act and how were these sought to be remedied subsequently?
6. Discuss critically the recommendations of Kumar Mangalam Birla Committee 1999.

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PART TWO

Legal Framework and Agents in Corporate Governance

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5



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Legal and Regulatory Aspects of Corporate Governance

CHAPTER OUTLINE

- Indian Companies Act 2013
- Securities Contract Act 1956
- SEBI Act 1992
- Listing Agreements Under Rule 49
- National Depositaries Act 1996
- Chartered Accountants Act 1949
- Company Secretary Act 1980
- Financial Accounting Standards
- Corporate Governance Rating Mechanism
- Reporting Framework
- Investor Protection Measures
- Auditor Accountability
- Risk Management
- Board of Directors and Board Committies
- CSR
- Whistle Blowing Mechanism

Introduction

Corporate governance is the system by which companies are directed and controlled. The Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to the shareholders on their stewardship. The board's actions are subject to the laws, the regulations and the shareholder's wish in general meeting.

Legal Frame-work of the Corporate Governance in India

Strengthening the investor's confidence technology based trading, increased interest on the part of domestic and foreign institutional investors warranted a strong regulatory system in India.

During the last three decades since the economic liberalization was initiated in India there has been a significant increase in the corporate form of business establishments. The removal of several licensing hurdles, the financial market reforms especially capital market reforms, the introduction of modern technology based trading, the strengthening the regulatory system of the capital market has increased the confidence of the retail investors and foreign and domestic institutional investors and they are not hesitating to invest their savings in the Indian capital market. The primary market and the secondary market reforms have improved the profitability, the liquidity and the transparency in the capital market investment and reduced risk in it. The investors' confidence has also improved in the capital market investment. At the same time corporate misconduct and frauds have also increased as seen in the developed countries. Capital market frauds like Harshad Mehta case, corporate frauds like 'The Satyam Computers' case, the Sahara case, the Kingfisher case have affected the confidence of the investors. To overcome this and to regain investor confidence in capital market, several legal and regulatory measures have been initiated by the government during the last two decades. These include formal and informal measures that are established among private actors as well as the by state or the public enterprises. Some of the key legal and regulatory measures are as follows.

1. The Indian Company Act 2013
2. The Security Contracts (Regulation) Act 1956
3. The Securities and Exchange Board of India Act 1992
4. The Listing agreement to the Indian Stock Exchange 31 December 2015
5. The National Depositaries Act 1996
6. The Chartered Accountants Act 1949
7. The Company Secretaries Act 1980
8. Financial and Accounting Standards
9. Corporate governance rating mechanism, etc.

The Indian Companies Act 2013

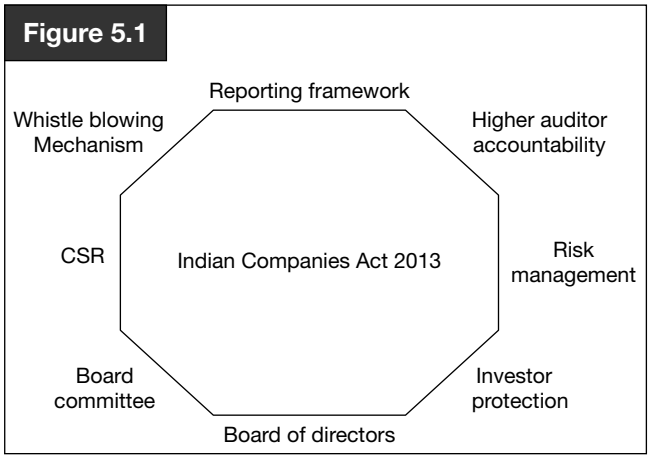
The new Companies Act of 2013 replacing the 56 year old company legislation of independent India has put forward a series of provisions relating to corporate governance apart from simplification and liberalization of other aspects of company

formation and administration. This is a major reform of independent India in the area of company legislation.

Corporate Governance under the new Companies Act 2013 has broadened its meaning and scope. It includes among other things a complete module for fixing the liability on the corporate entity. It is prescriptive to the companies rather than recommendatory in nature. The major provisions relating to corporate governance introduced in the new Company Law can be broadly grouped in to eight groups namely:

1. Increased reporting standards
2. Higher auditing accountability
3. Risk management
4. Emphasis on investor protection
5. Composition of director board members and their responsibilities
6. Board committees
7. Inclusive Corporate Social Responsibility and
8. Compulsory whistle-blower mechanism

Figure 5.1



Salient Features of The Companies Act 2013 Relating to Corporate Governance

- Increased reporting standards
- Risk management
- Compulsory whistleblowing mechanism
- Composition of director board members and their responsibilities
- Board committees
- Inclusive corporate social responsibility
- Emphasis on investor protection
- Higher auditing accountability

The Reporting Framework Under Companies Act 2013

A company communicates with outsiders through annual reports and financial statements. There is no other means for the outsiders to understand the happening in a corporate organization. Hence, it should be complete, comprehensive, clear and transparent. They are intended to provide relevant, reliable and timely

information essential for making investment decision. To achieve this aim, the new Companies Act prescribed the following.

As per the Act, the financial statement of a company includes:

(a) Balance Sheet as per Part II Schedule III of the Companies Act.
(b) Profit and Loss Account in the case of a trading company/ Income and Expenditure Account in the case of a non-trading concern as per Part II of the revised Schedule VI of the Companies Act 2013 prepared as per Accounting Standard 5.
(c) Cash flow statement showing (1) cash flow generated by operating activities, (2) cash flow generated from investment activities and (3) cash flow generated from financing activities as the case may be prepared as per Accounting Standard 3.
(d) A statement of changes of equity.

In addition to the above narrative disclosure of both quantitative and qualitative information relating (a) Accounting policy as per Accounting Standard 1 and (b) Note on accounts containing the following mandatory disclosures such as:

1. Contingent liabilities and capital commitments.
2. Disclosure relating to SSI undertakings.
3. Report of related party transactions.
   (a) Details of all material transactions with related parties shall be disclosed quarterly along with the Compliance Report on corporate governance.
   (b) The company shall disclose the policy on dealing with related party transactions on its website and also in the annual report.

What is Related Party Transaction?

1. A related party transaction is a transfer of resources, services or obligations between a company and a related party, regardless of whether a price is charged.
2. A 'related party' is a person or entity that is related to the company, if one party has the ability to control the other party or exercise significant influence over the other party, directly or indirectly, in making financial and/or operating decisions and includes the following:
   (a) A person or a close member of that person's family is related to a company if that person:
      - Is a related party under Section 2(76) of the Companies Act, 2013;
      - Has control or joint control or significant influence over the company;
      - Is KMP of the company or of a parent of the company; or
   (b) An entity is related to a company if any one of the following conditions applies:
      - The entity is a related party under Section 2(76) of the Companies Act, 2013; or
      - The entity and the company are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others); or
      - One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member); or
      - Both entities are joint ventures of the same third party; or

- One entity is a joint venture of a third entity and the other entity is an associate of the third entity; or
- The entity has a post-employment benefit plan for the benefit of employees of either the company or an entity related to the company. If the company is itself of such a plan (clarify), the sponsoring employers are also related to the company; or
- The entity is controlled or jointly controlled by a person identified in (1).
- A person identified in (1) (b) has a significant influence over the entity (or of a parent of the entity); or

Explanation: 'control' shall have the same meaning as defined in the SEBI Takeovers Regulations, 2011.

3. The company shall formulate a policy on materiality of related party transactions and also on dealing with related party transactions. Provided that such a transaction with a related party shall be considered material if the transaction/transactions to be entered into individually or taken together with previous transactions during a financial year, exceeds five per cent of the annual turnover or twenty per cent of the net worth of the company as per the last audited financial statements of the company, whichever is higher.
4. All related party transactions shall require the prior approval of the audit committee.
5. All material related party transactions shall require approval of the shareholders through related party's special resolution and they shall abstain from voting on such resolution.
6. **Disclosure of accounting treatment:** Where in the preparation of financial statements, a treatment different from that prescribed in the accounting standard has been followed, the fact shall be disclosed in the financial statements, together with the management's explanation as to why it believes such an alternative treatment is more representative of the true and fair view of the undertaking business transaction in the Corporate Governance Report.

Reporting Framework
■ Reporting of related party transactions ■ Disclosure of accounting treatment ■ Remuneration of directors ■ Disclosure of resignation of directors ■ Disclosure in annual report ■ Disclosure of proceeds from public issue ■ CEO/CFO certification ■ Reporting of CG ■ Compliance report ■ Reporting of share holders ■ Reporting about management

7. **Remuneration of directors and management:**
   (a) All pecuniary relationship or transactions of the non-executive directors with regard to the company shall be disclosed in the annual report.

(b) In addition to the disclosures required under the Companies Act, 2013, the following disclosures on the remuneration of directors shall be made in the section on the corporate governance of the annual report:
- All elements of remuneration package of individual directors summarized under major groups, such as salary, benefits, bonuses, stock options, pension.
- Details of fixed component and performance linked incentives, along with the performance criteria.
- Service contracts, notice period, severance fees.
- Stock option details, if any, and whether issued at a discount as well as the period over which accrued and over which exercisable.

(c) The company shall publish its criteria of making payments to non-executive directors in its annual report. Alternatively, this may be put up on the company's website and reference drawn thereto in the annual report.

(d) The company shall disclose the number of shares and convertible instruments held by the non-executive directors in the annual report.

(e) The Non-executive directors shall be required to disclose their shareholding (both own or held by/ for other persons on a beneficial basis) in the listed company in which they are proposed to be appointed as directors, prior to their appointment. These details should be disclosed in the notice to the general meeting called for appointment of such director.

(f) Statement showing computation of net profit for the purpose of managerial remuneration calculation.

8. **Disclosure of resignation of directors:** The company shall disclose the letter of resignation along with the detailed reasons of resignation provided by the director of the company on its website not later than one working day from the date of receipt of the letter of resignation. The company shall also forward a copy of the letter of resignation along with the detailed reasons of resignation to the stock exchanges not later than one working day from the date of receipt of resignation for dissemination through its website. As per new Companies Act, a director has to give detailed reasons for the resignation and has also to forward a copy of resignation letter along with detailed reasons to the Office of Registrar of Companies. As per the Listing Agreement the company shall, in addition, put the resignation letter and reasons on, website not later than one working day.
9. **Disclosure in the annual report:** The following shall be disclosed in the Annual report:
   (a) Training imparted to independent directors.
   (b) Remuneration policy and the evaluation criteria.
   (c) Establishment of vigil mechanism (Also in the Board Report).
10. Payment to auditors
11. Value of imports, if any
12. Quantitative information relating to capacity utilization.
13. Earnings and expenditure in foreign currencies.
14. Prior period items
15. Extraordinary items
16. Government grants
17. Lease agreements, if any
18. Disclosure of interest in joint ventures
19. Disclosure of Earnings per Share

20. Disclosure of taxes on income
21. Proceeds from Public Issues, Rights Issues, Preferential Issues, etc. When money is raised through an issue, the company shall disclose the uses/ applications of funds by major category (Capital expenditure, sales and marketing, working capital, etc.) on a quarterly basis as a part of quarterly declaration of financial results to the audit committee. On annual basis the company shall prepare a statement of funds utilized for the purposes other than those stated in the offer document/prospectus/notice and place before audit committee.
22. **CEO / CFO certification:** The CEO, i.e., MD or Manager (as per Companies Act) and the CFO shall certify to the Board – that the financial statements do not contain any materially untrue statement or has not omitted any material factor contain statements that might be misleading, that they accept the responsibility for establishing and maintaining internal control, that statements present a true and fair view of the company's affairs.

Requirements in the Case of Listed Companies

In addition to the above, the listed companies are required to have the following in their annual report.

1. Disclosure in respect of the holding company and the subsidiary company in respect of loans, advances and investments.
2. **Report on Corporate Governance:** There shall be a separate section on Corporate Governance in the annual report of the company with a detailed compliance report on Corporate Governance. Non-compliance of any mandatory clause to be specifically highlighted. (Suggested list including non-mandatory requirements is appended to Clause 49). A quarterly compliance report is to be submitted to the stock exchanges within 15 days of the close of the quarter.
3. **Compliance report:** The company shall obtain a certificate from either the auditors or the practicing company secretary the compliance of conditions of corporate governance and annex the same with the directors' report.
4. **Shareholder information report:**
   (a) In case of appointment of a new director or re-appointment of a director the shareholders must be provided with the following information:
      - A brief resume of the director.
      - Nature of his expertise in specific functional areas.
      - Names of companies in which the person also holds the directorship and the membership of committees of the board and
      - Shareholding of the non-executive directors as stated in Clause 49 (IV) (E) (v) above.

   (b) Disclosure of relationships between the directors shall be made in the annual report, the notice of appointment of a director, prospectus and letter of offer for issuances and any related filings made to the stock exchanges where the company is listed.

   (c) Quarterly results and presentations made by the company to analysts shall be put on company's website, or shall be sent in such a form so as to enable the stock exchange on which the company is listed to put it on its own website.

   (d) A committee under the chairmanship of a non-executive director and such other members as may be decided by the board of the company shall be formed to specifically look into the redressal of grievances of shareholders, debenture holders and other security holders. This committee

shall be designated as 'Stakeholders Relationship Committee' and shall consider and resolve the grievances of the security holders of the company including complaints related to transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends.

5. **Management discussion and analysis report:** As part of the directors' report or as an addition thereto, a management discussion and analysis report should form a part of the annual report to the shareholders. This management discussion and analysis should include discussion on the following matters within the limits set by the company's competitive position:
   (a) Industry structure and developments.
   (b) Opportunities and threats.
   (c) Segment-wise or product-wise performance.
   (d) Outlook.
   (e) Risks and concerns.
   (f) Internal control systems and their adequacy.
   (g) Discussion on financial performance with respect to operational performance.
   (h) Material developments in human relations front including the number of people employed.

Senior management shall make disclosures to the board relating to all material, financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large.

Senior management shall make disclosures to the board relating to all material, financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large (For example: dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives, etc.)

Explanation: For this purpose, the term 'senior management' shall mean personnel of the company who are members of its core management team excluding the board of directors. This would also include all members of management one level below the executive directors including all functional heads. The code of conduct for the board of directors and the senior management shall be disclosed on the website of the company.

The Risk Management Under Indian Companies Act 2013

The company shall lay down procedures to inform board members about the risk assessment and minimization procedures. The board shall be responsible for framing, implementing and monitoring the risk management plan for the company. The company shall also constitute a risk management committee. The board shall define the roles and the responsibilities of the risk management committee and may delegate monitoring and reviewing of the risk management plan to the committee and such other functions as it may deem fit. This is applicable to top 100 listed companies. Presently the company needs to inform the board about the risk assessment and minimization procedures.

Risk Management
■ The board shall be responsible for framing, implementing and monitoring the risk management plan for the company.

The Compulsory Whistle-blower Mechanism Under Companies Act 2013

What is Whistle-blower Mechanism?

A whistle-blower is an employee, former employee, or member of an organization, especially a business or government agency, who reports misconduct to people or entities that have the power and presumed willingness to take corrective action. Generally the misconduct is a violation of law, rule, regulation and/or a direct threat to public interest such as fraud, health, safety violations and corruption are just a few examples.

For instance, Jeffrey Wigand is well-known in the United States for exposing the big tobacco scandal, revealing that the executives of the companies knew that cigarettes were addictive and that they added other carcinogenic ingredients to the cigarettes. In India, Mr Satyendra Dubey, who accused an employer of NHAI of corruption in highway construction projects in India, in letter to the then Prime Minister Atal Bihari Vajpayee.

Whistle blowing is termed 'internal' when an employee airs his complaint internally and 'external' when an employee blows the whistle outside the organization. For example: to media or a regulatory body.

A whistle-blower is an employee, former employee, or member of an organization, especially a business or government agency, who reports misconduct to people or entities that have the power and presumed willingness to take corrective action.

Benefits of Whistle-blowing Mechanism

1. The whistle-blower policy would encourage the elimination of malpractices in the system. The policy would encourage all the employees to come out with their complaints regarding any kind of misuse of company's properties, mismanagement or wrongful conduct prevailing in the company, if any.
2. Companies would enjoy the stakeholder confidence and goodwill.
3. The whistle-blower protection policy would enhance corporate accountability as personnel within the organization would act as watchdogs as compared to an outside agency, i.e., the government regulating corporate policies

The Indian Companies Act and Whistle Blowing Mechanism

The company shall establish a vigil mechanism for the directors and the employees to report concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethical policy. The mechanism should also provide for adequate safeguard against victimization of director(s)/ employee(s) who avail of the mechanism and also provide for direct access to the Chairman of the Audit Committee in exceptional cases. The details of establishment of vigil mechanism shall be disclosed by the company on its website and in the Board's Report. Similar requirement under sections 177(9) of the Cos Act, 2013 for listed companies is to establish a Vigil Mechanism for Directors and Employees to report genuine concerns. (Before amendment of Clause 49, it was a non-mandatory requirement). The SEBI has also incorporated the whistle-blower protection policy in clause 49 as a non-mandatory requirement.

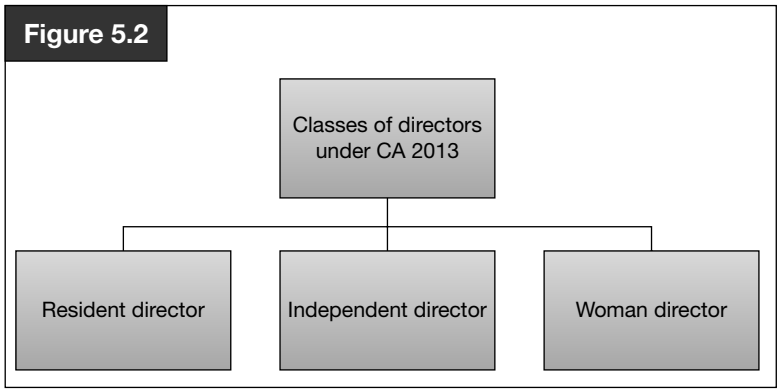
Whistle-blowing Mechanism

Whistle-blowing mechanism is considered to be highly desirable in the pursuit of better corporate governance. It is based on the principle of 'Prevention is Better than Cure'. Institutionalization of whistle-blowing mechanism is essential for good corporate governance. It failed in Enron when Mr Sherro Watkins, director of the company wrote to the CEO, Mr Kenneth Lay who did not pay heed to it. It succeeded in Tata Finance when Mr Sankar Sharma wrote to Mr Ratan Tata.

Director's Composition and Their Responsibilities Under the New Companies Act

1. **Number of Directors:** One person company shall have a minimum of 1 (one) director; as per Companies Act 2013. The maximum number of directors for a public company is fixed as 15. However, it can be increased above the 15 directors by a special resolution. As per Companies Act 1956 the Articles of Association of the company was able to fix the maximum number of directors.
2. **Composition of the Board:** The board shall have optimum combination of executive directors and non-EDs with at least one woman director on the board of the company, not less than 50 per cent of the board comprising non-executive directors. Requirement of woman director is to align with Section 149(1) of the Cos. Act 2013. As per new Companies Act, the non-listed companies having paid-up a share capital of ₹100 crore or more, or a turnover of ₹300 crore or more need to have a Woman Director before 31 March 2015.

Figure 5.2



3. **Independent Directors:** Where the Chairman is a non-executive director at least 1/3rd of the board should represent independent directors. Where chairman is the executive director, at least 1/2 of the board should represent independent directors. Also where the Chairman is a non-executive director but is a promoter or is related to any promoter or person occupying management position at the board level or at one level below the board, at least 1/2 of the board must represent independent directors.

Who is an Independent Director?

Independent director shall mean a non-executive director other than nominee director of the company:

1. Who, in the opinion of the Board, is a person of integrity and possesses relevant expertise and experience;
2. (i) Who is or was not a promoter of the company or its holding, subsidiary or associate company; (ii) Who is not related to promoters or directors in the company, its holding, subsidiary or associate company;
3. Apart from receiving director's remuneration, he has or had no pecuniary relationship with the company, its holding, subsidiary or associate company, or their promoters, or directors, during the two immediately preceding financial years or during the current financial year.
4. None of whose relatives has or had pecuniary relationship or transaction with the company, its holding, subsidiary or associate company, or their promoters,

or directors, amounting to two per cent or more of its gross turnover or total income or fifty lakh rupees or such higher amount as may be prescribed, whichever is lower, during the two immediately preceding financial years or during the current financial year; who, neither himself nor any of his relatives:

(a) Holds or has held the position of a key managerial personnel or is or has been an employee of the company or its holding, subsidiary or associate company in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed;

(b) Is or has been an employee or a proprietor or a partner, in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed, of —

- A firm of auditors or company secretaries in practice or cost auditors of the company or its holding, subsidiary or associate company; or
- Any legal or a consulting firm that has or had any transaction with the company, its holding, subsidiary or associate company amounting to ten per cent or more of the gross turnover of such firm;

(c) Holds together with his relatives two per cent or more of the total voting power of the company; or

(d) Is a Chief Executive or director, by whatever name called, of any non-profit organization that receives twenty-five per cent or more of its receipts from the company, any of its promoters, directors or its holding, subsidiary or associate company or that holds two per cent or more of the total voting power of the company;

(e) Is a material supplier, service provider or customer or a lessor or lessee of the company;

5. Possesses appropriate skills, experience and knowledge in one or more fields of finance, law, management, sales, marketing, administration, research, corporate governance, technical operations or other disciplines related to the company's business.
6. Who is not less than 21 years of age.

Duties of Independent Directors

Neither the listing agreement nor the Companies Act 1956 prescribed the scope of duties of independent directors. The Companies Act 2013 includes a guide to professional conduct for independent directors, which crystallizes the role of independent directors by prescribing facilitative roles, such as offering independent judgment on issues of strategy, performance and key appointments and taking an objective view on performance evaluation of the board. Independent directors are additionally required to satisfy themselves on the integrity of financial information, to balance the conflicting interests of all stakeholders and in particular, to protect the rights of the minority shareholders. The SEBI circular, however, states that the board is required to lay down a code of conduct which would incorporate the duties of independent directors as set out in Companies Act 2013.

Liability of Independent Directors

Under the Companies Act 1956, independent directors were not considered to be 'officers in default' and consequently were not liable for the actions of the board. The Companies Act 2013 however, provides that the liability of independent directors would be limited to acts of omission or commission by a company which occurred with their knowledge, attributable through board processes and with their consent and connivance or where they have not acted diligently.

Woman Director

Listed companies and certain other public companies shall be required to appoint at least 1 (one) woman director on its board. Companies incorporated under the Companies Act 2013 shall be required to comply with this provision within 6 (six) months from date of incorporation. In case of companies incorporated under the Companies Act 1956, are required to comply with the provision within a period of 1 (one) year from the commencement of the Act.

Limit on Number of Directorships

A person can become an independent director of a maximum seven listed companies if he/she is not a Whole Time Director of a listed company. An Independent Director (if he is WTD in any listed co.) can act as an independent director in a maximum three listed companies. The restriction on number of Directorships as Independent in listed companies is on full-time Director and not on MD. Section 165 of the Companies Act, 2013 provides maximum number of directorships where 20 companies (including alternate directorships) out of which not more than 10 can be public companies.

Maximum Tenure of Independent Directors

An independent director shall hold office for a term up to five consecutive years on the board of a company and shall be eligible for re-appointment for another term of up to 5 consecutive years on passing of a special resolution by the Company.

- Provided that a person who has already served as an ID for five years or more in a company as on 1 October 2014 shall be eligible for re-appointment, on completion of his present term, for one more term of up to five years only.
- Provided further that an Independent Director, who completes his above mentioned term, shall be eligible for appointment as ID in the company only after the expiration of three years of ceasing to be an Independent Director in the company. This is broadly in line with Section 149 of the Companies Act, 2013. However, as per the Companies Act, two tenures of five years each can be taken by an independent director with effect from 1st April 2014. Any tenure of an ID on the date of commencement of this Act shall not be counted as a term.

Formal Letter of Appointment to Independent Director

The company shall issue a formal letter of appointment to independent director in the manner as provided in the Companies Act, 2013.

The Letter of Appointment along with the detailed profile of independent director shall be disclosed on the website of the company and the stock exchanges not later than one working day from the date of such appointment. This is to align with the Schedule IV of the Companies Act, 2013 which provides the contents of the Appointment Letter of independent director also. Companies also post the terms and the conditions of appointment of ID on the website, which shall also be open for inspection at the registered office by any member.

Performance Evaluation of Independent Directors (ID)

1. The Nomination Committee shall lay down the evaluation criteria for performance evaluation of IDs.
2. The company shall disclose the criteria for performance evaluation, as laid down by the Nomination Committee, in its Annual Report.

3. The performance evaluation of ID shall be done by the entire Board of Directors (excluding the director being evaluated).
4. On the basis of the report of performance evaluation, it shall be determined whether to extend or continue the term of appointment of the ID.

This is to align with Schedule IV of the Companies Act, 2013 which provides the mechanism for evaluation of IDs.

Separate Meeting of the Independent Directors (IDs)

The IDs of the company shall hold at least one meeting in a year, without the attendance of the non-independent directors and the members of management. All the IDs of the company shall strive to be present at such a meeting. The IDs in the meeting shall, inter-alia:

1. Review the performance of the non-independent directors and the board as a whole;
2. Review the performance of the Chairperson of the company, taking into account the views of the executive directors and the nonexecutive directors;
3. Assess the quality, quantity and timeliness of flow of information between the company management and the board that is necessary for the board to effectively and reasonably perform their duties. (This is to align with Schedule IV of the Companies Act, 2013.)

Training of Independent Directors

The company shall provide suitable training to independent directors to familiarize them with the company, their roles, rights, responsibilities in the company, the nature of the industry in which the company operates, the business model of the company, etc. The details of such training imparted shall be disclosed in the annual report.

Non-EDs' Compensation and Disclosures

All fees/compensation, if any paid to Non-EDs including IDs shall be fixed by the board of directors and shall require previous approval of the shareholders in the general meeting. The shareholders' resolution shall specify the limits for the maximum number of stock options that can be granted to the Non-EDs, in any financial year and in aggregate. Prior approval of shareholders shall not apply to payment of sitting fees, if made within the limits prescribed under the Companies Act, 2013. Independent directors shall not be entitled to any stock option. (This is to align with Section 149(9) of the Companies Act, 2013.)

Board Meeting and Procedure

The key changes introduced by the Companies Act 2013 with respect to board meetings and processes are as follows:

First board meeting of a company to be held within 30 (thirty) days of incorporation; A notice of minimum 7 (seven) days must be given for each board meeting. The notice for board meetings may be given by electronic means. However, the board meetings may be called at a shorter notice to transact 'urgent business' provided such meetings are either attended by at least 1 (one) independent director or decisions taken at such meetings on subsequent circulation are ratified by at least 1 (one) independent director. The Company Act 2013 has permitted directors to participate in the board meetings through video conferencing or other audio visual means which are capable of recording and recognizing the

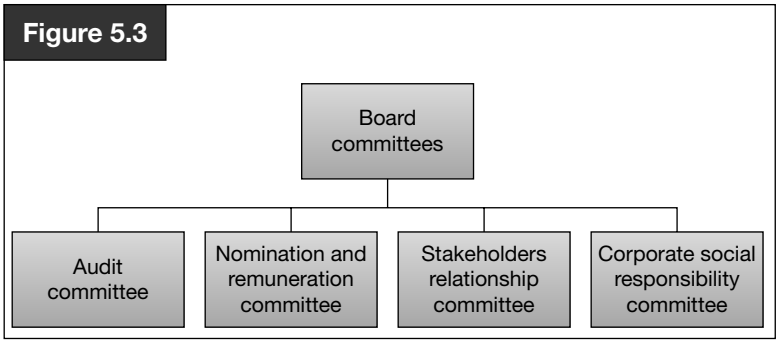
participation of the directors. The participation of the directors by audio visual means would also be counted towards quorum. The requirement for holding board meeting every quarter has been discontinued. Now at least 4 (four) meetings have to be held each year, with a gap of not more than 120 (one hundred and twenty) days between 2 (two) board meetings.

Certain new actions have been identified, that require approval by directors in a board meeting. These include issuance of securities, grant of loans, guarantee or security, approval of financial statement and board's report, diversification of business, etc. Approval of circular resolution will be by a majority of directors or members who are entitled to vote on the resolution, irrespective of whether they are present in India or otherwise.

Committees of Board of Directors

The Company Act 2013 envisages four board committees for a better corporate governance such as audit committee, nomination and the remuneration committee, the shareholders relationship committee and the CSR committee.

Figure 5.3



(a) **Audit committee:** Under the Company Act 1956, the public companies with a paid up capital in excess of ₹50,000,000 (Five crore) were required to set up an audit committee comprising not less than 3 (three) directors. At least one third had to be directors other than Managing Directors or Whole Time Directors. The Company Act 2013 however, requires the board of every listed company and certain other public companies to constitute the audit committee consisting of a minimum of 3 (three) directors, with the independent directors forming a majority. It prescribes that a majority of members, including its Chairman, have to be persons with the ability to read and understand financial statements. The audit committee has been entrusted with the task of providing recommendations for appointment and remuneration of auditors, the review of independence of auditors, providing approval of related party transactions, and scrutinying other financial mechanisms of the company.

Committee of Directors

- Audit committee
- Nomination and remuneration committee
- Stake holders relationship committee
- CSR Committee

(b) **Nomination and remuneration the committee:** While the Company Act 1956 did not require companies to set up the nomination and the remuneration committee, the Listing Agreement provided the companies with the option to constitute a remuneration committee. However, the Company Act 2013 requires the board of every listed company to constitute the nomination and remuneration

Committee consisting of 3 (three) or more non-executive directors out of which not less than one half are required to be independent directors. The committee has the task of identifying persons who are qualified to become directors and providing recommendations to the board regarding their appointment and removal, as well as carrying out their performance evaluation.

(c) **Stake holders' relationship committee:** The Company Act 1956 did not require a company to set up a stakeholder's relationship committee. The listing agreement required listed companies to set up a shareholders/investors grievance committee to examine complaints and issues of shareholders. The Companies Act 2013, requires every company having more than 1000 (one thousand) shareholders, debenture holders, deposit holders and any other security holders at any time during a financial year to constitute a stakeholders' relationship committee to resolve the grievances of security holders of the company.

(d) **CSR committee:** The Company act 1956 did not impose any requirement on companies relating to corporate social responsibility ('CSR'). The Company Act 2013 however, requires certain companies to constitute a CSR Committee, which would be responsible to devise, recommend and monitor the CSR initiatives of the company. The committee is also required to prepare a report detailing the CSR activities undertaken and, if not, the reasons for its failure to comply.

CSR Activities Under Indian Companies Act 2013

Section 135 and Schedule VII of the Companies Act 2013 explain the provisions of the Companies Act relating to the Corporate Social Responsibility Policy which came into effect, from 1 April 2014.

As per the Act every company, private limited or public limited, which either has a net worth of ₹500 crores or a turnover of ₹1000 crores or a net profit of ₹5 crores, needs to spend at least 2 per cent of its average net profit for the immediately preceding three financial years on corporate social responsibility activities. The CSR activities should not be undertaken with respect to any activity directly or indirectly connected with the business carried by the company. It should be any activity mentioned in Schedule VII of the 2013 Act. Contribution to any political party is not considered to be a CSR activity and only activities in India would be considered for computing the CSR expenditure.

CSR has been made compulsory under the new companies Act 2013 Every company with a net worth of ₹500 crores or a turnover of ₹1000 crores or a net profit of ₹5 crores has to spend at least 2 per cent of its average net profit for CSR activities.

The CSR rules appear to widen the ambit for compliance obligations to include the holding and its subsidiary companies as well as foreign companies whose branches or project offices in India fulfil the specified criteria. There is a need for clarity with respect to the compliance obligations of a company as well as its holding and subsidiary companies.

The activities that can be undertaken by a company to fulfil its CSR obligations include eradicating hunger, poverty and malnutrition, promoting preventive healthcare, promoting education and promoting gender equality, setting up homes for women, orphans and the senior citizens, measures for reducing inequalities faced by the socially and economically backward groups, ensuring environmental sustainability and ecological balance, animal welfare, protection of national heritage and art and culture, measures for the benefit of the veterans of the armed forces, war widows and their dependents, training to promote rural, nationally recognized, Para Olympic or Olympic sports, contribution to the Prime Minister's National Relief Fund or any other fund set up by the Central government for socio-economic development and relief and welfare of SC, ST, OBCs, minorities and women, contributions or funds provided to technology-incubators located within academic institutions approved by the Central government and the rural development projects.

To formulate and to monitor the CSR policy of a company, a CSR Committee of the board needs to be constituted. Section 135 of the 2013 Act requires the CSR Committee to consist of at least three directors, including an independent director. However, the CSR rules exempts unlisted public companies and private companies that are not required to appoint an independent director from having an independent director as a part of their CSR Committee and stipulates that the committee for a private company and a foreign company need have a minimum of only 2 members.

A company can undertake its CSR activities through a registered trust or society, a company established by its holding, subsidiary or associate company or otherwise, provided that the company has specified the activities to be undertaken, the modalities for utilization of funds as well as the reporting and monitoring mechanism. If the entity through which the CSR activities are being undertaken is not established by the company or its holding, subsidiary or associate company, such an entity would need to have an established track record of three years undertaking similar activities. Companies can also collaborate with each other for jointly undertaking the CSR activities; provided that each of the companies is able individually to report on such projects.

The CSR rules specify that a company which does not satisfy the specified criteria for a consecutive period of three financial years is not required to comply with the CSR obligations, implying that a company not satisfying any of the specified criteria in a subsequent financial year would still need to undertake the CSR activities unless it ceases to satisfy the specified criteria for a continuous period of three years. This could increase the burden on small companies which do not continue to make significant profits.

The report of the board of directors attached to the financial statements of the Company would also need to include an annual report on the CSR activities of the company in the format prescribed in the CSR rules setting out inter alia a brief outline of the CSR policy, the composition of the CSR Committee, the average net profit for the last three financial years and the prescribed CSR expenditure. If the company has been unable to spend the minimum required on its CSR initiatives, the reasons for not doing so are to be specified in the board report.

Investor Protection Under the Companies Act 2013

Introduction

Strong investor protection is associated with effective corporate governance. When an investor places his hard-earned money in the securities of a corporation, he does so with certain expectations of its performance, the corporate benefits that may accrue to him, and above all, the prospects of income from, and the possibilities of capital growth of the securities he holds in the firm. At the same time, while he makes an investment decision the investor would have obviously taken note of and evaluated the attendant risks that go with such expectations, especially the possibility of the risk that the income and/or capital growth may not materialise. This mismatch between the expectations of the investors and the unexpected final outcome in terms of income and/or capital growth arises mainly because their hard earned money is entrusted to managers in a corporation whose investment decisions, apart from carrying certain risks of their own, may not match those of the investors.

Strong investor protection is associated with effective corporate governance. When an investor places his hard-earned money in the securities of a corporation, he does so with certain expectations of its performance, the corporate benefits that may accrue to him, and above all, the prospects of income from, and the possibilities of capital growth of the securities he holds in the firm. A mismatch occurs when the expectations of the investors and the unexpected final outcome in terms of income and/or capital in a corporation whose investment decisions, apart from carrying certain risks of their own, may not match those of the investors.

Why is Investor Protection Needed?

An appropriate definition of investor protection is very much needed to relate it to corporate governance and to establish the correlation between these two. As stated earlier, when the investors finance the companies, they take a risk that could land them in a situation in which the returns on their investments would not be forthcoming because the managers or those whom they appointed to represent them on the board may keep them or expropriate them either covertly or overtly. This kind of betrayal of the investors by the "insiders" as the managers or the board of directors of the company may shake their confidence, which in the long run would have a determetal impact on the overall investment climate with serious repercussions on the economic development of the country. The economic parameters of a nation such as output, employment, income, expenditure, and above all, overall economic growth will be badly jeopardised due to declining investment. Therefore, there is a very strong reason to maintain the investors' morale, protect their interests and restore their confidence as and when there is a tendency for investors to lose confidence in the system or when their investments are at stake. Research findings also reveal that when the law and its agencies fail to protect investors, corporate governance and external finance do not fare well. If there is no investor protection, the insiders can easily steal the firm's profits, while, when it is good, they will find it very difficult to do it.

Definition of Investor Protection

Investors by virtue of their investments in securities of corporations obtain certain rights and powers that are expected to be protected by the State which gave the charter or the legal entity to the corporate bodies or the regulators designated by the State to do so. Their basic rights include disclosure and accounting rules that will enable them to obtain proper, precise and accurate information to exercise other rights such as approval of the executive decisions on substantial sale or investments, voting out incompetent or otherwise ineligible directors and appointment of the auditors. There are also laws that mainly deal with bankruptcy and reorganisation procedures that outline the measures and the procedures to enable creditors repossess collateral to protect their seniority and make it difficult for the firms to seek court protection in reorganisation. In many countries, laws and legal regulations are enforced in part by the different law enforcing agencies such as the market regulators, i.e. SEBI, courts or government agencies, i.e. the Department of Corporate Affairs in India and the markets themselves. If the investors' rights are effectively enforced by one or all of these agencies, "It would force insiders to repay creditors and distribute profits to the shareholders and thereby protect external financing mechanism from breaking down".[1] Thus, investor protection can be defined as both (i) the extent of the laws that protect investors' rights and (ii) the strength of the legal institutions that facilitate law enforcement.

Relationship Between Investor Protection and Corporate Governance

Recent research confirms that an essential feature of good corporate governance is the strong investor protection.[2] According to Rafael La Porta et al (1999) "corporate governance to a large extent is a set of mechanisms through which outside investors protect themselves against expropriation by the insiders". Expropriation is possible because of the agency problems that are inherent in the formation and structure

The core substance of corporate governance lies in designing and putting in place mechanisms such as disclosures, monitoring, oversight and corrective systems so that we can align the objectives of the two sets of players (investors and managers) as closely as possible and minimise agency problems.

of corporations. The Shareholders or the investors of a firm are numerous and scattered and therefore cannot manage it. Hence, they entrust the management of the firm to the managers who include the board of directors and the senior executives such as the CEO and the CFO. However, managerial actions depart from those required to maximise shareholder returns. Such mismatch of objectives results in the agency problem. Investors do realise and accept to a certain level of self-interested behaviours in the managers while they delegate responsibilities to them. But when such self-indulgence by managers exceed reasonable limits, principles of corporate governance come in to check such abuses and malpractices. The core substance of corporate governance lies in designing and putting in place, mechanisms such as disclosures, monitoring, oversight and corrective systems that we can align with the objectives of the two sets of players (investors and managers) as closely as possible and minimise the agency problems.

How do Insiders Steal Investors' Funds?

The insiders, both managers and controlling shareholders, can expropriate the investors in a variety of ways. Insiders use profits of the firm to benefit themselves, instead of returning the money to outside investors to whom it rightly belongs. Expropriation is also done by insiders selling additional securities in the firm they control to another firm or subsidiaries they own at 'below-market' prices, with assistance from obliging interlocking directorates, and also by diverting corporate opportunities to subsidiaries.

The insiders, both the managers and the controlling shareholders, can expropriate the investors in a variety of ways. Rafael La Porta et al (cited above) describe several means by which the insiders siphon off the investor's funds. "In some countries, the insiders of the firm simply steal the earnings. In some other countries, the arrangements they go through to divert the profits are more elaborate. Sometimes, the insiders sell the output or the assets of the firm they control, but which outside investors have financed, to another entity they own at below market prices. Such transfer pricing and asset stripping have largely the same effect as theft. In still other instances, expropriation takes the form of installing possibly under-qualified family members in managerial positions, or excessive executive pay." In all these instances, it is clear that the insiders use the profits of the firm to benefit themselves (either as excessive executive salaries or in the form unjustifiable perquisites), instead of returning the money to outside investors to whom it legitimately belongs. In this context, the minority shareholders and the creditors are far more vulnerable. Expropriation also is done by insider selling additional securities in the firm they control to another firm or subsidiaries they own at below market prices, with assistance from obliging interlocking directorates, and also by diverting corporate opportunities to subsidiaries and so on. Such practices, though often legal, have the same effect as theft. However, it must be stressed that these sharp practices of insiders vary from country to country depending on the existence or non-existence of the democratic and corporate values, the maturity or otherwise of the securities market, the financial systems, the pace of new security issues, the corporate ownership structures, the dividend policies, the efficiency of investment allocation, the legal system and the competence of the securities market regulator.

Rights to Information and Other Rights

Investor protection is not attainable without adequate and reliable corporate information. Several other rights provided to them under the law cannot be exercised by shareholders unless companies in which they have invested in share with them such information. Minority shareholders have the same rights as majority shareholders in dividend policies and in accessing new security issues.

Investor protection is not attainable without adequate and reliable corporate information. All outside investors, whether they are the shareholders or the investors, have an inalienable right to have certain corporate information. In the fact, several other rights provided to them under the law cannot be exercised by shareholders unless companies in which they have invested in, share with them such information. For instance, "without accounting data, a creditor cannot know whether a debt covenant has been violated. In the absence of these rights, the insider does not have to repay the creditors or to distribute profits to shareholders". Apart from the rights to information, creditors have also certain other rights, and these are to be protected. Minority shareholders have the same rights as

majority shareholders in dividend policies and in accessing new security issues. The significant but non-controlling shareholders need the right to have their votes counted and respected. This is the reason why the SEBI-appointed Kumar Mangalam Birla Committee recommended postal ballot for the benefit of those who could not attend the AGMs held by the corporations in cities where their corporate offices are located. The Committee recommended that in case of the shareholders, who are unable to attend the meeting, there should be a requirement, which would enable them to vote by postal ballot on important key issues such as corporate restructuring, sale of assets, new issues on preferential allotment and matters relating to change in management. Likewise, even the large creditors such as institutional investors who are powerful enough by virtue of their large stakes need relatively few formal rights, should be able to "seize and liquidate collateral, or to reorganise the firm". Investors would be unable to protect their turfs even if they have a large number or chunk of the share, if they are not able to enforce their rights.

There are, however, rules and regulations that are designed to protect investors. Some of the important regulations are with regard to disclosure and accounting standards, which provide investors with the information they need to exercise other rights of investors such as the "ability to receive dividends on pro-rata terms, to vote for directors, to participate in shareholders' meeting, to subscribe to new issues of securities on the same terms as the insiders, to sue directors for suspected wrongdoing including expropriation, to call extraordinary shareholders meeting, etc. Laws protecting creditors largely deal with bankruptcy procedures and include measures which enable creditors to repossess collateral, protect their seniority and make it harder for firms to seek court protection in reorganisation. In different jurisdictions, rules protecting investors come differently from various sources, including company, security, bankruptcy, takeover and competition laws but also stock exchange regulations and accounting standards". In India, for instance, rules protecting investors emanate from the Department of Corporate Affairs of the Ministry of Finance, the Securities and Exchange Board of India, the Listing Agreements of Stock Exchanges, the Accounting Standards of the Institute of Chartered Accountants of India, and sometimes decisions of the superior courts of the country. It should be stressed though that the enforcement of laws by these agencies are as crucial as their content and in most emerging economies these are lax, delayed and dilatory, resulting in poor corporate governance.

India Companies Act 2013 and New Investor Protection Measures

The Companies Act, 2013 has been enacted with the main aim to assure maximum protection to every section of investors irrespective of their classes. The Companies Act, 2013 has been embedded with several new provisions in regards to the protection of investor's interest. Some of the provisions to protect investor's interest under the Companies Act, 2013 are discussed hereunder.

1. **Acceptance of deposits:** The acceptance of deposit from the general public is not permitted under the Act and violation of any of the provision is a punishable offense. Section 73 of the Act provides that no company shall accept or review deposit under this Act from the public except in a manner recognized under Chapter V of the Act and Companies (Acceptance of Deposit) Rule 2014.
2. **Misstatement in prospectus:** The prospectus is a written statement issued by the company to the general public containing brief information regarding companies profile and their investment proposals. Section 34

of the Act deals with the criminal liability for mis-sstatement in the prospectus issued by a company. The prospectus issued, circulated or distributed, include any statement, which is untrue or misleading in form or context to induce people to make an investment, shall be liable for action under section 447.

3. **Fraudulently inducing person to invest money:** Section 36 of the Act deals with the punishment of the person who intentionally or recklessly induces the investor to make the investment through any agreement for the purpose or the pretended purpose of which to secure a profit. This kind of deliberate concealment of fact shall be liable for punishment under section 447.
4. **Non-payment of dividend:** Declaration of the dividend is usually one of the items of agenda of every AGM. The dividend is nothing but profits earned by the company and divided among shareholders in proportion to the amount paid-up shares held by them, i.e., return on the investment made by shareholders. Section 125 of the Act provides for the establishment of investors education and protection fund by the central government. This fund is credited with the unpaid/unclaimed amount of application money/ matured money or mature deposits. Such accumulations of the fund are to be utilized for promotion of investor's awareness and protection of investor interest. Section 123 of the Act states that the dividend should be credited in investors-account within in five days after the declaration.
5. **Right to demand financial statements:** Section 136 of the Act provides for the right of a member to obtain copies of the Balance Sheet and Auditors Reports. In the case of default in complying with this requirement, the company shall be liable for a penalty of 25 rupees and the authorized officer who is in default shall be liable for a penalty of five thousand rupees. Besides, this investor has the option to proceed against the company or its authorities in a court of law under the guidelines determined under Section 436 of the Act.

The N. K. Mitra Committee on Investors Protection

This committee chaired by N. K. Mitra submitted its report on investors' protection, in April 2001, with the following recommendations:

(i) There is a need for a specific Act to protect investor's interest. The Act should codify, amend and consolidate laws and practices for the purpose of protecting investors' interest in corporate investment.
(ii) Establishment of a judicial forum and award of compensation for aggrieved investors.
(iii) Investor Education and Protection Fund which is under the Companies Act should be shifted to the SEBI Act and be administered by the SEBI.
(iv) The SEBI should be the only capital market regulator, clothed with the powers of investigation.
(v) The regulator, the SEBI, should require all IPO's to be insured under third party insurance with differential premium based on the risk study by the insurance company.
(vi) The SEBI Act 1992 should be amended to provide for statutory standing committees on investors' protection, market operation and standard-setting.
(vii) The Securities Contracts (Regulation) Act 1956 should be amended to provide for corporatisation and good governance of stock exchanges.

Problems of Investors in India

Most of the investor complaints can be divided into the following three broad categories: Complaints against member-brokers of the stock exchange; complaints against companies listed for trading on stock exchange; complaints financial intermediaries sub-brokers, agents, merchant bankers, issue managers, etc., and generally centre around non-delivery of securities and non-settlement of payment due to investors.

Investor protection is a broader term that covers various measures to protect the investors from the malpractices of companies, brokers, merchant bankers, issue managers, registrar of new issues and so on. It is also incumbent on the investor to take necessary and appropriate precautions to protect their own interest, since all investments have some risk elements. But where they find that their interests are adversely impacted because of the malpractice by companies, brokers or any other capital market intermediaries, they can seek redressal of their grievances from the appropriate designated authorities. Most of the investor complaints can be divided into the following three broad categories:

1. **Against member–brokers of stock exchanges:** Complaints of this category generally centre around the price, quantity, etc., at which transactions are put through defective delivery, delayed payments or non-payments from brokers.
2. **Against companies listed for trading on stock exchanges:** Complaints against companies generally centre around non-receipt of allotment letters, refund orders, non-receipts of dividends, interest, etc.
3. **Complaints against financial intermediaries:** These complaints can be against sub-brokers, agents, merchant bankers, issue managers, etc., and generally centre around non-delivery of securities and non-settlement of payment due to investors. However, these complaints cannot be entertained by the stock exchanges, as per their rules.

Law Enforcement for Investor Protection

There are several agencies in India that are expected to protect investors. In fact, there are so many with overlapping functions that they cause confusion to the investors as to who they should go for redressal of their grievances. The stated primary objective of the country's sole capital market regulator, the Securities and Exchange Board of India, popularly known as SEBI, is protection of investors' interests. But, investor protection is a multi-dimensional function, requiring checks at various levels, as shown below:

- **Company level:** Disclosure and Corporate Governance norms.
- **Stock brokers level:** Self-regulating organisation of brokers.
- **Stock exchanges:** Every stock exchange has to have a grievance redressal mechanism in place as well as an investor protection fund.
- **Regulatory agencies:**
  - Investors' Grievances and Guidance Division of the SEBI
  - The Department of Corporate Affairs
  - The Department of Economic Affairs
  - The Reserve Bank of India
  - The Consumer Courts
  - The Courts of Law

Grievance Redressal Mechanisms

When an investor has a complaint and feels that his interest as an investor has not been protected, he should approach the company concerned, the Mutual Fund or the Depository Participant as the case may be. If he is not satisfied with their response, the investor can approach the SEBI. The SEBI on its part, has instituted a Redressal Mechanism as detailed below in Table 5.1.

TABLE 5.1 Redressal mechanism of SEBI

Type	*Nature of grievance*	*Can be taken up with*
I	Issues related to non-receipt of refund order, allotment advice, cancelled stock invests, etc.	Investors' Grievances and Guidance Division (IGG)
II	Non-receipt of dividend	Investors' Grievances and Guidance Division (IGG)
III	Share-related, i.e., non-receipt of share certificates	Investors' Grievances and Guidance Division (IGG)
IV	Debenture related, i.e., non-receipt of debenture certificates, non-receipt of warrants	Investors' Grievances and Guidance Division (IGG)
V	Non-receipt of letter of offer of rights and interest on delayed payments of refund orders	Investors' Grievances and Guidance Division (IGG)
VI	Complaints relating to collective investment scheme	Investors' Grievances and Guidance Division (IGG)
VII	Complaints relating to MFs	Mutual Funds Dept., SEBI
VIII	Complaints relating to Dematerialisation or DPs	Depositories and Custodian Cell, SEBI

It is likely that there may be complaints that may be sometimes beyond the purview and jurisdiction of SEBI. There may be many problems arising due to corporate misgovernance. Table 5.1 provides a comprehensive mechanism of legal protection to investors.

Lacunae in Investor Protection

The multiplicity of authorities, the overlapping functions, the lack of knowledge and the understanding by the common investor about these agencies and the lack of enforcement have all acted against investor protection.

Though there is a redressal mechanism in place in the country, investors can not get their complaints adequately addressed to, much less solved to their satisfaction by these public authorities. The multiplicity of authorities, the overlapping functions, the lack of knowledge and the understanding by the common investor about these agencies and the lack of enforcement have all acted against investor protection. Notwithstanding the existence of this seemingly comprehensive network of public institutions established for investor protection in India, a series of scams have taken place that has shaken the confidence of investors since 1991, the year of economic liberalisation.

The loss of investor confidence due to these scandals that conveyed an image of fraud and manipulation was so great that for several years stock market remained moribund.

To understand the policy issues connected with the securities market, it is important to know how these scams burst out in the open due to misgovernance, greed, corruption, inefficiency and market manipulations.

Some Major Indian Scams

1. **Harshad Mehta scam (market manipulation), 1992:** This first stock market scam was one which involved both the bond and the equity markets in India. The manipulation was based on the inefficiencies on the settlement systems in GOI bond market transactions. A pricing bubble came about in equity market

TABLE 5.2 Nature of complaints against companies under various Acts and relief provided

Sl. No.	*Complaints*	*Legislative provision*	*Relief provided*
1.	Delay in refund of excess application money or allotment letters	Section 73 of the Companies Act, as amended in 1988	Payment of interest for the delayed period beyond 70 days from the closure of subscription list @ 15 per cent
2.	Delay in transfer of shares	Section 133 of the Companies Act.	A time limit of 2 months provided in the Act for effective transfer. As per the Listing Agreement, the time limit is only 1 month from the lodgement of shares
3.	Refusal of transfer of shares	Section 22(A) of the SC (R.) Act. (This section lists the reasons for which transfer of shares can be refused)	Transfer can be refused only for specific and valid reasons given in the Act and not otherwise
4.	Problem of odd lots	Listing Agreement provides for issue of certificates in marketable lots and avoidable odd lots	Need for consolidation of odd lots and ensuring the issue of shares only in marketable lot through conversion of debentures or rights issue, provision of an odd lot trading session and listing out broker willing to trade
5.	Take-over bids	New clauses 40(a) and 40(b) of Listing Agreement	Purchase or acquisition of shares beyond 5 per cent to be notified to the Stock Exchange. Acquisition beyond 10 per cent puts an obligation on the transferer and intermediary to notify the Stock Exchange and the public; and offer to the other shareholders of the company to buy at offer price or the highest market price during the preceding six months
6.	Insider trading, rigging and other malpractices	The SEBI (Insider Trading) Regulations Act 1993	The investors have to guard themselves regarding the price and their investments, besides making a complaint to SEBI
7.	Delay and non-payments of interest/fixed deposits by companies	Section 58(B) of the Companies Act	Appeal to the Company Law Board
8.	Delay and non-payment of dues or non-delivery of shares by brokers	Rules and by laws of the Stock Exchange.	Complaint to the grievance cell of the Stock Exchange concerned
9.	Non-supply of debenture trust deed, refusal to inspection	Section 163, 196, 219, 304 of the Companies Act.	Appeal to the Company Law Board and lodge complaint with the trustee

where the market index went up by 143 per cent between September 1991 and April 1992. The amount involved in the crisis was around ₹54 billion.

2. **MNCs efforts at consolidation of ownership, 1993:** There were a number of reported cases when several transnational companies were found to consolidate their ownership by issuing equity allotments to their respective controlling groups at steep discounts to their market price. In this preferential allotment scam alone investors lost around ₹5,000 billion.
3. **Vanishing Companies scam, 1993–94:** Between July 1993 and September 1994, the stock market index zoomed by 120 percent. During this boom 3911 companies that raised over ₹25,0000 million vanished or did not set up projects as promised in their prospectuses. This scam occurred because during the artificial boom, hundreds of obscure companies were allowed to make public issues at large share premia through high sales pitch of questionable investment banks and grossly misleading prospectuses.
4. **M. S. Shoes (insider trading), 1994:** The dominant shareholder of the firm, Pawan Sachdeva, took large leveraged positions through brokers at both the Delhi and the Bombay Stock Exchanges to manipulate share prices prior to a rights issue. When the share prices crashed, the broker defaulted and the BSE shut down for 3, days as a consequence. The amount involved in the default was about ₹170 million.
5. **Sesa Goa (price manipulation at the BSE), 1995:** This was caused by two brokers who later failed on their margin payments on leveraged positions in the shares. The exposure was around ₹45 million.
6. **Rupangi Impex and Magan Industries Ltd. (price manipulation), 1995:** The dominant shareholders implemented a short squeeze. In both the cases, dominant shareholders were found to be guilty of price manipulation. Amount involved was ₹11 million in case of the RIL and ₹5.8 million in case of the MIL.
7. **Fraudulent delivery of physical certificates, 1995:** When anonymous trading and nationwide settlement became the norm by the end of 1995, there was an increasing incidence of fraudulent shares being delivered into the market. It has been estimated that the expected cost of encountering fake certificates in equity settlement in India at the same time was as high as 1 per cent.
8. **Plantation Companies scam, 1995–96:** This scam saw ₹50,0000 million mopped up by unscrupulous and fly-by-night operators from gullible investors who believed plantation schemes would yield huge returns, being wiped out.
9. **Mutual Funds scam, 1995–98:** This scam saw public sector banks raising nearly ₹15,0000 million crore by promising huge returns, but all of them collapsed.
10. **CRB scam through market manipulation, 1997:** C. R. Bhansali, a chartered accountant, created a group of companies, called the CRB Group, which was a conglomerate of finance and non-finance companies. Market manipulation was an important focus of the activities of the group. The non-finance companies routed funds to finance companies to manipulate prices. The finance companies would obtain funds from external sources using manipulated performance numbers. The CRB episode was particularly important in the way it exposed extreme failure of supervision on the part of the RBI and the SEBI. The amount involved in CRB scam was ₹7 billion.
11. **Market manipulation by Harshad Mehta, 1998:** This was another market manipulation episode engineered by Harshad Mehta. He worked on manipulating the share prices of BPL, Videocon and Sterlite in collusion with their managements. The episode came to an end when the market crashed due to a major fall in index. Harshad Mehta did not have the liquidity to maintain his leveraged position. In this episode, the top management of the BSE resorted to tampering with the records in the trading system while trying to avert a payment crisis. The president,

the executive director and a vice-president of the BSE had to resign due to this episode. This incident also highlighted the failure of supervision on the part of the SEBI. The amount involved was of ₹0.77 billion.

12. **The IT scam, 1999–2000:** During this 2 year period, millions of investors lost their entire investments duped by firms that changed their names to sound infotech. But when the unsustainable dotcom bubble burst, the hapless investors realised that their stocks were not even worth the paper on which they were printed.
13. **Price manipulation by Ketan Parikh, 2001:** This scam, known as the Ketan Parekh scam, was triggered off by a fall in the prices of IT stocks globally. Ketan Parekh was seen to be the leader of this episode, with leveraged positions on a set of stocks called the K-10 stocks. There were allegations of fraud in this crisis with respect to an illegal *badla* market at the Calcutta Stock Exchange and banking fraud.
14. **Dramatic slide in the stock market, 2004:** Between May 14 and 17 2004, there was a dramatic fall in the scrips of the Reliance, the Hindustan Lever, the State Bank, the Infosys and the ONGC. On May 17, Sensex fell by 11.14 per cent. The SEBI has found a dozen players whose names have not been divulged, were responsible for the price rigging and have been put on notice. Earlier on May 14 also, the stock market crumbled. On that day, the largest loser in sensex was the State Bank of India with a dip of 14.77 per cent. In all these falls, the market capitalisation worth millions of rupees was wiped out and consequently investors' confidence was badly shaken.[3] In the aftermath of its investigations, in May 2005, the SEBI banned the Swiss investment firm the USB Securities from issuing participatory notes and other off-shore derivative instruments for one year for not cooperating in the process of investigation by the market regulator.
15. **Satyam Computer scam, 2009:** Ramalinga Raju, founder of Satyam Computer Services Ltd, India's fourth largest software exporter and the first Indian Internet company to be listed on the NASDAQ, confessed publicly to his involvement in major financial scandals. Raju was said to have falsified accounts, created fictitious assets, padded the company's profits and cooked up the bank balances, all the time keeping his employees and the board of directors in the dark. The company, its shareholders and the public authorities were said to have been duped to an astronomical amount of not less than ₹40,000 billion.[4]

The series of scams has cast a shadow over the credibility of SEBI, and its capacity to create a safe and sound equity market.

The SEBI, the capital market regulator, has a sort of mixed record in fostering and nurturing corporate governance in the Indian corporate sector.

SEBI's Poor Performance—Suggestions for Improvement

The Securities and Exchange Board of India (SEBI), the designated capital market regulator, has a sort of mixed record in fostering and nurturing corporate governance in the Indian corporate sector. Since its inception in 1992, the SEBI has registered substantial growth in its stature and reach. Presently, its regulatory framework is robust. It has also played a significant role in creating the country's capital market infrastructure that is recognised as one of the better advanced in the world. If the SEBI's growth and reach over the past 5 years have been significant, its failure too has been spectacular. S. Vaidyanathan in his column "Eye on the Market" in the *Hindu Businessline* (20 February 2005) lists the following failures:[5]

1. **Poor tackling of price manipulation and insider trading issues:** Insider trading and price manipulation ahead of key corporate actions still continue to be rampant. SEBI has not effectively tackled—unlike its American counterpart SEC—issues such as price manipulation and insider trading. It has to strengthen enforcement and surveillance and impose deterrent penalties to stop these wrongdoings.
2. **Poor conviction rate:** A regulator's credibility hinges on its ability to achieve a fairly high conviction rate against errant market players. SEBI's record is poor as without exception the Securities and Appellate Tribunal has overturned its decisions and penal measures in cases against prominent market players. To achieve more convictions, a focus on building a case that passes the test of stringent scrutiny is very much necessary.
3. **Need to enhance its manpower skills:** If SEBI is to make progress in its designated function, there has to be a vast improvement in the quality of its manpower skills at its disposal. Regulatory bodies always find it tough to move in lockstep with the market. It has to invest in developing skill-sets in areas such as finance, accounting, tax and law by attracting professionals of quality and integrity. This would mean making its compensation and working culture attractive.
4. **It should simplify and trim regulations:** There is a need to simplify and trim the regulations, so that they are compact, easy to follow and comprehensible. A plethora of reports is filed by a variety of market participants, institutions and companies to comply with the regulations. These should be placed in the public domain in a timely manner, so that analysts can record a history of trends in several areas. This would complement SEBI's efforts and enhance its effectiveness as a regulator.
5. **It should tone up quality of disclosures:** There is also a need to tone up the quality of disclosures in areas such as earnings, announcements, mergers/acquisitions and the FII flows to make them more meaningful for investors. There is an urgent need to streamline SEBI's website *www.sebi.gov.in* so as to make it a valuable source of information for investors.
6. **It should solve issues of IPOs and mutual funds:** There are a host of other issues it has to tackle such as confusion over the clearance of IPOs in the ₹200 million range ensuring that SEBI files and maintains its own internal databases accurately and efficiently, and to formally shelve the move to convert the Association of Mutual Funds of India into a self-regulatory organisation, as the time for it has not come and such a move could lead to conflicts of interest with the SEBI itself.

The foregoing analysis clearly shows that though the SEBI has emerged as the one and only capital market regulator in the country, its functioning has been ineffective so far due to its failure to exercise its authority and bring to book the violators and the wrongdoers. It has also let itself to be influenced unduly and unjustifiably by some corporate big-wigs. Therefore, SEBI badly needs to improve its administration and accountability and restore its credibility as a powerful regulator.[6]

Auditor's Responsibilities Under Companies Act 2013

Auditor is an important independent functionary in a company to look after the affairs of the company from the outsider point of view. This office has to play a key role in corporate governance. To improve the quality of corporate governance in India the new Companys Act 2013 has prescribed several new measures.

The basic approach of the new Companies Act with regards to the role of auditor is 'Auditor should not listen to management advice during the finalization of accounts and it should be purely independent finalization and financial statement should reflect true and fair view of the business. Otherwise the auditor will be held responsible'.

Appointment and Reappointment

Chapter 10 of the Companies Act 2013 deals with the role and the functions of auditors of a company. As per section 139, the first auditor has to be appointed in a Board Meeting within 30 days of registration of the company or else within 90 days in an EGM. Further the Act says that "Every company shall, at the first annual general meeting, appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its **sixth** annual general meeting and thereafter till the conclusion of every sixth meeting". Auditor already appointed by the board can be appointed by the shareholders at the first annual general meeting. The company shall place the matter relating to such appointment for ratification by members at every annual general meeting.

Written consent along with a certificate is required to be given by the proposed appointee. Certificate shall also indicate whether the auditor satisfies the criteria provided in **S. 141 & Rule 4 of (Audit & Auditors) Rules, 2014.** No audit firm having common partners or partners whose tenure has expired immediately preceding financial year shall be appointed as auditor of the same company for a period of five years. It means though auditor is appointed at AGM but he can conduct the audit for a particular financial year**.** The company has to inform the auditor and file **form ADT-1** for the appointment with the Registrar within **fifteen days** of the meeting in which the auditor is appointed.

Terms of Appointment

Listed company or a company belonging to such class or classes of companies as may be prescribed in **S.139(2) & Rule 5 of Companies (Audit & Auditors) Rules, 2014** shall not appoint or re-appoint:

> An individual as auditor for more than one term of 5 consecutive years and an audit firm as auditor for more than two terms of five consecutive years.

Provided that:

> An individual auditor who has completed his term shall not be eligible for reappointment in the same company for the next five years. Similarly, an audit firms which has completed its terms shall not be eligible for reappointment in the same company for five years. Three years transition period shall be given to comply with this requirement. However, according to the rules, period of five years will be calculated from retrospective effect.
>
> For the purposes of S.139, the classes of companies shall mean the following classes of companies excluding one person companies and small companies which include all unlisted public companies having paid up capital of ₹10 crore, all private limited companies having paid up share capital of ₹20 crore, all companies having paid up share capital of below threshold limit mentioned in (a) and (b) above, but having public borrowings from financial institutions, banks or public deposits of ₹50 crores or more.

A retiring auditor may be re-appointed at an annual general meeting, if he is not disqualified for re-appointment, or has not given the company a notice in writing of his unwillingness to be re-appointed. Where at an annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company. In case of death, casual vacancy is to be filled by the board of directors within 30 days. He shall hold office till the conclusion of the next AGM.

Auditor's Responsibilities

- Appointment and reappointment of auditor.
- Mandatory rotation of auditor.
- Powers and duties of auditors.
- Auditor not to render certain services.
- Auditor's liability in case of unlawful acts.
- Disclosures.
- Liabilities relating to contents of the prospectus under Section 35 of the Companys Act
- Duties and responsibilities in case of material misstatement.
- Liability in case of material misstatement.
- Punishment for contravention.
- Prosecution by NFRA (National Financial Reporting Authority) under section 132

Mandatory Rotation of Auditor

Compulsory rotation of auditors by the listed companies and the classes of companies is prescribed:

- Audit firm including LLP – not more than 2 terms of 5 consecutive years.
- Individual auditor – not more than 1 term of 5 consecutive years.
- During the cooling period (of 5 years) even any audit firm having one or more common partners with the audit firm being rotated is not eligible to be appointed auditor of the same company.

Powers and Duties of Auditors

The following powers and duties have been prescribed for auditors in the new Companies Act to ensure compliance of all auditing standards:

1. Consolidation of accounts exercises your right to access to the records of all its subsidiaries, if required.
2. Ensure you have sought the desired information. Keep all backups, preferably, certified copies.
3. The auditor's report shall state any qualifications, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith.
4. The auditor's report is to state whether company has adequate internal financial controls systems in place and operating effectiveness of such controls.
5. If an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by the officers or the employees of the company, he shall immediately report the matter to the Central government

immediately but not later than thirty days of his knowledge or information, with a copy to the audit committee or in case, the company has not constituted an audit committee, to the board.

6. If the auditor does not report the fraud committed or being committed, he shall be punishable with fine which shall be not less than ₹1 lakhs but may extend to ₹25 lakhs.

Auditor Not to Render Certain Services

The section provides that an auditor appointed under this Act shall not directly or indirectly provide any of the following '**other services**' to auditee-company or its holding company or subsidiary company:

- Accounting and book keeping services
- Internal audit
- Design and implementation of any financial information system
- Actuarial services
- Investment advisory services
- Investment banking services
- Rendering of outsourced financial services
- Management services

Any other services as may be prescribed is not clear whether the restriction will apply to rendering of non-audit services by the auditor to its **network firms** wherever located to the auditee's holding company or subsidiary located outside India. Further, the Act does not define the terms such as investment advisory services and management services which are subject to varying interpretation.

Auditor's Liability in Case of Unlawful Acts

The auditor's basic responsibility is to report whether in his opinion the accounts show a true and fair view and in discharging his responsibility in a fair manner. The general thinking with regards to unlawful acts or default by the clients appears to be that the auditor should not 'aid or abet' but he is not under any legal obligation to disclose the offence. The Institute of Chartered Accountants of India has considered the role of a chartered accountant in relation to taxation frauds by the assessees and has made the following major recommendations:

The auditor's basic responsibility is to report whether in his opinion the accounts shows a true and fair view and in discharging his responsibility in a fair manner

A professional accountant should keep in mind the provisions of section 126 of the Evidence Act whereby a barrister, an attorney or vakil is barred from disclosing any information made to him the course of and for the purpose of his employment.

Disclosures

If the fraud relates to the past years when the Chartered Accountant did not represent the client, the client should be advised to make a disclosure. The accountant should also be careful that the past disclosure should not affect the current tax matters. In case of fraud relating to the accounts examined by the accountant himself, he should advise the client to make a complete disclosure. In case, client refuses to do so, the accountant should inform him that he is entitled to dissociate himself from the case and he would make a report to the authorities that the accounts prepared and examined by him are unreliable on account of certain information obtained later. In case of suppression in current accounts the clients should be asked to make a full disclosure. If he refuses to do so, the accountant should make a complete reservation in his report and should not associate himself with the return.

Liabilities of the Auditor

The question of liability of an auditor for unlawful acts or frauds by the clients should be considered in the light of broad parameters given above. However, it appears that if an auditor is aware of any unlawful act has been committed by the client with respect to the accounts audited by him and the unlawfulness is not rectified by proper disclosure, the auditor owes a duty to make the suitable report if he does not do it, he may be held liable.

Liabilities Relating to Contents of the Prospectus Under Section 35 of the Company's Act

Where the person has subscribed, the securities of a company acting on any statement included, or the inclusion or the omission of any matter, in the prospectus is misleading and he has sustained any loss or damage as a consequence thereof, the company and every person who is a director; has authorized himself to be named and is named in the prospectus as a director of the company; Is a promoter; Is an **expert** referred in **sub section 5 of the section 26**, (AUDITOR is Covered) shall without prejudice to any punishment to which any person may be liable under the section 36, liable to pay the compensation to every person who has sustained such loss or damage. Notwithstanding anything contained in this section, where it is proved that prospectus has been issued with an intent to defraud the applicants for the securities of a company or any other fraudulent purposes, every person, (including auditor) referred to in the subsection (1) shall be personally responsible, without any limitation or liability, for all or any of the losses.

Liability in Case of Material Misstatement

- Misstatement in financial information can arise from fraud or error. The term FRAUD refers to the 'INTENTIONAL ACT' by one or more individuals amongst the management, those charged with governance.
- The auditor is concerned with fraudulent acts that cause a material misstatement in the financial statements.
- Fraud involving one or more members of management those charged with governance is referred to as MANAGEMENT FRAUD. The primary responsibility for the prevention and detection of fraud rests with those charged with governance and management of the entity.
- **Further, an audit conducted in accordance with the standards on auditing generally accepted in India, is designed to provide reasonable assurance that financial statements taken as a whole are free from material misstatement whether caused by fraud or error.** The fact that an audit is carried out may act as a deterrent, but the auditor is not and cannot be held responsible for the prevention of error and fraud.
- An auditor does not guarantee that all material misstatement will be detected because of such factors, as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature.
- Certain levels of management may be in a position to override control procedures designed to prevent similar frauds by other employees. Auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance. Hence in an audit the auditor does not guarantee that material misstatements will be detected.

Punishment for Contravention

- If any of the provisions of **S.139 to S.146** is contravened, the company shall be punishable with a fine which shall **not be less than ₹25000** but which may **extend to ₹5 lakhs** and every officer of the company who is in default shall be punishable with imprisonment for a term which may **extend to one year** or with a **fine** which shall **not be less than ₹10000** but which **may extend to ₹1 lakhs or with both.**
- If the **contravention** by the auditor is **wilful** or with intention to deceive the company or its shareholders or creditors or tax authorities, he shall be **punishable with imprisonment for a term which may extend to 1 year and with fine not less than ₹1 lakhs but extend to ₹25 lakhs**
- The auditor who has been convicted shall refund the remuneration and pay for damages to company or the statutory bodies.

Prosecution by NFRA (National Financial Reporting Authority) U/s 132

- NFRA may investigate either suo motu or on a reference made to it by the Central government on matters of professional or other misconduct committed by any member or firm of chartered accountants, registered under the Chartered Accountants Act, 1949. If professional or other misconduct is proved, NFRA has the power to make order for:
  - imposing penalty of (i) not less than one lakh rupees, but which may extend to five times of the fees received, in case of individuals; and (ii) not less than ten lakh rupees, but which may extend to ten times of the fee received, in case of firms;
  - debarring the member or the firm from engaging himself or itself from practice as member of the Institute of Chartered Accountant of India referred to in clause (e) of sub-section (1) of section 2 of the Chartered Accountants Act, 1949 for a minimum period of six months or for such higher period not exceeding ten years as may be decided by the National Financial Reporting Authority.

Key Changes Made in Companies Act 2013 Regarding Corporate Governance

Some of the key changes are:

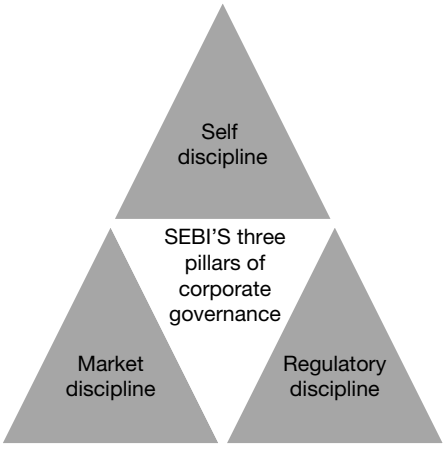
- Appointment of a Woman Director.
- Tenure of Independent Directors.
- Formal letter of appointment to Independent Directors.
- Performance evaluation of Independent Directors.
- Separate meeting of Independent directors and Training of independent directors.
- Succession Plan for Board/Sr. Management.
- Compulsory whistleblower mechanism.
- Constitution of Nomination and Remuneration Committee.
- Disclosure in the Annual Report about Remuneration Policy and evaluation criteria.
- Reporting of Related Party Transactions.
- Compulsory Electronic voting for all shareholders' resolutions.
- Compulsory profit share for CRS activities.

Securities and Exchange Board of India Act, 1992

Another major legislation relating to corporate governance in India is the Securities and Exchange Board of India Act of 1992 under which SEBI, the regulatory body of the stock markets in India was established. Till 1991 in India, the implementation of various provisions of the Companies Act 1956 relating to capital issue were in the hands of the Controller of Capital Issue, an office attached to The Ministry of Company Affairs. When the government moved to economic liberalization path in 1991, it realized the need of professionalizing the capital market operation and hence abolished the office of controller of capital issue and established the SEBI in 1988. Initially, it was an advisory body for advising the government on capital market issues and then made it a statutory regulatory body with effect from 1 April 1992. The aim of the SEBI was to professionalize the Indian capital market and win the confidence of the investors and ensure fairness to all capital market operators. Since the formation, the SEBI has initiated several measures to overcome the inherent weakness of Indian capital market. Now the SEBI is the official agency implementing various provisions of the Companies Act relating to public issue of shares and capital market operations in India and increase the corporate value creation process by ensuring better corporate governance.

SEBI's Three Pillars of Corporate Governance Initiatives

SEBI'S efforts to ensure quality corporate governance is based on three things namely (1) Self Discipline, (2) Market discipline and (3) Regulatory discipline.



Recognizing the rising concern of corporate governance issue, the SEBI has taken several steps for improvement in disclosures which are the control tools to resolve the conflict between the management and the shareholders. The main initiatives in this direction are as follows:

1. Appointment of a committee in May 1999 under the chairmanship of Mr Kumaramangalam Birla to promote and raise the standards of corporate governance. Based on the recommendation of this committee a new clause 49 was incorporated in the stock exchange listing agreement.
2. Constitution of another committee under the chairmanship of Mr N. R. Narayana Murthy to make extensive recommendations for the better corporate governance in the Indian corporate sector. Based on the recommendations of this committee a separate section on corporate governance in the annual report of the companies has been added.

3. Set up a system named Electronic Data Information Filing and Retrieval (EDIFR) through which all companies would electronically file the mandatory disclosure to the SEBI which would be available for all investors and public.
4. Introduced measures such as submission of quarterly compliance reports and company valuation on the line of US, Sarbanes-Oxley Act, to enhance the quality of corporate governance.
5. Introduced awareness-building about the need of full disclosure and transparency. However, this has only successes partially and
6. Proposed to introduce National listing Authority empowering the investors in line with the US Class Action using information technology and public disclosure aggressively to improve surveillance.

As the regulator of capital market in India, the SEBI has been focusing on the following areas to improve the corporate governance.

(a) Ensure timely disclosure of relevant information.
(b) Providing an efficient and effective market system.
(c) Demonstrating reliable and effective enforcement and
(d) Enabling the highest standard of governance.

Specific measures taken by the SEBI in respect of corporate governance:

- Strengthening of disclosure norms for Initial Public Offers following the recommendations of the Committee set up by SEBI under the Chairmanship of Shri Y. H. Malegam.
- Providing information in the directors' reports for utilization of funds and variation between projected and actual use of funds according to the requirements of the Companies Act; inclusion of cash flow and funds flow statement in annual reports.
- Declaration of quarterly results.
- Mandatory appointment of compliance officer for monitoring the share transfer process and ensuring compliance with various rules and regulations.
- Timely disclosure of material and price sensitive information including details of all material events having a bearing on the performance of the company.
- Dispatch of one copy of complete balance sheet to every household and abridged balance sheet to all shareholders.
- Issue of guidelines for preferential allotment at market related prices and
- Issue of regulations providing for a fair and transparent framework for takeovers and substantial acquisitions.

Governance and Value Creation Rating

Based on the assumption that good governance should result in creation and fair distribution of tangible benefits CRISIL has developed a value creation rating system for Indian companies. This system is based on the following facts:

(a) The strength of shareholder relationships can add future wealth creation by the corporations.
(b) Governance process must be that wealth created is evenly distributed across all classes of shareholders.
(c) Management quality must be such that it is able to adopt the above to match the dynamics of business environment and
(d) All these impact stability of future wealth creation.

Rule 49 of the Listing Agreements of Listed Companies

On 17th April 2014 SEBI amended Clause 49 of the Listing Agreement. This has come into effect from 1st October 2014. All listed companies must agree to comply with the provisions of the Listing Agreement.

Rule 49 of the Listing Agreement

- Board of directors-composition-appointment-executive and non-executive director-tenure-compensation-disclosure-code of conduct to BOD.
- Audit committee-size and composition-meetings-powers-role-information review.
- Subsidiary companies.
- Disclosure-related party transaction-accounting treatment-risk management-use of the proceeds of public issue-directors remuneration-management-shareholders.
- CEO/CFO Certification.
- Report on corporate governance.
- Compliance.

To Whom Clause 49 is Applicable?

The provisions of the revised Clause 49 shall be applicable as follows:

- All listed entities having a paid up share capital of ₹3 crores and above or net worth of ₹25 crores or more at any time in the history of the company.
- For other listed entities which are not companies, but body corporate (Example: private and public sector banks, financial institutions, insurance companies, etc.) incorporated under other statutes, the revised Clause 49 will apply to the extent that it does not violate their respective statutes and guidelines or directives issued by the relevant regulatory authorities. The revised Clause 49 [(which came into effect from 1 January 2006) is not applicable to Mutual Funds.

Some of the Key Aspects of Rule 49 of the Listing Agreement

Board of Directors

Composition of Board

1. The board of directors of the company shall have an optimum combination of the executive and the non-executive directors with not less than fifty per cent of the board of directors comprising the non-executive directors.
2. Where the chairman of the board is a non-executive director, at least one-third of the board should comprise independent directors and in case he is an executive director, at least half of the board should comprise independent directors. Provided that where the non-executive chairman is a promoter of the company or is related to any promoter or person occupying management positions at the board level or at one level below the board, at least one-half of the board of the company shall consist of independent directors.
3. For the purpose of the sub-clause (2), the expression 'independent director' shall mean

(a) a non-executive director of the company who, apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect independence of the director;
(b) one who is not related to promoters or persons occupying management positions at the board level or at one level below the board;
(c) one who has not been an executive of the company in the immediately preceding three financial years;
(d) one who is not a partner or an executive or was not partner or an executive during the preceding three years, of any of the following:
  • the statutory audit firm or the internal audit firm that is associated with the company, and
  • the legal firm(s) and consulting firm(s) that have a material association with the company.
(e) one who is not a material supplier, service provider or customer or a lessor or lessee of the company, which may affect independence of the director;
(f) one who is not a substantial shareholder of the company, i.e., owning two per cent or more of the block of voting shares.
(g) one who is not less than 21 years of age.

Non Executive Directors' Compensation and Disclosures

All fees/compensation, if any paid to the non-executive directors, including independent directors, shall be fixed by the Board of Directors and shall require previous approval of the shareholders in general meeting. The shareholders' resolution shall specify the limits for the maximum number of stock options that can be granted to the non-executive directors, including the independent directors, in any financial year and in aggregate. But the prior approval of the shareholders in general meeting shall not apply to payment of sitting fee to the non-executive directors, if made within the limits prescribed under the Companies Act, 1956 for payment of sitting fee without the approval of the Central Government.

Other Provisions as to Board and Committees

1. The board shall meet at least four times a year, with a maximum time gap of four months between any two meetings.
2. A director shall not be a member in more than 10 committees or act as chairman of more than five committees across all companies in which he is a director.

Explanation

1. For the purpose of considering the limit of the committees on which a director can serve, all public limited companies, whether listed or not, shall be included and all other companies including private limited companies, foreign companies and companies under Section 25 of the Companies Act shall be excluded.
2. For the purpose of reckoning the limit under this sub-clause, chairmanship/membership of the audit committee and the shareholders' grievance committee alone shall be considered.
3. The board shall periodically review compliance reports of all laws applicable to the company, prepared by the company as well as steps taken by the company to rectify instances of non-compliances.

4. An independent director who resigns or is removed from the board of the company shall be replaced by a new independent director within a period of not more than 180 days from the day of such resignation or removal, as the case may be: Provided that where the company fulfils the requirement of independent directors in its board even without filling the vacancy created by such resignation or removal, as the case may be, the requirement of replacement by a new independent director within the period of 180 days shall not apply.

Code of Conduct

1. The board shall lay down a code of conduct for all board members and senior management of the company. The code of conduct shall be posted on the website of the company.
2. All board members and the senior management personnel shall affirm compliance with the code on an annual basis. The annual report of the company shall contain a declaration to this effect signed by the CEO.

Audit Committee

Qualified and Independent Audit Committee

A qualified and independent audit committee shall be set up, giving the terms of reference subject to the following:

1. The audit committee shall have a minimum of three directors as members. Two-thirds of the members of audit committee shall be independent directors.
2. All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.
3. The chairman of the audit committee shall be an independent director;
4. The chairman of the audit committee shall be present at the annual general meeting to answer the shareholder queries;
5. The audit committee may invite such of the executives, as it considers appropriate, particularly the head of the finance function to be present at the meetings of the committee, but on some occasions it may also meet without the presence of any executives of the company. The finance director, the head of internal audit and a representative of the statutory auditor may be present as invitees for the meetings of the audit committee;
6. The Company Secretary shall act as the Secretary to the Committee.

Meeting of Audit Committee

The audit committee should meet at least four times in a year and not more than four months shall elapse between two meetings. The quorum shall be either two members or one third of the members of the audit committee whichever is greater, but there should be a minimum of two independent members present.

Powers of Audit Committee

The audit committee shall have powers, which should include the following:

1. To investigate any activity within its terms of reference.
2. To seek information from any employee.
3. To obtain outside legal or other professional advice.
4. To secure the attendance of outsiders with relevant expertise, if it considers necessary.

Role of Audit Committee

The role of the audit committee shall include the following:

1. Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.
2. Recommending to the board, the appointment, re-appointment and if required, the replacement or removal of the statutory auditor and the fixation of audit fees.
3. Approval of payment to statutory auditors for any other services rendered by the statutory auditors.
4. Reviewing, with the management, the annual financial statements before submission to the board for approval, with particular reference to:
   (a) Matters required to be included in the Director's Responsibility Statement to be included in the Board's report in terms of clause (2AA) of section 217 of the Companies Act, 1956.
   (b) Changes, if any, in accounting policies and practices and reasons for the same.
   (c) Major accounting entries involving estimates based on the exercise of judgment by the management.
   (d) Significant adjustments made in the financial statements arising out of audit findings.
   (e) Compliance with listing and other legal requirements relating to financial statements.
   (f) Disclosure of any related party transactions.
   (g) Qualifications in the draft audit report.
5. Reviewing, with the management, the quarterly financial statements before submission to the board for approval.
6. Reviewing, with the management, performance of statutory and internal auditors, and the adequacy of the internal control systems.
7. Reviewing the adequacy of internal audit function, if any, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit.
8. Discussion with internal the auditors on any significant findings and follow up thereon.
9. Reviewing the findings of any internal investigations by the internal auditors into matters where there is a suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the board.
10. Discussion with the statutory auditors before the audit commences, about the nature and the scope of audit as well as post-audit discussion to ascertain any area of concern.
11. To look into the reasons for any substantial defaults in the payment to the depositors, the debenture holders, the shareholders (in case of non-payment of declared dividends) and creditors.
12. To review the functioning of the Whistle Blower mechanism, in case the same is existing.

(a) Approval of appointment of the CFO (i.e., the whole-time Finance Director or any other person heading the finance function or discharging that function) after assessing the qualifications, experience and background, etc., of the candidate.

13. Carrying out any other function as is mentioned in the terms of reference of the Audit Committee.

Review of Information by Audit Committee

The Audit Committee shall mandatorily review the following information:

1. Management discussion and analysis of financial condition and results of operations.
2. Statement of any significant related party transactions (as defined by the audit committee), submitted by the management.
3. Management letters / letters of internal control weaknesses issued by the statutory auditors.
4. Internal audit reports relating to internal control weaknesses.
5. The appointment, the removal and the terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee.

Subsidiary Companies

1. At least one independent director on the board of directors of the holding company shall be a director on the Board of Directors of a non listed Indian subsidiary company.
2. The Audit Committee of the listed holding company shall also review the financial statements, in particular, the investments made by the unlisted subsidiary company.
3. The minutes of the board meetings of the unlisted subsidiary company shall be placed at the Board meeting of the listed holding company. The management should periodically bring to the attention of the board of directors of the listed holding company, a statement of all significant transactions and arrangements entered into by the unlisted subsidiary company.

Disclosures

Basis of Related Party Transactions

1. A statement in summary form of transactions with related parties in the ordinary course of business shall be placed periodically before the audit committee.
2. Details of material individual transactions with related parties which are not in the normal course of business shall be placed before the audit committee.
3. Details of material individual transactions with related parties or others, which are not on an arm's length basis, should be placed before the audit committee, together with the Management's justification for the same.

Disclosure of Accounting Treatment

Where in the preparation of financial statements, a treatment different from that prescribed in an accounting standard has been followed, the fact shall be disclosed in the financial statements, together with the management's explanation

as to why it believes such alternative treatment is more representative of the true and fair view of the underlying business transaction in the Corporate Governance Report.

Board Disclosures – Risk Management

The company shall lay down procedures to inform the board members about the risk assessment and minimization procedures. These procedures shall be periodically reviewed to ensure that executive management controls risk through means of a properly defined framework.

Proceeds from Public Issues, Rights Issues, Preferential Issues, etc.

When money is raised through an issue (as public issues, rights issues, preferential issues), then it shall disclose to the Audit Committee, the uses/applications of funds by major category (capital expenditure, sales and marketing, working capital, etc.), on a quarterly basis as a part of their quarterly declaration of financial results.

Further, on an annual basis, the company shall prepare a statement of funds utilized for purposes other than those stated in the offer document/prospectus/notice and place it before the audit committee. Such disclosure shall be made only till such time that the full money raised through the issue has been fully spent. This statement shall be certified by the statutory auditors of the company. Furthermore, where the company has appointed a monitoring agency to monitor the utilization of proceeds of a public or rights issue, it shall place before the audit committee the monitoring report of such agency, upon its receipt, without any delay. The audit committee shall make appropriate recommendations to the Board to take up steps in this matter.

Remuneration of Directors

1. All pecuniary relationship or transactions of the non-executive director's with regard to the company shall be disclosed in the annual report.
2. Further the following disclosures on the remuneration of directors shall be made in the section on the corporate governance of the annual report:
   (a) All elements of remuneration package of individual directors summarized under major groups, such as salary, benefits, bonuses, stock options, pension, etc.
   (b) Details of fixed component and performance linked incentives, along with the performance criteria.
   (c) Service contracts, notice period, severance fees.
   (d) Stock option details, if any, and whether issued at a discount as well as the period over which accrued and over which exercisable.
3. The company shall publish its criteria of making payments to the non-executive directors in its annual report. Alternatively, this may be put up on the company's website and reference drawn thereto in the annual report.
4. The company shall disclose the number of shares and convertible instruments held by the non-executive directors in the annual report.
5. The non-executive directors shall be required to disclose their shareholding (both own or held by/for other persons on a beneficial basis) in the listed company in which they are proposed to be appointed as directors, prior to their appointment. These details should be disclosed in the notice to the general meeting called for appointment of such a director.

Management

As part of the directors' report or as an addition thereto, a management discussion and analysis report should form part of the annual report to the shareholders. This management discussion and analysis should include discussion on the following matters within the limits set by the company's competitive position:

1. Industry structure and developments.
2. Opportunities and threats.
3. Segment–wise or product-wise performance.
4. Outlook
5. Risks and concerns.
6. Internal control systems and their adequacy.
7. Discussion on financial performance with respect to operational performance.
8. Material developments in the Human Resources/ the Industrial Relations front, including the number of people employed.

Senior management shall make disclosures to the board relating to all material such as financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large (For example: dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives, etc.)

Shareholders

1. In case of the appointment of a new director or re-appointment of a director the shareholders must be provided with the following information:
   (a) A brief resume of the director.
   (b) Nature of his expertise in specific functional areas.
   (c) Names of companies in which the person also holds the directorship and the membership of Committees of the Board.
   (d) The disclosure of relationships between directors shall be made in the annual report, the notice of appointment of a director, the prospectus and the letter of offer for issuances and any related filings made to the stock exchanges where the company is listed.
2. Quarterly results and presentations made by the company to analysts shall be put on company's website, or shall be sent in such a form so as to enable the stock exchange on which the company is listed to put it on its own website.
3. A board committee under the chairmanship of a non-executive director shall be formed to specifically look into the redressal of shareholder and investors complaints like the transfer of shares, the non-receipt of balance sheet, the non-receipt of declared dividends, etc. This committee shall be designated as shareholders/Investors Grievance Committee'.
4. To expedite the process of share transfers, the board of the company shall delegate the power of share transfer to an officer or a committee or to the registrar and share transfer agents. The delegated authority shall attend to share transfer formalities at least once in a fortnight.

CEO/CFO Certification

The CEO, i.e., the Managing Director or Manager appointed in terms of the Companies Act, 1956 and the CFO, i.e. the whole-time Finance Director or any other person heading the finance function discharging that function shall certify to the Board that:

1. They have reviewed financial statements and the cash flow statement for the year and, that to the best of their knowledge and belief,
   (a) these statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading;
   (b) these statements together present a true and fair view of the company's affairs and are in compliance with the existing accounting standards, the applicable laws and regulations.
2. There are, to the best of their knowledge and belief, no transactions entered into by the company during the year which are fraudulent or illegal of the company's code of conduct.
3. They accept responsibility for establishing and maintaining internal controls for financial reporting and that they have evaluated the effectiveness of internal control systems of the company pertaining to financial reporting and they have disclosed to the auditors and the audit committee, deficiencies in the design or operation of such internal controls, if any, of which they are aware and the steps they have taken or propose to take to rectify these deficiencies.
4. They have indicated to the auditors and the audit committee any:
   (a) significant changes in the internal control over financial reporting during the year;
   (b) significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements and
   (c) instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or an employee having a significant role in the company's internal control system over financial reporting.

Report on Corporate Governance

1. There shall be a separate section on corporate governance in the annual reports of company, with a detailed compliance report on corporate governance. Non-compliance of any mandatory requirement of this clause with reasons thereof and the extent to which the non-mandatory requirements have been adopted should be specifically highlighted. The suggested list of items to be included in this report is given in **Annexure- I C** and the list of non-mandatory requirements is given in **Annexure – I D.**
2. The companies shall submit a quarterly compliance report to the stock exchanges within 15 days from the close of the quarter as per the format given in **Annexure I B**. The report shall be signed either by the Compliance Officer or the Chief Executive Officer of the company.

Compliance

1. The company shall obtain a certificate from either the auditors or practicing company secretaries regarding the compliance of conditions of corporate governance as stipulated in this clause and annex the certificate with the directors' report, which is sent annually to all the shareholders of the company. The same certificate shall also be sent to the Stock Exchanges along with the annual report filed by the company.

2. The non-mandatory requirements given in **Annexure – I D** may be implemented as per the discretion of the company. However, the disclosures of the compliance with mandatory requirements and adoption (and compliance)/non-adoption of the non-mandatory requirements shall be made in the section on corporate governance of the annual report.

Annexure I A

Information to be placed before Board of Directors

1. Annual operating plans and budgets and any updates.
2. Capital budgets and any updates.
3. Quarterly results for the company and its operating divisions or business segments.
4. Minutes of meetings of audit committee and other committees of the board.
5. The information on recruitment and the remuneration of senior officers just below the board level, including the appointment or the removal of the Chief Financial Officer and the Company Secretary.
6. Show cause, demand, prosecution notices and penalty notices which are materially important.
7. Fatal or serious accidents, dangerous occurrences, any material effluent or pollution problems.
8. Any material default in financial obligations to and by the company, or any substantial non-payment for the goods sold by the company.
9. Any issue, which involves possible public or product liability claims of substantial nature, including any judgment or order which, may have passed strictures on the conduct of the company or taken an adverse view regarding another enterprise that can have negative implications on the company.
10. Details of any joint venture or collaboration agreement.
11. Transactions that involve substantial payment towards goodwill, brand equity or intellectual property.
12. Significant labour problems and their proposed solutions. (Any significant development in the Human Resources/the Industrial Relations front like signing of wage agreement, implementation of Voluntary Retirement Scheme, etc.)
13. Sale of material nature, of investments, subsidiaries, assets, which is not in the normal course of business.
14. Quarterly details of foreign exchange exposures and the steps taken by management to limit the risks of adverse exchange rate movement, if material.
15. Non-compliance of any regulatory, statutory or listing requirements and shareholders service such as non-payment of dividend, delay in share transfer, etc.

National Depositaries Act 1996

While initiating several steps in reforming the Indian capital market, the SEBI has identified that although India had a vibrant capital market which is more than a century old, the floor based trading and the paper-based settlement of transactions caused substantial problems such as a lack of transparency in trading, the lengthy settlement procedure, bad delivery, high cost of delivery and delayed transfer of title. Solution to the problem is the introduction of screen based trading in

place of conventional floor based trading and settlements and digitalization of corporate securities in India. For this purpose, The Depositories Act 1996 was introduced in India which paved the way for digitization of corporate securities and screen based trading. For this purpose two national securities depositories namely the National Securities Depository Limited (NSDL) in 1996 and the Central Securities Depository Limited (CSDL) in 1999 were established. This facilitated the conversion of Indian capital market to international standards that handle most of the securities held and settled in de-materialized form in the Indian capital markets.

What is a Depository?

Depository means a place where something is deposited for safe keeping. It is an organization which holds securities of a shareholder in an electronic form and facilitates the transfer of ownership of securities on the settlement date. The system is based on the concept of paperless trading. It is similar to opening a bank account where the depositor's money is safely kept. This method does away with all the risks and hassles normally associated with paperwork. Consequently, the cost of transacting in a depository environment is considerably lower as compared to transacting in certificates. The NSDL is promoted by Industrial Development Bank of India Limited (IDBI) - the largest development bank of India, the Unit Trust of India (now, Administrator of the Specified Undertaking of the Unit Trust of India) and the National Stock Exchange of India Limited (NSE). Some of the prominent banks in the country that have taken a stake in the NSDL are Axis Bank Limited, the State Bank of India, the Oriental Bank of Commerce, Citibank, the Standard Chartered Bank, HDFC Bank Limited, Dena Bank, Canara Bank and the Union Bank of India. The CSDL was started in 1999 by BSE, SBI Bank of India, Bank of Baroda and HDFC bank. Stock Holding Corporation of India Limited started in 1988 by IDBI, ICICI, UTI, LIC and GIC also carries out the depository functions in India.

Depository means a place where something is deposited for safe keeping. It is an organization which holds securities of a shareholder in an electronic form and facilitates the transfer of ownership of securities on the settlement date.

Benefits of Depositories System

The major benefits of the depository system are as follows:

- Enables immediate allotment, transfer and settlement.
- Eliminate all problems associated with paper security.
- Problem of odd lot is eliminated.
- Interest rate for loans against pledged demat security is less.

ICA and Corporate Governance

The Role of Chartered Accountant in Corporate Governance

Chartered Accountants as professionals act as catalysts in applying good principles of corporate governance. Some of the key roles that they can play include:

(a) Specialized guidance in designing code of corporate governance.
(b) Specialized guidance in designing risk management framework.
(c) Specialized guidance in designing internal control framework.
(d) Specialized guidance in designing whistleblower policy.
(e) Internal Audit - Compliance of clause 49.

(f) Internal Audit- risk management framework.
(g) (Certificate under section VII (1) of clause 49.
(h) Management Audit pertaining to various regulatory, statutory or listing requirements (Item 15 of Annex. 1A of clause 49).
(i) Effective role as chairman of audit committee.
(j) Effective role as independent director.
(k) Assessment of internal control function under section V CEO/CFO Certification.
(l) (As a consultant giving specialized guidance to the management, regular and speedy updates on all applicable provisions, evaluating future growth potential and in taking proactive actions in the interests of the company.

Rating of Corporate Governance

The increasing focus on corporate governance has resulted in a number of rating companies publishing corporate governance scores of various types. Each company uses its own system and criteria for rating the corporate governance practices of public companies. The SEBI is also providing the rating of corporate governance. The South Asian Federation of Accountants (SAFA) has already started rating of corporate governance by outside agencies.

Some of the Providers of Corporate Governance Ratings Include

Board Analyst: The factors considered are: Board Composition, CEO Compensation, Shareholder Responsiveness, Accounting, Strategic Decision making, Litigation and Regulatory Problems and Takeover Defenses.

Core Ratings: European provider of independent ratings reports on corporate governance, the environmental impact, employment practices and impact on the societies.

CRISIL Ltd. (India) Governance and Value Creation Ratings: This rating scale reviews, management capabilities, transparency, influence of major stakeholders, board composition and effectiveness.

Deminor Rating: This system helps to bridge the corporate governance expectation gap between the investors and the listed companies. This is the first European corporate governance rating agency using more than 600 variables, including environmental, workplace safety and earnings management.

ICRA Limited. It provides a Corporate Governance Ratings (CGR) service for the Indian Market. ICRA's Corporate Governance Rating (CGR) is meant to indicate the relative level to which an organization accepts and follows the codes and the guidelines of corporate governance practices. Corporate Governance practices prevalent in a company reflect the distribution of the rights and the responsibilities among different participants in the organization such as the Board, management, shareholders and other financial stakeholders and the rules and procedures laid down and followed for making decisions on corporate affairs. The emphasis of ICRA rating is on corporate business practices and quality of disclosure standards that addresses the requirements of the regulators and is fair and transparent for its financial stakeholders.

The variables, which are analysed for arriving at the rating, are the shareholding the structure, the executive management processes, the board structure and processes, the stakeholder relationship, transparency and disclosures and the

financial discipline. Each of these variables is evaluated with respect to a set of attributes and a composite score is computed using a proprietary model developed by ICRA. The rating process also looks at compliance with statutory regulations as laid down in Clause 49 of the Listing Agreement. The focus, however, is on substance over form and compliance with regulations is only the starting point. The ICRA opinion, is, however, not a certificate of statutory compliance or a comment on company's future financial performance, credit rating or stock price.

Moody's Investors Service is overhauling the corporate governance assessment in its existing ratings. The firm hired Kenneth Bertsch to serve as director of corporate governance, a position he held at TIAACREF.

Open Compliance and Ethics Group, a non-profit group focused on providing universal guidelines (benchmarks) for integrated compliance and ethics programs.

Standard & Poor's: Governance Services offers a range of products and services to evaluate the corporate governance standards of individual companies around the world. The corporate governance score assesses the companies' corporate governance performance for investors. The corporate governance evaluation service confidentially diagnoses corporate governance for companies. The corporate governance customized research tailors research for investors, companies, regulators, or other organizations.

Shareholder's Activism

Shareholder activism is a way in which shareholders can influence a corporation's behaviour by exercising their rights as owners.

Shareholder activism is a way in which shareholders can influence a corporation's behaviour by exercising their rights as owners. Although shareholders don't run a company, there are ways for them to influence the board of directors and management. They sometimes use their rights as shareholder of a publicly-traded corporation to bring about a social change. Some of the issues most often addressed by the shareholder activists are related to the environment, the investments in politically sensitive parts of the world and the workers' rights. The term is also referred to investors who believe that a company's management is doing a bad job and who attempt to gain control of the company and replace management for the good of the shareholders.

Shareholders in general have the following powers:

1. To attend meetings of shareholders and exercise voting rights, either personally or through proxy.
2. To transfer shares.
3. To receive dividend when declared.
4. To elect directors.
5. To requisition an extraordinary general meeting of the company.
6. To have right shares and bonus shares.
7. To apply to tribunal.
8. To file Class Action suits.
9. To file a suit in case of any misleading statements in the prospectus.

The Board of Directors of a company shall be entitled to exercise all such powers and to do all such acts as the company is authorized to do. However, this power is subject to powers as given in Companies Act, 2013 and which are to be done by the company in general meetings. The Powers of Board of Directors in brief are as follows:

1. To issue securities, including debentures.
2. To invest the funds of the company.
3. To grant loans or give guarantee or provide security in respect of loans.
4. To approve financial statement and the Board's report.
5. To borrow money.
6. To diversify the business of the company.
7. To appoint and remove key managerial personnel.
8. To appoint internal auditor.
9. To approve quarterly, half yearly and annual financial statements.
10. To accept or renew public deposits.
11. To authorize buy-back of securities.

Residuary Powers

There arise some situations that the Board is unwilling or unable to act. In such situations, it is permissible for the general meeting to exercise the powers vested in the Board of Directors even though it may be exercising powers which are conferred on the board. There are a number of situations conceivable where the general meeting may be called upon to exercise these 'default' or 'residuary' powers. For example: Where there is a deadlock on the board; where an effective quorum cannot be obtained either because the directors are disqualified from voting, or because there are no directors; where the transaction in question is beyond the powers of the board. Also, it is important to understand that in these situations the General Meeting is exercising its residuary powers and therefore it can either ratify the acts of the directors, or authorize the directors to act on their behalf through an ordinary resolution. In either case, since the directors are acting as agents of the general meeting and not as directors of the company, they are governed by the rules of agency.

As per Section—100 of the Companies Act, 2013 General Meetings are of three kinds:

1. Annual General Meeting
2. Extraordinary General Meeting (EGM)
3. Class Meeting

What makes the AGM of great significance is that it is a mandatory statutory requirement to hold an AGM at the specified period complying with the conditions laid in Section 96 of Companies Act, 2013. The period between two AGMs can thus not be more than fifteen months and there has to be an AGM in every calendar year. Further, the requirement of submission of Report on AGM containing a fair and correct summary of the proceedings of the meeting has to be compiled with. What this implies is that the AGM has to be held by the Board of Directors, even if it does not want to, which might be the case if the company has performed badly, and hence this being a mandatory requirement itself makes the AGM a powerful tool in the hands of the shareholders. Further, the AGM is not just means by which important business is transacted but also a form in which the shareholders are informed of the important aspects of the functioning of the company, especially relating to the financial health of the company. They can question the directors; raise important issues regarding the company; pass resolutions and exercise their most important power with respect to the appointment of directors standing for re-election and the removal of directors.

While most of these transactions can be undertaken in extra-ordinary General Meetings also, members who may want to raise such issues may not be able to ask for convening the meeting due to the strict requirement of the number of

members needed to convene an EGM as specified in Rules 17 of the Companies (Management and Administration) Rules 2014. Important mandatory matters that have to be dealt with in the AGM are the Appointment of Directors and the Power of Removal of Directors and the Placing of Accounts, the Balance Sheet, the Report of Director, Auditor and the Corporate Governance Report.

The new Companies Act 2013, subsequent revisions to Clause 49 of the Listing Agreement and other regulatory changes by SEBI have ushered in many changes that enhance the shareholders' activism and consequent corporate governance in India. The requirements for a greater degree of disclosures by companies aided shareholders to analyse particular actions and make better informed decisions. E-voting was made mandatory in 2013 which resulted in a greater investor participation as it made voting process painless and independent of the location of the investor. Provisions like class action suits against companies and directors are in the offing, which can also give minority investors the confidence to raise voice against companies whenever the need arises.

Some of the Examples of Domestic Shareholders Activism in India

- Tata Group owned Indian Hotels classified Mr Shapoor Mistry as an independent director in its annual report of 2012. Such a classification was wrong since Mr Mistry is from the family that has a major shareholding in the Tata Sons and is the brother of Mr Cyrus Mistry. Proxy firms recommended that investors raise this issue following which the company correctly classified him as a non-independent director in the annual report of 2013.
- Jindal Steel and Power (JSPL) proposed a resolution in 2012 to hand over authority to its CMD to set the remuneration of executive directors. Once again, due to activism by proxy firms and shareholders, the company withdrew the proposal.
- In 2014, Tata Motors' proposal of payment of remuneration to two of its executive directors and the managing director in the event of inadequate profits was rejected by public shareholders. This was the first instance of a routine proposal by a prominent Indian company failing to approval by the shareholders.
- Similarly, in late 2014, many proposals of the United Spirits to enter into related party transactions with its promoter Diageo Plc. and other related entities were rejected by its shareholders.
- Siemens' proposal for selling the metal technologies business to a 100 per cent subsidiary of Siemens AG, the German parent company, was rejected by the shareholders. All the three companies have re-proposed their resolutions with enhanced disclosures and explanations that are more informative.
- In the Extra Ordinary General meeting of the Tata Motors held on 22 December 2016 for the removal of Mr Nusil Wadia from the directorship of Tata Motors, 99 per cent of promoters and 50 per cent of the institutional investors voted in favour of the removal while another 50 per cent of the institutional investors voted against the resolution. Voting pattern in this issue indicated that most public and retail shareholders put together accounted for 53 per cent against the resolution and 47 per cent in favour of the resolution.

Role of Company Secretary and Corporate Governance

Statutory Requirement

Pursuant to section 383A of the Companies Act, 1956, companies with a paid-up share capital of ₹5 crore or more are legally obliged to appoint a whole-time Company Secretary who must be a member of the Institute of Company Secretaries

Activism by Foreign Investors

- The proxy advisory firms and domestic investors were not the only ones to take a proactive stance on activism; a few foreign investors too started taking keen interest in their Indian investee companies.
- In 2012, The Children's Investment Fund (TCI), a UK based hedge fund with AUM of more than $5 billion, initiated a legal action against Coal India's directors and the Govt. of India over under-pricing of coal resulting in lesser profits by Coal India. TCI, at that time, held 1 per cent of Coal India's shares which accounted for 10 per cent of the total outstanding shares held by the public.
- In 2014, Knight Assets, another UK based fund, engaged with the Tata Motors to list the A-shares in the American bourses. The investor believed the DVRs were undervalued in the Indian markets and listing in the US could enhance the shareholder value.

of India. Every company having a paid-up share capital of ₹10 lakh more but less than ₹5 crore is required to engage the services of a Secretary in Whole-time Practice for issue of compliance certificate.

Role

The secretary is a vital link between the company and its Board of Directors, shareholders, government, regulatory authorities and all other stakeholders. He has to ensure that the board procedures are followed and regularly reviewed and provides guidance to the Chairman and the Directors on their responsibilities under various laws. He commands high position in the value chain and acts as a conscience seeker of the company. A Company Secretary being multidisciplinary professional renders services in following areas:

1. **Corporate Governance and Secretarial Services:** With regards to corporate governance the Company Secretary has to carry out functions such as advising on good governance practices and compliance of corporate governance norms as prescribed under various corporate, securities and other business laws and regulations and guidelines made thereunder.
2. **Corporate Secretarial Services:** The major activities of a Company Secretary in corporate secretarial service includes Promotion, formation and incorporation of companies and matters related therewith filing, registering any document including forms, returns and applications by and on the behalf of the company as an authorized representative, maintenance of secretarial records, statutory books and registers, arranging board/general meetings and preparing minutes thereof. A relating to shares and their transfer and transmission.
3. **Corporate Laws Advisory and Representation Service:** With regard to corporate laws, advisory and representation services, the Company Secretary has to represent before, The Company Law Board, the National Company Law Tribunal, the Competition Commission of India, the Securities Appellate Tribunal, the Registrar of Companies Consumer Forums, the Telecom Disputes Settlement and Appellate Tribunal, the Tax Authorities, other quasi-judicial bodies and tribunals.

4. **Arbitration and Conciliation Services:** Advising on arbitration, negotiation and conciliation in commercial disputes between the parties, acting as arbitrator/conciliator in domestic and international commercial disputes, drafting Arbitration/Conciliation Agreement/Clause.
5. **Financial Market Services:** With regard to financial market services the Secretary has to supervise the following.

The National Company Law Tribunal (NCLT)

The NCLT is a quasi-judicial body in India that adjudicates issues relating to companies in India. The NCLT was established under the Companies Act 2013 and was constituted on 1 June 2016. The NCLT has eleven benches, two at New Delhi (one being the principal bench) and one each at Ahmadabad, Allahabad, Bengaluru, Chandigarh, Chennai, Guwahati, Hyderabad, Kolkata and Mumbai. Justice M. M. Kumar, a retired judge of the Punjab and Haryana High Court has been appointed as President of the NCLT. The NCLT Bench at Bangalore began functioning on 18 July 2016. The NCLT will comprise a president and judicial and technical members, as necessary. The NCLT has an appellate body called NCLAT, which consist of a chairperson and a maximum of eleven judicial and technical members. Justice S. J. Mukhopadhaya, a retired judge of the Supreme Court of India, has been appointed the chairperson of the NCLAT. While the tribunals have been set up to deal with all company related disputes (except any criminal prosecution for offences under the Companies Act), the powers currently provided to the NCLT and the NCLAT under the recent notifications are limited.

The establishment of NCLT is another landmark contribution of the companies Act 2013. This is aimed at fast and efficient resolution of disputes relating to the affairs of the companies with out going to court of law when is very time consuming.

The formation of the NCLT and the NCLAT is a significant step towards attaining fast and efficient resolution of disputes relating to affairs of the Indian corporates. It is expected that once all relevant provisions under the Companies Act and the Bankruptcy Code are made effective, these tribunals would provide holistic solutions to issues being faced by companies, including those of winding up, oppression/mismanagement and insolvency. Being the sole forum dealing with company related disputes, these tribunals would also eliminate any scope for overlapping or conflicting rulings and minimize delays in resolution of disputes, thus, proving to be a boon for the litigants. Decisions of the NCLT may be appealed to the National Company Law Appellate Tribunal.

The NCLT has been given wide powers under the Companies Act to adjudicate:

1. All cases initiated before the Company Law Board (**CLB**) under the Companies Act, 1956 (**Old Act**) (which, pursuant to the NCLT's constitution, stand transferred to the NCLT);
2. All proceedings pending before any district court or High Court under the Old Act including proceedings relating to arbitration, compromise, arrangements and reconstruction and winding up of companies (which, upon the relevant notification being issued, stand transferred to the NCLT);
3. References/inquiries/proceedings pending before the Board for Industrial and Financial Reconstruction (**BIFR**), including those pending under the Sick Industrial Companies (Special Provisions) Act, 1985 (**SIC Act**), which would be abated, upon relevant notification being issued, are to be referred to the NCLT within 180 days from the date of abatement;
4. Appeals or any other proceedings pending before the Appellate Authority for Industrial and Financial Reconstruction (**AAIFR**), including those pending under the SIC Act, which would be abated, upon relevant notification being issued, are to be referred to the NCLT within 180 days from the date of abatement; and

5. Fresh proceedings pertaining to claims of oppression and mismanagement of a company, winding up of companies and all other powers prescribed under the Companies Act.

In addition, the recently enacted Insolvency and Bankruptcy Code, 2016 (**Bankruptcy Code**), also provides wide powers to the NCLT to adjudicate upon the 'insolvency resolution process' and liquidation of corporate debtors. However, the bankruptcy code is yet to be notified and made effective.

In the light of the limited provisions under the Companies Act which have been made effective, presently, the NCLT has jurisdiction to:

1. Entertain any claims of oppression and mismanagement of a company and to pass any order that the NCLT may deem fit in this regard;
2. Adjudicate proceedings and cases initiated before the CLB under the Old Act, which now stand transferred to the NCLT; and
3. Exercise powers under various sections of the Companies Act which have been notified and made effective by the Government of India, including (a) power to pass any order against a company incorporated by providing false information or by fraud, (b) power to grant approval for alteration of articles of a company, if such alteration changes its nature from public to private, and (c) power to provide approval for issuance of redeemable preference shares by a company under certain circumstances.

All appeals against any order of the NCLT may be filed by the aggrieved parties with the NCLAT. Any appeal against the orders of the CLB before the constitution of the NCLT would continue to lie before the relevant High Court and not the NCLAT. Currently, for matters pertaining to the winding up of companies and sick companies, parties would have to continue to approach the concerned High Courts, the BIFR or the AAIFR.

Insider Trading

Insider trading is the buying or selling of a security by someone who has access to material non-public information about the security.

In common language, Insider trading is the buying or selling of a security by someone who has access to material non-public information about the security. Insider trading can be illegal or legal depending on when the insider makes the trade. It is illegal when the material information is still non-public; trading while having special knowledge is unfair to other investors who don't have access to such knowledge. Illegal insider trading includes tipping others when you have any sort of non-public information. Legal insider trading happens when directors of the company purchase or sell shares, but they disclose their transactions legally. The Securities and Exchange Commission (SEC) has rules to protect investments from the effects of insider trading. It is a malpractice wherein trade of a company's securities is undertaken by people who by virtue of their work have access to the otherwise non-public information which can be crucial for making investment decisions.

Insiders includes directors of the company, auditors of the company, legal advisors of the company, management consultants, key employee, executives or any other officer of the company who have access to the strategic information about the company which is not known to others and use the same for trading in the company's stocks or securities. Insider trading is an unfair practice, wherein the other stockholders are at a great disadvantage due to lack of important insider non-public information. However, in certain cases if the information has been made public, in a way that all concerned investors have access to it. Then that will not be an insider trading.

Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015

The SEBI on 15th January 2015 has issued a detailed regulation prohibiting insider trading in India capital market. The salient features of the regulation are as follows:

1. The regulation has defined an insider as any person or a connected person in possession of or having access to unpublished price sensitive information.
2. 'Trading' means and includes subscribing, buying, selling, dealing, or agreeing to subscribe, buy, sell, deal in any securities and 'trade' shall be construed accordingly.
3. 'Trading day' means a day on which the recognized stock exchanges are open for trading and
4. 'Unpublished price sensitive information' means any information, relating to a company or its securities, directly or indirectly, that is not generally available which upon becoming generally available, is likely to materially affect the price of the securities and shall, ordinarily including but not restricted to, information relating to the following:
   (a) Financial results
   (b) Dividends
   (c) Change in capital structure
   (d) Mergers, de-mergers, acquisitions, de-listings, disposals and expansion of business and such other transactions.
   (e) Changes in key managerial personnel.
   (f) Material events in accordance with the listing agreement.

Communication or Procurement of Unpublished Price Sensitive Information

No insider shall communicate, provide, or allow access to any unpublished price sensitive information, relating to a company or securities listed or proposed to be listed, to any person including other insiders except where such communication is in furtherance of legitimate purposes, performance of duties or discharge of legal obligations.

Trading When in Possession of Unpublished Price Sensitive Information

No insider shall trade in securities that are listed or proposed to be listed on a stock exchange when in possession of unpublished price sensitive information.

Code of Fair Disclosure

The board of directors of every company, whose securities are listed on a stock exchange, shall formulate and publish on its official website, a code of practices and procedures for fair disclosure of unpublished price sensitive information that it would follow in order to adhere to each of the principles set out in Schedule A to these regulations, without diluting the provisions of these regulations in any manner.

Based on the above regulations, no insider is permitted to buy, sell or intermediate the buying or selling of shares of the company in which he/she is an insider. If by violating the provisions, the insider conducts any trading, then it will be illegal and punishable.

CONCLUSION

The economic liberalization initiated during the last three decade all over the world has increased the importance of corporate mode of business. Because of higher return potentials and lower risk investors were attracted to this method of investment. Along with the corporate growth corporate scams and frauds also increased due to several unethical practices followed by many companies like Enron, World Com, Satyam computers, etc. This has affected the investor confidence significantly during the last 20 years. Attempts were made both under industry level and government level to redefine the corporate governance structure and strengthen the legal and regulatory framework s of corporate governance. In India several laws are directly or indirectly related to the corporate governance namely The Indian Companies Act, The Security Contract (Regulation) Act, SEBI Act, Listing agreement under Clause 49, The National Depositaries Act, The Chartered Accounts Act, The Company Secretary Act, etc. Among these The India Companies Act is the most important one giving a detailed legal framework of governance. This has been broadly divided in to eight segments such as Reporting framework, Higher auditor accountability, Risk management, Investor protection, Board of directors, Board committee, CSR and whistle blowing mechanism.

KEYWORDS

- Board committees
- Board of Directors
- Class Action
- Companies Act 2013
- CSR
- Investor Protection
- Legal framework
- Reporting framework
- Risk Management
- Rule 49, listing agreement.
- Stake holders
- Shareholder activism
- Whistle blowing

DISCUSSION QUESTIONS

1. Explain the legal framework on corporate governance.
2. Discuss the legal and regulatory measures of corporate governance in India.
3. What are the salient features of Indian Companies Act 2013 on corporate governance?
4. What do you mean by reporting framework under Indian Companies Act 2013?
5. What is related party transaction? State its importance in corporate governance.
6. Write a note on remuneration to Directors and Management under Indian Companies Act 2013.
7. What do you mean by risk management under Indian Companies Act 2013?
8. What is whistleblowing mechanism?
9. Explain CSR activities under Indian Companies Act 2013.
10. Explain the provisions involved in Indian Companies Act on investor protection.
11. Explain Auditor's responsibility under Indian Companies Act 2013.
12. What is rule 49? Explain the provisions of rule 49 of the listing agreement.

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Share Holders—The Prime Stake Holders

CHAPTER OUTLINE

- Introduction
- Corporate Stakeholders and their Concern
- Rights of Shareholders
- Views of Various Committees on the Issue
- SEBI Guidlines for Investors
- Shareholders Activism and Class Actives
- Poor Track-record of Shareholder Protection
- Grievance Redressal Process

Introduction

Corporate governance is needed to create a corporate culture of consciousness, transparency and openness. It refers to a combination of laws, rules, regulations, procedures and voluntary practices to enable companies to maximise shareholders' long-term value. It should lead to increasing customer satisfaction, shareholder value and wealth. Corporate governance deals with a company's ability to take managerial decisions *vis-á-vis* its claimants, in particular its shareholders, apart from other stakeholders.

Corporate governance is needed to create a corporate culture of consciousness, transparency and openness. It refers to a combination of laws, rules, regulations, procedures and voluntary practices to enable companies to maximise shareholders' long-term value. The most fundamental theoretical basis of corporate governance is agency costs. This divergence in objectives between ownership and management leads to agency costs, which in turn leads to the need for corporate governance.

Corporate Stake Holders

In any form of business organisation there will be different stakeholders with varying interest without whose support the organisation ceases to exist. The interest of some stakeholders at some points of time may be complementary while at some other be contradictory. Corporate form of business is not an exemption to this. In a corporate form of business there are several groups of stakeholders. They are broadly grouped into (1) Internal stakeholders and (2) external stakeholders.

1. Internal stakeholders are those who engage in economic transactions with the organization such as the owners, the employees, the managers.
2. External stakeholders are those who do not engage in direct economic transaction but their actions can affect the business. Examples: the Government, the Suppliers, the Creditors. The following table shows the different types of stakeholders and their varying interest in a corporate organization.

Main Stakeholders and their Concern in a Company

Corporate stakeholders	*Their interest*
Shareholders	Value maximization, profitability, liquidity-growth-market price
Employees/trade union	Benefit maximization, quality of work, life, etc.
Government	Tax, employment, true reporting, diversity.
Creditors	Liquidity, debt servicing
Customers	Quality, price, care
Community	Job, environment protection, equity
Institutional investors	Share price and corporate image
Competitors	Fair business

Conflict of interest of stakeholders: Frequently there may be a conflict of interest of stakeholders and this will become a major problem in the good corporate governance. For example: shareholders aiming to maximize profit and share value may be interested in reducing wages or other benefits to workers or increasing price of the product while the customers oppose the price increase and the employees oppose the wage-cut-type measures. Similarly, government may want a higher tax which will adversely affect profit and high customer price for the product. As far as the society is concerned, a pollution-free environment and new employment opportunities are required. But these involve additional cost and higher price

of the product to the consumers and a lower profitability to the shareholders. To protect the interest of major groups there will be representatives in the governing body like the shareholder's representatives, employee's representatives, etc. But many other groups are not represented in the governance system.

One of the prime principles of good corporate governance is to ensure fairness and equity to all the stakeholders. Unless the goals of all stakeholders are adequately protected the ultimate goal of the organization will not be achieved. The OECD principles of good governance extensively emphasise the need of equitable treatment to all the shareholders and, the role of other stakeholders in good governance. According to the OECD Principle 4, '**The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises**'. The Cadbury Committee on corporate governance also recognizes the importance in satisfying the interest of all stakeholders in good governance. The basic philosophy followed by **Mr N. R. Narayan Murthy Committee** on Corporate Governance is that "Corporation is an integration of various stakeholders, such as customers, employees, investors, vendor partners, government and society, and capital flowing from various persons staying in different parts of the world. Hence, it is essential that the business must be conducted ethically and be governed in a fair and transparent manner protecting the interest of all stakeholders. It is a key element in improving economic efficiency of the firm. Further the Committee views corporate governance not in a strict legal point of view but from the point of view of mindset and culture of the management". The Committee is of the view that good corporate governance brings credibility to the company and investors attach superior value to it and, vice versa for bad governance.

Regarding whose interest the board of directors should give prime importance, the **Hampel Committee on Corporate Governance** is of the view that 'the directors of board are responsible for relations with all stakeholders, but they are accountable to the shareholders only'. **The US Securities Exchange Commission's** view in this respect is explained in Principle 13 of the SEC report which says that the 'Company should treat all the shareholders fairly and equitably, and also recognize, protect and facilitate the exercise of their rights and recommended that:

1. The Board should ensure that basic shareholder rights are disclosed in the Manual on Corporate Governance and on the company's website.
2. The Board should encourage active shareholder participation by sending them the Notice of Annual and Special Shareholders' Meeting with sufficient and relevant information at least 28 days before the meeting.
3. The Board should encourage active shareholder participation by making the result of the votes taken during the most recent Annual or Special Shareholders' Meeting publicly available the next working day. In addition, the Minutes of the Annual and Special Shareholders' Meeting should be available on the company website within five business days from the date of the meeting.
4. The Board should make available, at the option of a shareholder, an alternative dispute mechanism to resolve intra-corporate disputes in an amicable and effective manner. This should be included in the company's Manual on Corporate Governance and

5 The Board should establish an Investor Relations Officer (IRO) to ensure constant engagement with its shareholders. The IRO should be present at every shareholder's meeting.

Further Principle 14 SEC report says that "the rights of stakeholders established by law, by contractual relations and through voluntary commitments must

be respected. Where the stakeholders' rights and/or interests are at stake, the stakeholders should have the opportunity to obtain prompt effective redressal for the violation of their rights". The committee also recommended that (1) The Board should identify the company's various stakeholders and promote cooperation between them and the company in creating wealth, growth and sustainability. (2) The Board should establish clear policies and programs to provide a mechanism on the fair treatment and protection of the stakeholders and (3) The Board should adopt a transparent framework and process that allow the stakeholders to communicate with the company and to obtain redress for the violation of their rights. **Birla Committee** also recognizes the importance of the stakeholders other than the shareholders in the long term value maximization of companies and the need of a mechanism to incorporate their views in the governance system.

Hence, the main focus of corporate governance is to satisfy the interest of all stakeholders. It is necessary to create a corporate culture of consciousness, transparency and openness. A governance system is a combination of laws, regulations, procedures and voluntary practices to enable companies to maximize shareholder's value. It should also lead to increasing customer value, employee's benefits and government revenue.

Shareholders—The Prime Stakeholders: Being the contributors of capital, the shareholders are the prime stakeholders. They are engaged in the economic transactions with the organization and become the residual owners of the company. In the words of the Birla Committee on Corporate Governance, 'The shareholders are the primary stakeholders hence, the report primarily focused on shareholders. The Committee recognizes that the fundamental objective of corporate governance is the enhancement of shareholder value, keeping in view the interests of other stakeholder'. The OECD Principle 2 states that "The corporate governance framework should protect and facilitate the exercise of shareholders' rights".

Theoretical Basis—Agency Costs

The most fundamental theoretical basis of corporate governance is agency costs. Shareholders are the owners of joint-stock, limited liability company, and are its principals. By virtue of their ownership, the principals define the objectives of the company. The management, directly or indirectly selected by the shareholders to pursue such objectives, are the agents. While the principals might assume that the agents will invariably do their bidding, it is often not so. In many instances, the objectives of the managers are quite at variance with those of the shareholders. This divergence in objectives between the ownership and the management leads to agency costs, which in turn leads to the need for corporate governance.

Two broad instruments that reduce agency costs and hence improve corporate governance are as follows:

- Financial and non-financial disclosures.
- Independent oversight of management, which consists of two aspects—the first relates to the role of the independent, statutory auditors and the second aspect of independent oversight is the board of directors of a company.

Long-term Shareholder Value

There is a global consensus about the objective of "good" corporate governance: *maximising long-term shareholder value*. It is useful to limit the claimants to the shareholders for three reasons:

(i) In most of the countries, generally labour laws are strong enough to protect the interests of workers in the organised sector, and employees as well as

trade unions are well aware of their legal rights. In contrast, there is very little in terms of the implementation of the law and of corporate practices that protects the rights of the creditors and the shareholders.

(ii) There is much to recommend in law, procedures and practices to make companies more attuned to the need for servicing debt and equity properly.

(iii) Managers have to look after the rights of the shareholders to dividends and capital gains, because if they do not do so over a period of time, they face the real risk of take-over.

For a corporate governance code to have real meaning, it must first focus on listed companies. These are financed largely by public money (be it equity or debt) and, hence, need to follow codes and policies that make them more accountable and value oriented to the investing public.

There have been various committees and boards that have been set up both internationally and in India to improve the situation of shareholders with regard to corporate governance. Before we see how a shareholder could help bring about good corporate governance we need to see what are the rights of the shareholders as laid down by the Indian Companies Act of 1956.

Rights of Shareholders

The members of a company enjoy various rights in relation to the company. These rights are conferred on the shareholders of the company either by the Indian Companies Act of 1956 or by the Memorandum and Articles of Association of the company or by the general law, especially those relating to contracts under the Indian Contract Act, 1872.

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Some of the more important rights of the shareholders as stressed by the above Acts are the following:

- He has a right to obtain copies of the Memorandum of Association, the Articles of Association and certain resolutions and agreements on request, on payment of prescribed fees (Section 39).
- He has a right to have the certificate of shares held by him within 3 months of the allotment.
- He has a right to transfer his shares or other interests in the company subject to the manner provided by the articles of the company.
- He has a right to appeal to the Company Law Board if the company refuses or fails to register the transfer of shares.
- He has the preferential right to purchase shares on a *pro-rata* basis in case of a further issue of shares by the company. Moreover, he/she also has the right of renouncing all or any of the shares in favour of any other person.
- He has a right to apply to the Company Law Board for the rectification of the register of members.
- He has the right to appeal to the competent Court to have any variation or abrogation to his/her rights set aside by the Court.
- He has the right to inspect the register and the index of members, annual returns, register of charges and register of investments not held by the company in its own name without any charge. He/she can also take extracts from any of them.
- He is entitled to receive the notices of general meetings and to attend such meetings and vote either in person or by proxy.
- He is entitled to receive a copy of the statutory report.

- He is entitled to receive copies of the annual report of directors, annual accounts and auditors' report.
- He has the right to participate in the appointment of auditors and the election of Directors at the annual general meeting of the company.
- He has a right to make an application to the Company Law Board for calling annual general meeting, if the company fails to call such a meeting within the prescribed time limits.
- He can require the Directors to convene an extraordinary general meeting by presenting a proper requisition as per the provisions of the Act and hold such a meeting on refusal.
- He can make an application to the Company Law Board for convening an extraordinary general meeting of the company where it is impracticable to call such a meeting either by the directors or by the members themselves.
- He is entitled to inspect and obtain copies of minutes of proceedings of general meetings.
- He has a right to participate in declaration of dividends and receive his/her dividends duly.
- He has a right to demand a poll.
- He has a right to apply to the Company Law Board for investigation of the affairs of the company.
- He has the right to remove a director before the expiry of the term of his office.
- He has a right to make an application to the Company Law Board for relief in case of oppression and mismanagement.
- He can make a petition to the High Court for the winding up of the company under certain circumstances.
- He has a right to participate in passing of a special resolution that the company be wound up by the court or voluntarily.
- He has a right to participate in the surplus assets of the company, if any, on its winding up.

However, whether the shareholder has these rights in reality or he is even aware of his rights is a moot question that leads invariably to unscrupulous managements taking the unwary investors for a ride.

Views of Various Committees on the Issue

The Kumar Mangalam Committee on Shareholder's Rights

The CII was the first to come out with its version of an audit committee. The SEBI, as the custodian of investor interests, did not lag behind. On 7 May 1999, it constituted an 18-member committee, chaired by the young and forward-looking industrialist, Kumar Mangalam Birla (a chartered accountant himself), on corporate governance, mainly with a view to protecting the investors' interests. The committee made 25 recommendations, 19 of them "mandatory", that is, these were enforceable. The listed companies were obliged to comply with these on account of the contractual obligation arising out of the listing agreement with stock exchanges.

It is interesting to note that the Kumar Mangalam Birla Committee while drafting its recommendations was faced with the dilemma of statutory versus voluntary compliance. As mentioned earlier, the Desirable Code of Corporate

SEBI, as the custodian of investor interests, did not lag behind. On 7 May 1999, it constituted an 18-member committee, chaired by the young and forward-looking industrialist, Kumar Mangalam Birla, on corporate governance, mainly with a view to protecting the investors' interests. The committee made 25 recommendations, 19 of which were "mandatory". The Indian listed companies were obliged to comply with these on account of the contractual obligation arising out of the listing agreement with stock exchanges.

Governance, which was drafted by the CII and was voluntary in nature, did not produce the expected improvement in corporate governance. It was thus felt that under Indian conditions, a statutory rather than voluntary code would be far more effective and meaningful. This led the Committee to decide between mandatory and non-mandatory provisions. The Committee felt that some of the recommendations were absolutely essential for the framework of corporate governance and virtually would form its code, while others could be considered as desirable. Besides, some of the recommendations needed a change of statute, such as the Companies Act for their enforcement. Faced with this difficulty, the Committee settled for two categories of recommendations—namely, mandatory and non-mandatory. This Committee made some recommendations especially with regard to shareholders.

Recommendations Relating to the Shareholders

The shareholders are the owners of the company and as such they have certain rights and responsibilities. But in reality companies cannot be managed by shareholder referendum. They are not expected to assume responsibility for the management of corporate affairs. A company's management must be able to take business decisions quickly, which cannot be done if they were to consult the shareholders, who are too numerous and scattered for any meaningful consultation. The shareholders, therefore, delegate many of their responsibilities as owners of the company to the directors who then become responsible for corporate strategy and operations. The implementation of this strategy is done by a management team. This relationship, therefore, brings in the accountability of the boards and management to shareholders of the company. A good corporate framework is one that provides adequate avenues to the shareholders for effective contribution in the governance of the company while insisting on a high standard of corporate behaviour without getting involved in the day-to-day functioning of the company.

Shareholders are the owners of the company and as such they have certain rights and responsibilities. A good corporate framework is one that provides adequate avenues to the shareholders for effective contribution in the governance of the company while insisting on a high standard of corporate behaviour without getting involved in the day-to-day functioning of the company.

Responsibilities of the Shareholders

The Committee believed that the general body meetings provide an opportunity to shareholders to address their concerns to the board of directors and comment on and demand any explanation on the annual report or on the overall functioning of the company. It is important that the shareholders use the forum of general body meetings for ensuring that the company is being stewarded for maximising the interests of shareholders. This is important especially in the Indian context. It follows from the above that for an effective participation, the shareholders must maintain alertness and decorum during the general body meeting, so that it constitutes the forum in which they can get their doubts clarified, apart from airing their grievances, if any.

The effectiveness of the board is determined by the quality of the directors whereas the quality of the financial information is dependent to an extent on the efficiency with which the auditors carry on their duties. The shareholders must, therefore, show a greater degree of interest and involvement in the appointment of directors and auditors. They should indeed demand complete information about directors before approving their directorship.

The Committee recommended that in case of the appointment of a new director or re-appointment of a director, shareholders must be provided with the following information:

- A brief resume of the director.
- Expertise in specific functional areas.
- Names of companies in which the person also holds directorship and membership of committees of the board. This is a mandatory recommendation.

Rights of Shareholders

The basic rights of shareholders include the right to transfer and obtain registration of shares, obtaining relevant information on the company on a timely and regular basis, participating and voting in shareholder meetings, electing members of the board and sharing in the residual profits of the corporation.

As we have seen earlier, the Companies Act of 1956 confers certain rights on shareholders to enable them enjoy their rights as rightful owners of companies. The basic rights of shareholders include the right to transfer and obtain registration of shares, obtaining relevant information on the company on a timely and regular basis, participating and voting in the shareholder meetings, electing members of the board and sharing in the residual profits of the corporation.

The Committee, therefore, recommended that as the shareholders have a right to participate in, and be sufficiently informed on decisions concerning fundamental corporate changes, they should not only be provided information as under the Companies Act, but also in respect of other decisions relating to material changes such as takeovers, sale of assets or divisions of the company, changes in capital structure which will lead to change in control or may result in certain shareholders obtaining control disproportionate to their equity ownership.

The Committee recommended further that information such as quarterly results, presentation made by companies to analysts may be put on their websites or may be sent in such a form so as to enable the stock exchange on which the company is listed to put it on its own website.

The Committee also recommended that the company's half-yearly declaration of financial performance including summary of significant events in the last six months, should be sent to each household of the shareholders. This recommendation is mandatory.

The Kumar Mangalam Birla Committee prescribed too that a company must have appropriate systems in place, which will enable shareholders to participate effectively and vote in shareholders' meetings. The company should also keep shareholders informed of the rules and voting procedures, which govern the general shareholder meetings. This recommendation is mandatory.

The annual general meetings of the company should not be deliberately held at inconvenient venues or the timing should not be such which makes it difficult for most of the shareholders to attend. The company must also ensure that it is not inconvenient or expensive for the shareholders to cast their votes. This recommendation is mandatory.

Currently, although the formality of holding the general meeting is gone through, in actual practice, only a small fraction of the shareholders of the company do or can really participate therein. This virtually makes the concept of corporate democracy illusory. It is imperative that this situation which has lasted too long needs an early correction. In this context, for the shareholders who are unable to attend meetings, there should be a requirement which will enable them to vote by postal ballot for key decisions such as investment proposals, appointment of directors, auditors, committee members, loans and advances above a certain percentage of net worth, changes in capital structure which will lead to change in control or may result in certain shareholders obtaining control disproportionate to equity shareholding, sale of assets or divisions and takeovers etc. This would require changes in the Companies Act. The Committee was informed that the SEBI has already made recommendations in this regard to the Department of Corporate Affairs. The Committee recommended that the Department of Corporate Affairs should again be requested to implement this recommendation at the earliest, if possible by issue of an ordinance, so that corporate democracy becomes a reality in the true sense.

The Committee recommended that a board committee under the chairmanship of a non-executive director should be formed to specifically look into the redressing of shareholder complaints such as transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends, etc. The Committee believed that the formation of such a committee would help focus the attention of the company on

shareholders' grievances and sensitise the management to the redressal of their grievances. This is a mandatory recommendation.

The Committee further recommended that to expedite the process of share transfers, the board of the company should delegate the power of share transfer to the registrars and share transfer agents. This is a mandatory recommendation.

The Narayana Murthy Committee, 2003

This SEBI-appointed Narayana Murthy Committee on corporate governance submitted its report on 8 February 2003. It recommended that in order to achieve the objectives of corporate governance and to realise long term shareholder value, companies should agree to shareholders' rights for participation and postal ballots. The Narayana Murthy Committee asserted shareholders' rights to receive from the company half-yearly declaration of financial performance including summary of the significant events during the past 6 months.

This SEBI-appointed Narayana Murthy Committee on Corporate Governance, which submitted its Report on 8 February 2003, has in its own words, "primarily focussed on the investors and the shareholders, as they are the prime constituencies of the SEBI".

The Committee recommended that in order to achieve the objectives of corporate governance and to realise long term shareholder value, companies should agree to the following terms and conditions.

(a) In the case of the appointment of a new director or reappointment of a director, the shareholders must be provided with the following information:
   (i) A brief resume of the director.
   (ii) Nature of his expertise in specific functional areas.
   (iii) Names of companies in which the person also holds the directorship and the membership of committees of the board.

(b) Information such as the quarterly result and the presentation made by companies to analysts shall be put on company's website or shall be sent in such a form so as to enable the stock exchange on which the company is listed to put it on its own website.

(c) A board committee under the chairmanship of a non-executive director shall be formed to specifically look into the redressing of the shareholder and the investors complaints such as transfer of shares, non-receipt of balance sheet, declared dividends, etc. This committee shall be designated as "Shareholders/ Investors Grievance Committee".

(d) To expedite the process of share transfers the board of directors shall delegate the power of share transfer to an officer or a committee or to the registrar and share transfer agents. The delegated authority shall attend to share transfer formalities at least once in a fortnight.

Shareholders' Rights and Postal Ballots

The Narayana Murthy Committee asserted shareholders' rights to receive from the company half-yearly declaration of financial performance including summary of the significant events during the past 6 months.

The Committee recommended the facility of postal ballot to such of those shareholders who cannot participate in the AGM of the company they have invested in, so as to participate effectively in corporate democracy and in the decision-making process. Key issues that may be decided by postal ballots could include the following:

(a) Alteration in the Memorandum of Association.
(b) Sale of whole or substantially the whole of the undertaking.
(c) Sale of substantial investments in the company.
(d) Making a further issue of shares through preferential allotment or private placement basis.
(e) Corporate restructuring.

(f) Entering into a new business not germane to the existing business of the company.
(g) Variations in rights attached to class of securities.
(h) Matters relating to change in management.

SEBI Guidelines for Investors/Shareholders

The Securities and Exchange Board of India (SEBI), the Indian capital market regulator in its guidelines to investors/shareholders, titled "A Quick Reference Guide for Investors" published recently makes it known that a shareholder of a company enjoys the following rights:

The Securities and Exchange Board of India (SEBI), the Indian capital market regulator, in its guidelines to investors/shareholders, titled "A Quick Reference Guide for Investors" enumerates the rights that a shareholder of a company enjoys. It also classifies rights of a shareholder, as an individual, and rights of a debenture-holder.

Rights of a Shareholder, as an Individual

- To receive the share certificates on allotment or transfer, as the case may be, in due time.
- To receive copies of the abridged annual report, the balance sheet and the Profit & Loss Account and the Auditors' report.
- To participate and vote in general meetings either personally or through proxies.
- To receive dividends in due time once approved in general meetings.
- To receive corporate benefits such as rights, bonus etc. once approved.
- To apply to Company Law Board (CLB) to call or direct the convening the annual general meeting.
- To inspect the minute books of the general meetings and to receive copies thereof.
- To proceed against the company by way of civil or criminal proceedings.
- To apply for the winding-up of the company.
- To receive the residual proceeds.
- To sell securites, that he/she holds at a price and at the time that he/she may choose

Besides these rights one enjoys as an individual shareholder, he also enjoys the following rights as a group of shareholders:

- To requisition an extraordinary general meeting.
- To demand a poll on any resolution.
- To apply to the Company Law Board to investigate the affairs of the company.
- To apply to the Company Law Board for relief in cases of oppression and/or mismanagement.

Rights of a Debenture-holder

- To receive interest/redemption in due time.
- To receive a copy of the trust deed on request.
- To apply for winding up of the company if the company fails to pay its debt.
- To approach the debenture trustee with the debenture holder's grievance.

However, one should note that the above mentioned rights may not necessarily be absolute. For example, the right to transfer securities is subject to the company's right to refuse transfer as per statutory provisions.

Shareholders' Responsibilities

While a shareholder may be happy to note that one has so very rights as a stakeholder in the company, it should not lead one to complacency because one also has certain responsibilities to discharge, such as

- To remain informed.
- To be vigilant.
- To participate and vote in general meetings.
- To exercise one's rights on one's own, or as a group.

Depository and Dematerialisation

Shares are traditionally held in physical or paper form. This method has its own inherent weaknesses such as loss/theft of certificates, forged/fake certificates, cumbersome and time consuming procedure for transfer of shares, etc. Therefore, to eliminate these weaknesses, a new system called "Depository System" has been established.

A depository is a system which holds shares in the form of electronic accounts in the same way a bank holds one's money in a savings account.

Depository system provides the following advantages to an investor:

- His shares cannot be lost or stolen or mutilated.
- He never needs to doubt the genuineness of his shares, i.e., whether they are forged or fake.
- Share transactions such as transfer, transmission, etc. can be effected immediately.
- Transaction costs are usually lower than on the physical segment.
- There is no risk of bad delivery.
- Bonus/rights shares allotted to the investor will be immediately credited to his account.
- He will receive the statement of accounts of his transactions/holdings periodically.

When a shareholder decides to have his shares in electronic form, he should approach a Depository Participant (DP) who is an agent of depository and open an account. He should surrender his share certificates in physical form and his DP will arrange to get them sent to and verified by the company and on confirmation credit his account with an equivalent number of shares. This process is known as de-materalisation. One can always reverse this process if one so desires and get his shares reconverted into paper form. This reverse process is known as "re-materialisation".

Share transactions (such as sale or purchase and transfer/transmission, etc.) in the electronic form can be effected in a much simpler and faster way. All one needs to do is that after confirmation of sales/purchase transaction by one's broker, one should approach his DP with a request to debit/credit his account for the transaction. The depository will immediately arrange to complete the transaction by updating his account. There is no need for separate communication to the company to register the transfer.

Table 6.1

Redressal of grievance mechanism

Nature of grievance	*To be taken up with*
In case of any public Issue, non-receipt of	
▪ Refund order	– SEBI
▪ Interest on delayed refund	– Dept. of Corporate Affairs
▪ Allotment advice	– Dept. of Corporate Affairs
▪ Share certificates	– Stock Exchange
▪ Duplicates for all of the above	– Registrars to the Issue
▪ Re-validations	– Registrars to the Issue
In case of a listed security, non-receipt of the certificates after	
▪ Transfer	– SEBI
▪ Transmission	– SEBI
▪ Conversion	– SEBI
▪ Endorsement	– Dept. of Corporate Affairs
▪ Splitting	– Dept. of Corporate Affairs
▪ Duplicates of securities	– Dept. of Corporate Affairs
Regarding listed debentures, non-receipt of	
▪ Interest due	– SEBI
▪ Redemption proceeds	– Dept. of Corporate Affairs
▪ Interest on delayed payment	– Debenture Trustees, Stock Exchange
▪ Regarding bad delivery of shares	– Bad Delivery Cell of the Stock Exchange
▪ Regarding shares or debentures in unlisted companies	– Dept. of Corporate Affairs
▪ Deposits in collective investment schemes such as plantations etc.	– SEBI
▪ Units of mutual funds	– SEBI
▪ Fixed deposits in banks and finance companies	– Reserve Bank of India
▪ Fixed deposits in manufacturing companies	– Dept. of Corporate Affairs

Source: *SEBI's "A Quick Reference Guide for Investors, 2003*

Grievance Redressal Process

There will be occasions when an investor has a grievance against the company in which one is a stakeholder. It may be that one has not received the share certificates on allotment or on transfer; it may be that one did not receive the dividend/interest warrant or refund order; perhaps one did not receive the Annual Accounts etc. While one would first approach the company in that regard, one may not be satisfied with the company's response thereto and one would like to know whom he should turn to get his grievance redressed. Table 6.1 provides an investor the guidance in this regard.

Inventory Information Centres have been set up in every recognised stock exchange which in addition to the complaints related to the securities traded/listed with them, will take up all other complaints regarding the trades effected in the exchange and the relevant member of the exchange.

Moreover, two other avenues always available to the investor to seek redressal of his complaints are as given below:

(i) Complaints with Consumers Disputes Redressal Forums;
(ii) Suits in a Court of Law.

Shareholder's Activism and Class Action

Shareholder activism is a way in which the shareholders can influence a corporation's behaviour by exercising their rights as owners. Although the shareholders don't run a company, there are ways for them to influence the board of directors and management. They sometimes use their rights as the shareholder of a publicly-traded corporation to bring about social change. Some of the issues most often addressed by shareholder activists are related to the environment, investments in politically sensitive parts of the world and workers' rights. The term is also referred to investors who believe that a company's management is doing a bad job and who attempt to gain control of the company and replace management for the good of the shareholders.

The shareholders in general have the following powers:

1. To attend meetings of shareholders and exercise voting rights, either personally or through proxy.
2. To transfer shares.
3. To receive dividend when declared.
4. To elect directors.
5. To requisition an extraordinary general meeting of the company.
6. To have right shares and bonus shares.
7. To apply to Tribunal.
8. To file class action suits.
9. To file a suit in case of any misleading statements in the prospectus.

The Board of Directors of a company shall be entitled to exercise all such powers and to do all such acts as the company is authorized to do. However, this power is subject to powers as given in Companies Act, 2013 and which are to be done by the company in general meetings. Powers of Board of Directors in brief are as follows:

1. To issue securities, including debentures
2. To invest the funds of the company

3. To grant loans or give guarantee or provide security in respect of loans
4. To approve the financial statement and the Board's report
5. To borrow money
6. To diversify the business of the company
7. To appoint and remove key managerial personnel
8. To appoint internal auditor
9. To approve quarterly, half yearly and annual financial statements
10. To accept or renew public deposits
11. To authorize the buy-back of securities.

Residuary Powers: There arise some situations that the Board is unwilling or unable to act. In such situations, it is permissible for the general meeting to exercise the powers vested in the Board of Directors even though it may be exercising powers which are conferred on the board. There are a number of situations conceivable where the general meeting may be called upon to exercise these 'default' or 'residuary' powers. For example: Where there is a deadlock on the board; where an effective quorum cannot be obtained either because the directors are disqualified from voting, or because there are no directors; where the transaction in question is beyond the powers of the board. Also, it is important to understand that in these situations the General Meeting is exercising its residuary powers, and therefore it can either ratify the acts of the directors, or authorize the directors to act on their behalf through an ordinary resolution. In either case, since the directors are acting as agents of the general meeting and not as directors of the company, they are governed by the rules of agency.

As per Section—100 of the Companies Act, 2013, General Meetings are of three kinds:

1. Annual General Meeting
2. Extraordinary General Meeting (EGM)
3. Class Meeting

What makes the AGM of great significance is that it is a mandatory statutory requirement to hold an AGM at the specified period complying with the conditions laid in Section 96 of Companies Act, 2013. The period between two AGMs can thus not be more than fifteen months and there has to be an AGM in every calendar year. Further, the requirement of submission of Report on AGM containing a fair and correct summary of the proceedings of the meeting has to be compiled with. What this implies is that the AGM has to be held by the Board of Directors, even if it does not want to which might be the case if the Company has performed badly and hence this being a mandatory requirement itself makes the AGM a powerful tools in the hands of the shareholders. Further, the AGM is not just means by which important business is transacted; but also a form in which the shareholders are informed of the important aspects of the functioning of the Company, especially relating to the financial health of the Company. They can question the directors; raise important issues regarding the company; pass resolutions and exercise their most important power with respect to the appointment of directors standing for re-election and removal of directors.

While most of these transactions can be undertaken in extra-ordinary general meetings also, members who may want to raise such issues may not be able to ask for convening the meeting due to the strict requirement of the number of members needed to convene an EGM as specified in Rules 17 of the Companies (Management and Administration) Rules 2014. Important mandatory matters

that have to be dealt with in the AGM are the Appointment of Directors and the Power of Removal of Directors and Placing of Accounts, the Balance Sheet, the Report of Director, Auditor and Corporate Governance Report.

The new Companies Act 2013, subsequent revisions to Clause 49 of the Listing Agreement and other regulatory changes by the SEBI have ushered in many changes that enhance the shareholders activism and consequent corporate governance in India. The requirements for greater degree of disclosures by companies aided shareholders to analyse particular actions and make better-informed decisions. E-voting was made mandatory in 2013 which resulted in greater investor participation as it made voting process painless and independent of the location of the investor. Provisions like class action suits against companies and directors are in the offing, can also give minority investors the confidence to raise voice against companies whenever the need arises.

Class Action

Some of the examples of domestic shareholders activism in India are given below.

- Tata Group owned Indian Hotels classified Mr Shapoor Mistry as an independent director in its annual report of 2012. Such a classification was wrong since Mr Mistry is from the family that has a major shareholding in the Tata Sons and is the brother of Mr Cyrus Mistry. Proxy firms recommended that investors raise this issue following which the company correctly classified him as a non-independent director in the annual report of 2013.
- Jindal Steel and Power (JSPL) proposed a resolution in 2012 to hand over authority to its CMD to set the remuneration of Executive Directors. Once again, due to activism by proxy firms and shareholders, the company withdrew the proposal.
- In 2014, Tata Motors' proposal of payment of remuneration to two of its Executive Directors and the Managing Director in the event of inadequate profits was rejected by public shareholders. This was the first instance of a routine proposal by a prominent Indian company failing to approval by the shareholders.
- Similarly, in late 2014, many proposals of United Spirits to enter into related party transactions with its promoter Diageo Plc and other related entities were rejected by its shareholders.
- Siemens' proposal for selling the metals technologies business to a 100% subsidiary of Siemens AG, the German parent company, was rejected by shareholders. All the three companies have re-proposed their resolutions with enhanced disclosures and explanations that are more informative.
- In the extra-ordinary general meeting of Tata Motors held on 22 December 2016 for the removal of Mr Nusil Wadia from the directorship of Tata Motors, 99 per cent of promoters and 50 per cent of the institutional investors voted in favour of the removal while another 50 per cent of the institutional investors voted against the resolution. Voting pattern in this issue indicated that most public and retail shareholders put together accounted for 53 per cent against the resolution and 47 per cent in favour of the resolution.

Activism by Foreign Investors

The proxy advisory firms and domestic investors were not the only ones to take a proactive stance on activism; a few foreign investors too started taking keen interest in their Indian investee companies.

In 2012, The Children's Investment Fund (TCI), a UK based hedge fund with AUM of more than $5 billion, initiated a legal action against Coal India's directors and the Government of India for under-pricing of coal resulting in lesser profits to Coal India. TCI, at that time, held 1 per cent of Coal India's shares which accounted for 10% of the total outstanding shares held by the public.

In 2014, Knight Assets, another UK based fund, engaged with Tata Motors to list the A-shares in the American bourses. The investor believed the DVRs were undervalued in the Indian markets and listing in US could enhance shareholder value.

CONCLUSION

Implementation of steps that will ensure lasting shareholder value will vary among companies depending to a large extent upon top management support, the nature and diversity of the business portfolio, the degree of decentralisation, and on its size, global reach, employee mix, culture, management style and the sense of urgency. However, bringing about long-term shareholder value is the right thing to do for a company and competitive pressures, greater awareness among shareholders, government regulations and institutional shareholders seeking maximum returns will ensure that it is there to stay.

KEYWORDS

- Class Action
- Dematerialisation
- Depository
- Grievance redressal process
- Guide for protection of investors and shareholders
- Poor track-record
- Rights of shareholders
- Shareholder's Activism
- Theoretical basis of agency costs

DISCUSSION QUESTIONS

1. What do you understand by agency costs? How could these costs be minimised by corporations?
2. What are the rights and privileges of shareholders as enumerated by the Indian Companies Act 1956 and the amendments made thereto?
3. Critically comment on the recommendations of the Kumar Mangalam Birla Committee 1999.
4. Discuss briefly the recommendations of the Narayana Murthy committee on corporate governance.
5. What is the need and justification for postal ballot? Do you think it will offer better prospects for ensuring corporate governance?
6. Critically analyse the poor track record of investor protection in India. In this context, what are the guidelines offered by SEBI to ensure investor protection?

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7



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Other Stake Holders of the Company

CHAPTER OUTLINE

- Introduction
- Corporate Governance and Employees
- Corporate Governance and Customers
- Corporate Governance and Institutional Investors
- Corporate Governance and Creditors
- Corporate Governance and the Community
- Corporate Governance and the Government

Introduction

It is a well-accepted principle nowadays that corporations exist not only for the benefit of its part-owners called shareholders, but also to serve the interests of other stakeholders in society. It is fallacious to argue anymore that the immediate concern of a company is exclusively towards the shareholders, while other stakeholders are only of a peripheral importance to it. A corporate does not exist by itself and it does not operate in a vacuum. Its work is organised and facilitated with the help and co-operation of all constituents of the society in which it functions. Therefore, it is only natural that the corporates are expected to reciprocate and contribute in a fair measure to the well-being of all stakeholders. Besides, if a corporate is interested in establishing a long term shareholder value itself, it is vitally necessary to earn the goodwill of other stakeholders such as employees, customers, institutional investors, creditors, community at large, and the government, by serving their interests and being useful to them as much as possible.

It is a well-accepted principle now that corporates exist not only for the benefit of the shareholders, but also to serve the interests of other stakeholders. A corporate does not exist by itself or operates in a vacuum—its work is organised and facilitated with the help and co-operation of all constituents of the society in which it functions. Therefore, it is only natural that corporates are expected to reciprocate and contribute in a fair measure to the well-being of all stakeholder value.

Corporate Governance and Employees

As we have seen earlier, better and ethically acceptable corporate governance has been critically important ever since the start of the modern corporations, in which the owners and the managers of the companies are separated. When the owners directly manage their own company, governance issues may not be that important. The recent downfall of the Enron, the WorldCom, and other large corporations, partly due to the failure of their boards of directors, has resurrected governance as a significant corporate need. Employees are also one of the stakeholders of the organisation; by increasing their participation in the organisation, one could ensure better corporate governance.

Wealth Creation Requires Capital and Labour

An organisation needs capital and labour to create wealth. Earlier, the most important need for an organisation to be a success was capital; as long as they had capital, the organisation was able to be successful. But today, the need has extended beyond capital and includes labour. The conventional model was the "shareholder primacy" model, which left out the role of the employees in the creation of wealth. The Western-reform-advocates have promoted the concept of "shareholder capitalism" where the sole emphasis is on strengthening the rights of, and the protection for, financial investors. Today, the growing recognition that human capital is a source of competitive advantage has led to the understanding that labour is, if not, more important or at least as important as, capital. Today, corporate leaders in the developed countries increasingly understand that people and the knowledge they create are often the most valuable assets in a corporation. This is what they call knowledge capital, which is considered as an invaluable asset of an organisation. In fact, when a company acquires another company, they value human capital more than the plant and machinery the latter has. There are a variety of ways by which the interest of employees can be represented in an organisation. The growing representation proves that employee participation does create wealth. There is a need to realise that shareholders' long-run interests are probably well-served by including the employees in the corporate governance.

An organisation needs capital and labour to create wealth. Earlier, the most important need for an organisation to be a success was capital. But today, the growing recognition that human capital is a source of competitive advantage has led to the understanding that labour is equally important as capital.

The interests of employees can be protected through:

- Trade unions
- Co-determination: employee representation on the boards of directors

- Profit-sharing
- Equity-sharing
- "Team production" solution

Trade unions: Trade unions' role is to represent the collective voice of the employees and as such they provide a muscle in collective bargaining; this role cannot be underestimated. Labour with a perishable commodity to offer will not be able to withstand the financial might of employer otherwise. Trade unions alone could represent the collective interests of the employees and fight for what is rightly due to them from the organisation. Though the approach of such unions are often more confrontational than cooperative, it is a body that represents the collective interests of employees. They could use this as a platform to negotiate agreements between the organisation and the labour. These could sometimes reduce the flexibility of such agreements in the light of changing market conditions.

Co-determination: It is a situation where there is an employee representation on the board of directors of the organisation. This worked well in Germany in the post-World War II decades when the situation brought about labour peace, reduced the level of unemployment, and added to the robust growth of the economy. But in recent decades of the fast growing economy, it has led to economic rigidity and sluggish growth.

Profit-sharing: The concept of profit-sharing with the employees in order to protect the interests of employees in the organisation became much more widely used in Europe in 1990s. Most profit-sharing plans are broad-based, i.e. all or most employees were included in the scheme of profit-sharing rather than just executives only. This practice has been followed in firms facing intense competition and in firms with highly qualified workforce. Profit-sharing motivates the individual worker to put in his best as his efforts are directly related to the profits of the organisation, in which he gets a share. Profit-sharing could be done in many ways, such as

(a) cash-based sharing of annual profits where the annual cash profits of the organisation are shared among the employees,
(b) deferred profit-sharing where the deferred profits of the organisation are shared among the employees.

The objective of such profit-sharing is to encourage employee involvement in the organisation and improve their motivation and distribution of wealth among all the factors of production. Wage flexibility can improve a firm's performance where one's wage depends on the profit made by the organisation.

Equity-sharing: Under equity-sharing, employees are given an option to buy the company's shares, identify themselves with, and thus become the owners of the organisation. This leads to an improved employee commitment to management's goals, which motivates the employees to perform better. As a result, there is an alignment of interest between the employees and the shareholders. This may help make firms more adaptable to the changing environment and support the emergence of more transparent and effective corporate governance. This may foster more social responsibility of firms.

There are various ways in which equity sharing could be done: employees share (i) ownership plans, (ii) stock bonus plans, (iii) stock option plans, (iv) employee buyout and (v) worker cooperatives. This method of equity sharing to increase employee participation is followed in larger companies, with highly qualified workforce, and high level of worker empowerment, such as software companies.

Team production solution: Team production solution is a situation where the boards of directors must balance competing interests of various stakeholders and then arrive at decisions that are in the best interest of the organisation. Though they are employed by the shareholders to safeguard their interests in the organisation, they have to work for the common benefit of all the stakeholders of the company.

As a result of increasing participation of employees in the organisation, a company can reap the benefits of increase in productivity, which in turn, increases the profit of the organisation. This is the new perspective of wealth creation which in turn leads to the increase in wealth distribution. The grant of shares, though, should not be at the expense of the benefits and wages due to the employees. The provision of employee share alone is not enough, but it must be accompanied by the increased employee participation in decision-making. It should be understood that employee share plans are not a substitute for diversified retirement savings. The Enron fiasco reminds us that employees can lose everything if the business is not diversified, and the management has plans other than the long-term interest of the organisation and the workforce. There are some guidelines that could be used here while deciding on employee representation in an organisation.

1. **Voluntary participation:** There should be voluntary participation on the part of the employees and they should not be forced to do anything out of compulsion. If compulsion is exercised either by unions or employers, it may boomerang, instead of being beneficial.
2. **Extend benefits to all employees:** The benefits should be extended to all employees; factory workers, clerical staff and the executives of the organisation indiscriminately. Extension of benefits to selective groups of employees will create more problems than it will solve and will create dissension among workers and distrust towards employers.
3. **Clarity and transparency:** The process by which the allocation of shares is done should be clear and transparent, and not too complicated. Workers should clearly understand and appreciate the benefits they will get under the arrangement.
4. **Predetermined formula:** There should be a predetermined formula to work out the number of shares that could be offered, and it should not be left to the discretion of any party.
5. **Regularity:** There should be some regularity when such offers are made; they cannot be made as and when the organisation feels like making such offers.
6. **Avoiding unreasonable risk for employees:** The organisation should take into consideration the interests of the employees when they make any decisions, and they should see to it that there is no undue risk taken.
7. **Clear distinction:** There should be a clear distinction between the participatry schemes that are offered to the employees and the regular wages and the benefits that are offered by the organisation. Those participatory shemes should in no way affect regular wages and related benefits paid to the employees.
8. **Compatibility with worker mobility:** The participation schemes offered should be compatible with the worker mobility. The worker should not be penalised by accepting the schemes offered to him.

By increasing the role of the employees in the organisation, the company can ensure better corporate governance.

Corporate Governance and Customers

Though economics regards the consumer as the king and sovereign, who decides through the market forces the quality and quantity of goods produced, and though leaders like Mahatma Gandhi consider him the sole purpose for which an enterprise exists and therefore should be treated with respect in reality, he is given a raw deal—sub-standard products, increased prices through market manipulation, failed warranties, poor after-sale services, and a host of other unfair trade practices—befalls his lot. Good corporate governance should place the customer as one of the important stakeholders and should give him his due share.

"Consumer" means any person who buys or hires any services for some consideration, paid or promised, and includes any other user of goods or services using them with the approval of the buyer. It does not, however, include a person who obtains goods for any commercial purpose or for resale.

The consumer in India, far from being alive to his rights (as is the case in the US and the Britain) is generally at the mercy of the manufacturer of goods, the wholesaler and the retailer, all of whom exploit him. The six rights of the consumer as enunciated under Section 6 of the COPRA are as follows:

(i) **The right to safety:** The rights to be protected against the marketing of goods and services which are hazardous to life and property.

(ii) **The right to be informed:** The consumer has the right to be informed about the quality, quantity, potency, purity, standard and price of goods or services, as the case may be, so as to protect the consumer against unfair trade practices.

(iii) **The right to choose:** The right to be assured, wherever possible, access to a variety of goods and services at competitive prices.

(iv) **The right to be heard:** The right to be heard and assured that consumer's interests will receive due consideration at appropriate forums.

(v) **The right to seek redressal:** The right against unfair trade practices or restrictive trade practices or unscrupulous exploitation of consumers.

(vi) **The right to consumer education:** If a consumer wants to know on what basis the bus fare is fixed or whether a product contains ingredients that are vegetarian or not and on what basis a builder determines the area of the flat including the ratio between the super built-up area and the carpet area, then this information can be had through the Consumer Protection Councils.

The Consumer Protection Act also makes provision for the establishment of the other authorities for the settlement of consumer disputes through the consumer disputes redressal agencies which include the following:

- A Consumer Disputes Redressal Forum known as the District Forum established by the state government in each district of the state by notification.
- A Consumer Disputes Redressal Commission known as the State Commission established in each state by the state government by notification.
- A National Consumer Disputes Redressal Commission known as the National Commission established by the centre by notification.

Two of the salient features of the Act are that it is applicable even to enterprises in the government sector, financial institutions and co-operative societies and that its provisions are in addition to, and not in derogation of the provisions of other laws, relating to consumer.

Customers as Stakeholders

In a recent case Charitra Sharma Vs. the Union of India, the Supreme Court has highlighted the importance of consumers as important stakeholders in a company apart from the other normal stakeholders like promoters, financiers, trade creditors, employees, etc. In this case the petitioners, who are home buyers, submitted that insolvency proceedings against the real estate developer, Jaypee Infratech, under the Insolvency and Bankruptcy Code do not provide any protection to the home buyers who have deposited money with the company. The only alternative to the consumers is establishing their rights through consumer protection law which is very time consuming. The Supreme Court positively responded to this petition and allowed the insolvency proceedings with a condition to protect the interest of consumers. Among the other things, it has asked Jaypee Associates, the parent company of Jaypee Infratech, to deposit ₹ 2000 crores with the court by 27 October 2017 and submit the insolvency resolution plan within 45 days that will protect the interest of both home buyers and creditors. In the judgment, the Court also spoke in a detailed manner about the need of protecting the interest of home buyers as consumers. Further, the Court has appointed an amicus, who will participate in creditors' committee meeting on behalf of the home buyers

Apple Computer-Never let Down Consumers

Apple computer ever since it started by two stalwarts Steve Jobs and Steve Wozniak in 1976 has never let down the consumers in its history. Even after the death of Steve Jobs in 2011, the company continues to inspire the consumers by innovating new products systematically. Jobs and Wozniak are credited with revolutionizing the computer industry by democratizing the technology and making machines smaller, cheaper, and accessible to everyday consumers. Steve Jobs instigated Apple's success in the 1970s; he is credited with revitalizing the company in the 1990s. With a new management team, altered stock options and a self-imposed annual salary of $1 a year, Jobs put Apple back on the track. His ingenious products (like the iMac) effective branding campaigns and stylish designs caught the attention of consumers again and again

Source: Compiled from various sources

Corporate Governance and Institutional Investors

Most of the reports on corporate governance have emphasised the role which institutional investors play in the corporate governance. The Cadbury Committee (1992),[1] for example, states: "Because of their collective stake, we look to the institutions in particular, with the backing of the Institutional Shareholders' Committee, to use their influence as owners to ensure that the companies in which they have invested comply with the code." The Kumar Mangalam Birla Committee similarly states: "Given the weight of their votes, the institutional shareholders can effectively use their powers to influence the standards of corporate governance."[2]

Contrary to this, some argue that the investment objectives and the compensation system in the institutional investing companies often discourage their active participation in corporate governance. Peter Drucker (1976) has once commented that "...It is their job to invest the beneficiaries' money in the most profitable investment. They have no business trying to manage. If they do not like a company or its management, their duty is to sell the stock...".

Most of the reports on corporate governance have emphasised the role which institutional investors play in corporate governance. The Cadbury Committee states: "Because of their collective stake, we look to the institutions in particular, with the backing of the Institutional Shareholders' Committee, to use their influence as owners to ensure that the companies in which they invested comply with the code." The Kumar Mangalam Birla Committee similarly states: "Given the weight of their votes, the institutional shareholders can effectively use their powers to influence the standards of corporate governance."

Types of Institutional Investors in India

In India, there are broadly four types of institutional investors: (i) financial institutions, such as IFCI, ICICI and IDBI; (ii) insurance companies such as LIC, GIC and their subsidiaries; (iii) all banks; (iv) all mutual funds including the UTI. While an investment decision is under consideration, the key factors to be taken into consideration are financial results and solvency, financial statements and annual report, investors communications, composition and quality of the Board, corporate governance practices, corporation image, and share price.

In India, there are broadly four types of institutional investors:

- The development oriented financial institutions, such as the IFCI, the ICICI, the IDBI, the State Financial Corporations, form the first category.
- The second category covers all the insurance companies such as the Life Insurance Corporation of India (LIC), the General Insurance Corporation (GIC) and their subsidiaries.
- The third category includes all banks.
- Finally, in the last category, all mutual funds (MFs), including the UTI, are placed.

Factors Influencing Investment Decisions

While an investment decision is under consideration, the following are the key factors in the order of their importance, that are taken into consideration:

- Financial results and solvency
- Financial statements and annual reports
- Investor communications
- Composition and quality of the board
- Corporate governance practices
- Corporate image
- Share price.

1. **Financial results and solvency:** This is the most important factor among factors such as an upward trend in earnings per share and profits, a healthy cash flow, and a reasonable level of dividend payment. All these are considered major indicators of a company's financial health and are indicated in the financial results. However, a consistent dividend policy is less significant.
2. **Financial statements and annual reports:** There are two important aspects under this head. These are:
   (a) **Extent of disclosure:** The quality of the financial statements is the next most influential factor when it comes to investment decisions. Institutional investors consider the level of disclosure of the company's strategies, initiatives and quality of management's discussion and analysis of the year's results. Financial position in the annual report is equally important. This is a strong indication of the investing public's emphasis and preference for clear disclosures in a company's annual report, in excess of regulatory requirements.
   (b) **Comparability with International GAAP:** A significant proportion of institutional investors do not invest in a company if the financial statements are non-comparable to International Generally Accepted Accounting Principles (GAAP). Implicitly, this could mean that comparability of financial statements of companies with International GAAP is important in the eyes of the investor.
3. **Investor communications:** Institutional investors value the willingness of companies to provide additional information to investors, analysts and other commentators, their prompt release of information about transactions affecting the minority shareholders and the existence of other transparency mechanisms that help ensure fair treatment to all shareholders.
4. **Composition and quality of the board:** The most important aspect within this factor is the quality and the experience of the executive directors on the board. In stark contrast, investors would consider investing even though they

are dissatisfied with the quality, qualification and experience of independent non-executive directors and their role in board meetings. In addition, many investors are not very concerned if there are insufficient independent non-executive directors on the board.

5. **Corporate governance practices:** Investors consider corporate governance practices when they make investment decisions. The company should follow the principles for corporate governance being—auditing and compliance, disclosure and transparency and board processes.
6. **Corporate image:** The image of the company in the community is also considered when an institutional investor is called on to take an investment decision. The image of the organisation should not be bad.
7. **Share price:** This is the last factor that is considered by an institutional investor when an investment decision is made. If the shares of the company enjoy continuously rising prices in the bourses, investors could be encouraged to invest in them.

The above analysis shows how much importance institutional investors give to the above-mentioned factors when they consider making an investment decision. It is important to understand that corporate misgovernance is not the fault of the institutional investors who have invested in companies. However, in view of their large stake in these companies, it is expected that they play an important role in the corporate governance system of the company. Some even argue that institutional investors are answerable to their investors in the very same manner as companies are answerable to their investors. Therefore, it is their view that the primary objective of institutional investors should be to maximise the wealth of their own shareholders rather than looking at the corporate governance practices of companies in which they have invested.

Companies with good corporate governance records have performed better compared to those with poor governance records. This strengthens the argument put forth by most corporate governance reports that institutional investors must be more active while monitoring the performance of companies in which they have invested.

It can be seen that companies with good corporate governance records have actually performed better compared to companies with poor governance records. This, therefore, strengthens the argument put forth by most corporate governance reports that the institutional investors must be more active while monitoring the performance of companies in which they have invested. This helps them not only in meeting their investment objectives (in increasing shareholders' wealth), but also in doing something socially useful. Also it is noticed that institutional investors have extended loans to companies with good governance records.

The Kumar Mangalam Birla Committee and the Institutional Investors

Institutional shareholders have acquired large stakes in the equity share capital of the listed Indian companies. They have or are in the process of becoming the majority shareholders in many such companies and own shares largely on behalf of retail investors. They thus have a special responsibility given the weightage of their votes and have a bigger role to play in corporate governance as retail investors look upon them for a positive use of their voting rights.

Institutional shareholders have acquired large stakes in the equity share capital of the listed Indian companies. Thus, they have a special responsibility given the weightage of their votes and have a bigger role to play in corporate governance, as retail investors look upon them for positive use of their voting rights.

The Kumar Mangalam Birla Committee[3] recommends that institutional investors maintain an arm's length relationship with the managements and should not seek participation at the board level, which may make them privy to unpublished price sensitive information. Given the weight of their votes, the institutional shareholders can effectively use their powers to influence standards of corporate governance. Practices elsewhere in the world have indicated that they can sufficiently influence policies of a company. This is because of their collective stake which ensures that the company they have invested in complies with the corporate governance code in order to maximise shareholder value. What is important in view of the Committee is that the institutional shareholders put to good use their voting power.

The Committee, therefore, recommends that the institutional shareholders should reflect the following characteristics:

- Take active interest in the composition of the board of directors.
- Be vigilant.
- Maintain regular and systematic contact at senior level for exchange of views on management, strategy, performance and the quality of the management.
- Ensure that voting intentions are translated into practice.
- Evaluate the corporate governance performance of the company.

The shareholders are the owners of the company and as such they have certain rights and responsibilities. But in reality, companies cannot be managed by the shareholder referendum. Shareholders are not expected to assume the responsibility for the management of corporate affairs.

A company's management must be able to take business decisions quickly. The shareholders have to, therefore, necessarily delegate many of their responsibilities as owners of the company to the directors who then become responsible for corporate strategy and operations. A management team carries out implementation of this strategy. This relationship, therefore, brings in the accountability of the boards and the management to the shareholders of the company. A good corporate framework is one that provides adequate avenues to the shareholders for effective contribution in the governance of the company, while insisting on a high standard of corporate behaviour without getting involved in the day-to-day functioning of the company.

The McKinsey Survey on Corporate Governance

A survey by McKinsey in this regard is illuminating. In the survey, a large number of the institutional investors expressed a preference towards corporate governance over financials while deciding their emerging market portfolios.

A recent, well-published survey by McKinsey & Co. in this regard is illuminating. In the survey, around one-fifth of the institutional investors expressed preference towards corporate governance over financials while deciding their emerging market portfolios. Further, around a significant two-third felt corporate governance is almost as important as the balance sheet. In fact, respondents to the survey were ready to pay a premium of 28 per cent for the well-governed companies in emerging markets. The survey, which covered a sample of 188 companies in six emerging markets to test the link between the market valuation and the corporate governance, established that companies with better corporate governance command a higher price-to-book ratio. McKinsey conducted this survey in Malaysia, Mexico, South Korea, Taiwan, India and Turkey, to determine the correlation between good corporate governance and the market valuation of the company. The survey found that in India, good corporate governance increases market valuation by:

- Increasing financial performance;
- Transparency of dealings, thereby reducing the risk that boards will serve their own self-interests;
- Increasing investor confidence.

McKinsey rated the performance of corporate governance of each company based on the following components:

(i) **Accountability:** Transparent ownership, board size, board accountability, ownership neutrality.

(ii) **Disclosure and transparency:** Broad, timely and accurate disclosure, International Accounting Standards.

(iii) **Independence:** Dispersed ownership, independent audits and oversight, independent directors.

(iv) **Shareholder equality:** One share, one vote.

Through the survey, McKinsey found that companies with good corporate governance practices, have high price-to-book values indicating that investors are willing to pay a premium for the shares of a well-managed and governed company.

Companies in the emerging markets often claim that Western corporate governance standards do not apply to them. However, results from the survey show that investors from all over the world are looking for high standards of good governance. Additionally, they are even willing to pay a high premium for shares in companies that meet their requirements of good corporate governance.

Corporate Governance and Creditors

Both financial sector reform and private sector development have received considerable attention in the developing and the transitional economies in recent years. But the critical nexus between banks and firms—not only for financing but also for efficiency and ultimate survival has been underemphasised. Banks and other creditors have an extremely important role to play in fostering efficiency in the medium and the large private or the state-owned firms. Creditors, in turn, rely for their survival on debt repayment by their borrowers. Without dependable debt collection, no amount of supervision or competition can make banks run efficiently.

Banks and other creditors have an extremely important role to play in fostering efficiency in medium and large private firms. Creditors, in turn, rely for their survival on debt repayment by their borrowers. Without dependable debt collection, no amount of supervision or competition can make banks run efficiently. Strong creditors are as critical to the efficient functioning of enterprises as are strong owners.

Debt appears to be slowly emerging as a device for exerting control over the medium and the large enterprises in some transitional economies. The powers and incentives of creditors in these countries are still weak, however, compared to their counterparts in more mature market economies. Strong creditors are as critical to the efficient functioning of enterprises as are strong owners. External financing for private firms comes essentially from two sources: debt and equity. While control by the equity holders is appropriate in profitable times (when entrepreneurial risk taking is needed), creditor monitoring and control become binding in times of financial distress, particularly when tight controls on spending and investment are needed. Indeed, foreclosure and bankruptcy laws typically shift control of firms to creditors at such times. Thus, the development of the effective creditor controls is a crucial element in successful economic transition.

The legal and institutional requirements for effective debt monitoring have not been as thoroughly analysed as required, but are no less important. Like equity holders, creditors can monitor firms either actively or passively. The active mode involves hands-on evaluation of a firm's operations, investment decisions, and capacity and willingness to repay. The passive mode depends on collateral for security. To the extent analysis is carried out before a lending decision is made, the value of the firm's collateral is what is analysed rather than the operations of the firm.

Creditor Monitoring and Control

There are three crucial elements in the creditor monitoring and control in market economies: adequate information, market-oriented creditor incentives, and an appropriate legal framework for debt collection. The experiences of the emerging economies of the Eastern Europe in the first half of the 1990s provide fascinating lessons about how—and how not—to strengthen creditors as agents of governance and restructuring for the medium and the large enterprises. Based on these lessons one can arrive at the guidelines that could be used by creditors in ensuring that the organisation they lend to is not lacking in the corporate governance.

Adequate Information

The first requirement is information. Lenders need information on the creditworthiness or otherwise of potential borrowers, and depositors and bank supervisors need information on the bank portfolios. While this may seem obvious, constraints imposed by the poor quality and asymmetric distribution of information in the developing and the transitional economies should not be underestimated. Inadequate financial and cost accounting can hide the true value of firms' assets, and dramatic changes in the structure of input prices, demand, competition, and distribution channels reduce the value of prior information. Reputation, the basis for much lending in the stable market economies, is less binding, owing to the phenomenal pace of change.

Even if information on firms is available from the potential borrowers, the bank employees are often not trained in the techniques of market analysis and loan appraisal, and thus have difficulty using that information. Similarly, bank supervisors often lack not only the technical ability but also the political will to carry out tough supervision. Furthermore, the "watchdog" professions, including accounting, law, securities, and credit rating services, are still in their infancy, making it difficult for the outside investors to monitor firms and prevent fraud or misuse of their investments.

When information asymmetries are significant, adverse selection may make it costly, if not impossible, for the outside investors to fund the growth of a firm with either debt or equity. If formal lending occurs, it will typically be based on collateral (or perhaps reputation) rather than on active monitoring of the firm's operations.

Creditor Incentives

The second requirement for debt to serve a control function is the existence of appropriate market-based incentives for creditors, be they banks, trade creditors, or government. These incentives may be in the form of a higher margin of profit, high interest charges from customers and sometimes even reduction in the quantum of Non-Performing Assets (NPAs). A high growth achieved after consolidating the current business in an intensely competitive environment may by itself act as an incentive.

Debt Collection

The third requirement for creditor monitoring and control in a market economy is an appropriate legal framework and effective procedures for debt collection. Without an effective system of debt collection, debtors lose repayment discipline, the flow of credit is constrained, and creditors may be forced to come to the State to cover their losses if they are to survive. In informal credit markets, the effectiveness of debt collection depends on the non-legal or the extra-legal sanctions, such as the threat of a debtor's ostracism by the business community or, in extreme cases, self-help on the part of creditors or their agents. Formal credit markets depend more on legal procedures involving collateral, workouts (creditor-mandated reorganisation of the debtor firm), and bankruptcy. Well-designed and implemented rules facilitate rapid and low-cost debt recovery in cases of default, thereby lowering the risks of lending and increasing the availability of credit (particularly bank credit) to the potential borrowers. Poorly designed and implemented rules make lending more costly and stifle the flow of credit.

Kinds of Debts Provided to Corporates

There are two kinds of debts provided to an organisation and each of them has a different role to play with regard to corporate governance namely, (i) diffused debt and (ii) concentrated debt.

Diffused Debt

Debt purchasers provide finance in return for a promised stream of payments and a variety of other covenants pertaining to corporate behaviour, such as the value and risk of corporate assets. If the corporation violates these covenants or defaults on the payments, then debt holders typically obtain the rights to repossess collateral, throw the corporation into bankruptcy proceedings, vote in the decision to reorganise, and vote on removing managers. Since the legal obligation of the corporation is to each debt-holder, creditors do not need to coordinate to take action against a delinquent firm. This will tend to make debt re-negotiation much more difficult, so that corporate governance may be more severe with diffused debt-holdings than with concentrated debt. Clearly, the effective exertion of corporate control with diffused debt depends on the efficiency of the legal and the bankruptcy systems.

The ability of diffused debt holders to exert corporate governance effectively, however, is not without its own problems. The legal system in many countries gives companies the right of an automatic stay on assets and managers frequently remain in place pending a decision by the bankruptcy court. This makes repossession of assets difficult even for the secured creditors and reduces the governance power of the debt holders. Furthermore, inefficient bankruptcy proceedings frequently take years to complete even in the most developed economies, which further erodes the corporate governance role of diffused debt. Even where banks or other creditors take over the assets of the defaulted borrowers, they may not have the expertise to make use of the assets repossessed or even to dispose them off profitably.

Thus, around the world, legal protection of diffused debt holders seems insufficient to protect the rights of investors and limit managerial discretion.

Concentrated Debt

As with the large equity holders, concentrated debt can ameliorate some of the problems with diffused debt. For many companies, banks typically are the large creditors. A bank's corporate governance power derives from the following:

(i) Its legal rights in case the firms default or violate covenants.

(ii) The short maturity of its loans, so that corporations must return regularly.

(iii) Its frequent dual role as the voter of substantial equity shares (either its own shares or those of other investors).

Concentrated debt holders can also renegotiate the terms of the loan, which may avoid inefficient bankruptcies. Thus, the large creditors can frequently exert substantial control rights over firms as well as exercising important cash flow power.

Nevertheless, large creditors face important constraints to exerting sound corporate governance in many countries. First, the effectiveness of large creditors relies mostly on the legal and bankruptcy systems. It is by using and by threatening to use legal means that creditors exert influence over management. If the legal system does not efficiently identify the violation of covenants and payments and provide the means to bankrupt and reorganise firms, then creditors lose a crucial mechanism for bringing in corporate governance. Besides, except in a small

number of countries, legal systems around the world are demonstrably inefficient in protecting the outside investors. Also, with poor legal and bankruptcy systems, the flexibility to renegotiate debt arrangements with the large creditors may lead to the an inefficient renegotiation, the continuation of unprofitable enterprises, and impediments to corporate finance since the balance of power in those renegotiations shifts markedly towards the debtors. Second, large creditors like the large shareholders may attempt to shift the activities of the corporation to reflect their own preferences. Large creditors, for example, may induce the company to forgo good investments and take on too little risk because the creditor bears some of the cost but will not share the benefits. More generally, the large creditors may seek to manipulate the corporation's activities for their own gain rather than maximise the profits of the firm. These features suggest that the large creditors do not resolve the problem of aligning managers' incentives to maximise profits. Third, large creditors may not be independent to the extent that a single family controls both a bank and a non-financial firm, it would be surprising to see much discipline by the former on the latter. Where relatively few families control a large portion of an economy, only foreign creditors may be independent, and this group may suffer from a greater information problem.

Moreover, creditors, be it bankers, trade creditors or even governments, have a control over the corporate practices of the organisation and they need to steer it in the right direction.

The Corporate Governance and the Community

The corporation has grown up with the industrialisation, the modernisation and the now the globalisation. The corporation is the work-horse of the modern civilisation. Without corporations, there might not be the modern material civilisation with high living standards, longer life spans and great personal comforts. Modernisation and globalisation also remain the world's most viable mechanisms to enable the poor nations and the peoples to share in the growing global prosperity.

Without corporations, there might not be the modern material civilisation with high living standards, longer life spans and great personal comforts. The fundamental basis of corporate governance and responsibility in the value system of the corporation includes among others, its human resource principles, its dedication to accurate and transparent accounting and financial standards, its concern for the environment and its passion to serve the customers and to guarantee its products and services.

Only the corporation has been able to combine for economic value creation, financial capital, new technologies, and the human resources. Sole proprietorships and partnerships are too small to achieve the scale of research and production that the corporations can. Corporations will continue to create much of the wealth of society in future and open up new possibilities for humanity.

However, a corporation is a set of relationships among the different stakeholders. Each stakeholder plays some role in the success of the corporation. Without the capital and the stockholders, there can be no corporate entity. Without banks and other debt investors, the corporation cannot maximise its ability to earn a return on its equity capital.

But without customers, there will be no business for the corporation to do. Without employees, the corporation will be unable to do its business. Quality and cost-efficient suppliers are necessary for the success of any business. And, if the community turns against a company, losing confidence in its good faith, then that corporation will lose its business legitimacy, sometimes very rapidly as we have seen in several cases around the globe. The corporation must also have concerns for the physical and the social environments in which it does business and must take care not to take unfair advantage of its competitors.

By aligning and attending to the needs of these stakeholders, the corporation fulfils its duty to the society to promote modernisation and a better life for all in a sustainable way.

A modern corporation is under fire from many directions. It has duties and obligations to different the stakeholders when these duties and obligations often seem to be in conflict with one another.

How is a corporation to decide what to do? That is the role of governance. Corporate governance is the mechanism by which the values, principles, management policies and procedures of a corporation are made manifest in the real world.

The fundamental basis of corporate governance and responsibility in the value system of the corporation includes the following:

- Its human resource principles—respect and dignity for all.
- Its dedication to accurate and transparent accounting and financial standards.
- Its concern for the environment, for good business ethics and conduct, for social advancement.
- Its over-riding passion to serve customers and to guarantee its products and services.
- Its insistence on fair treatment of suppliers—and competitors.
- Its uncompromising commitment to comply with the government laws and regulations in all the countries in which it operates.
- Its desire to work with others to lead the society to a better economic standard and quality of life.

The managerial skill lies in accomplishing all these things at the same time. In the famous business book, *Built To Last*, the authors describe the ability of good corporations to sustain themselves over generations accomplishing potentially conflicting objectives at the same time.[4]

A good structure of corporate governance satisfies these needs and interests of different stakeholders in a way that provides for long-term growth in the value of the company and its contribution to the society. Its reputation and goodwill are enhanced, it commands success in the market for its products or services, its employees are productive and loyal, its equity owners are rewarded with good dividends and a rising price for their stock, and its growth is not impeded by external forces.

Responsible oversight should ensure that many factors and points of view are considered. Good corporate governance aligns with the interests of management, shareholders and other stakeholders.

Corporate governance divides responsibilities for policy-making, business decisions, and implementation among a board of directors, executive management, all management and all employees. This is the general pattern for corporations around the world, with differences in detail arising in different countries. For example, in the United Kingdom the positions of chairman of the board and the chief executive officer are usually given to different individuals while, in the United States, they are combined in one person. In Germany, employee representatives have a right to sit on a supervisory board. In Japan, few corporations have the so-called "outside" directors on the board, though recent legislation proposes to change that.

No matter the structure, a good governance requires checks and balances and responsible oversight to ensure that many factors and points of view are considered. For example, a board should have the power, and the time, to probe into, and give informed opinions on the plans of management.

When employees, managers, executive management, or board members look too much towards their own power, prestige or financial reward, they act less and less as good stewards for the interests of the stakeholders. Corporate governance is there to counteract this tendency to be selfish and short-sighted. Corporate governance is there to ensure that managers act as agents and fiduciaries, guiding their corporations to successful accomplishment of their corporate and societal responsibilities.

Thus it is obvious that good corporate governance aligns with the interests of the management, the shareholders and other stakeholders.

The management and the board of a corporation must define the values and principles for the company. To be effective and relevant to an individual company's specific circumstances, business principles must be developed and implemented by companies themselves, not mandated by outsiders.

A company must develop its own understanding of how its principles or behaviour relate to the external expectations or to the external codes or guidelines, like the Caux Round Table Principles for Business.[5] Internal monitoring of compliance, external reporting of performance and independent assurance are matters that should be decided by the companies themselves.

Of course, only when companies are profitable, can they contribute effectively to the improvement of the social conditions by creating jobs and economic growth. Prosperous companies are a precondition for corporate social responsibility.

Practical Steps to Corporate Social Responsibility

The International Chamber of Commerce recommends nine steps to attain customer confidence: confirm CEO/ board commitment that priority to responsible business conduct comes first; state company purpose and agree on company values; identify key stakeholders; define business principles and policies; establish implementation procedures and management systems; benchmark against selected external codes and standards; setup internal monitoring; use simple language and set pragmatic and realistic objectives.

The following sound principles of corporate governance and social responsibility may help a company in many ways—all elements of a long-term sustainability. They may help build customer loyalty, increase morale and trust within the workforce, enhance productivity, attract new business and long-term investors, find efficient solutions to business problems, improve supply management, build up reputation, and a host of other issues.

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2. State company purpose and agree on company values.
3. Identify key stakeholders.
4. Define business principles and policies.
5. Establish implementation procedures and management systems.
6. Benchmark against selected external codes and standards.
7. Set up internal monitoring.
8. Use language that everyone can understand
9. Set pragmatic and realistic objectives.

In conclusion, corporations exist because they, in a sustainable fashion, enable people to constructively practise their craft and create jobs, economic value, and wealth for the society and the enterprise, especially in the free societies. Always everywhere, governments that reflect and represent diverse interests of the society tend to look favourably at the growth of corporations because of the benefits they provide—the generation of wealth through production of goods and services, employment, income and the wherewithal of growing economies. Corporations, in turn, have a moral and social responsibility to live upto such expectations and justify their continued patronage.

Corporate Governance and the Government

The government plays a key role in corporate governance by defining the legal environment and sometimes by directly influencing managerial decisions. Beyond defining the rules of the game, the government may directly influence corporate governance. At one extreme, the government owns the firm, so that the government is charged with monitoring managerial decisions and limiting the ability of managers to maximise private benefits at the cost of society.

Government plays a key role in the corporate governance by defining the legal environment and sometimes by directly influencing managerial decisions. As the efficiency of the bankruptcy system and the degree to which managers maintain control through the bankruptcy process help determine whether or not the threat of bankruptcy influences managerial decisions. Similarly, the ability to write and then enforce contracts, to oblige management to provide accurate and comprehensive information before the shareholders, votes on important issues, to enforce the obligations of the boards of directors, to specify and have managerial

incentive contracts enforced, and to have confidence in the full range of contractual arrangements that define the firm in modern corporations—all determine the extent to which the equity and the bond holders can exert corporate governance.

Moreover, political economy forces that produce the laws, the enforcement mechanisms, the bankruptcy processes, and the ability of powerful managers to influence legislation will profoundly shape corporate governance. Beyond defining the rules of the game, the government may directly influence corporate governance. At one extreme, the government owns the firm, so that the government is charged with monitoring managerial decisions and limiting the ability of managers to maximise private benefits at the cost of the society. At a less extreme level, governments regulate corporations. Specifically, governments regulate the activities and asset allocations of corporations and may even insure corporate liabilities in the favoured industries, even in countries that traditionally tend to disavow such support. In theory, governments regulate to maximise social welfare, limit adverse externalities and exploit positive ones, deal with the monopoly power, and directly prohibit managers from undertaking socially adverse actions.

Some authors argue that governments will tend to use regulations instead of the threat of legal sanctions when the legal system does not effectively dissuade managers from taking socially costly actions. Thus, regulations that work *ex ante* may be optimal in situations where the use of *ex post-legal* penalties is ineffective. The problem with using the state ownership and regulation of corporate activities to resolve the corporate governance problem is that this places the control rights in the hands of government bureaucrats that almost certainly do not have the same incentives as a private owner. Thus, these government bureaucrats are unlikely to induce managers to maximise firm value. Rather, the politicians frequently use state enterprises for personal gains either by placing their cronies in the position of corporate power, catering to special interest groups, or supporting politically influential unions that help the politicians to retain power. Indeed, the evidence suggests that public enterprises are extremely inefficient producers and they frequently disregard social objectives, as evidenced by the finding that state enterprises are worse polluters than the private firms.

Thus the government in every country exercises a certain amount of control over operations of the organisation and the government could use this to steer the organisation towards the path of good corporate governance.

A detailed analysis of the role of government in ensuring corporate governance is given in the chapter on 'Role of Government in Ensuring Corporate Governance'.

CONCLUSION

It is clearly understood today that public corporations are meant not only to serve the interests of its shareholders but also of all its stakeholders including the society at large. With a view to achieving this objective, corporate managers including the board of directors should aim at not only making handsome profits, but while doing so, also protect the interests of its employees, customers, institutional investors—big and small, creditors, the community in general and the government. Though it appears at the outset that following such a course of action may lead to multiple conflicts of interest, in reality it is not so. After all, the sum total of collective interests of the entire community cannot be jeopardized by catering to the individual interests of all its constituents.

KEYWORDS

- Adequate information
- Co-determination
- Concentrated debt
- Corporate social responsibility
- Creditor incentives
- Creditor monitoring and control
- Diffused debt
- Equity-sharing
- Hidden taxation
- Institutional investors
- Investment decisions
- Profit-sharing
- Team Production Solution
- The Stakeholder Alliance
- Trade unions
- Wealth creation

DISCUSSION QUESTIONS

1. Who are the stakeholders involved in instituting corporate governance? Discuss briefly what they are expected to contribute to the process.
2. Today labour is considered as one of the most important factors of production. Discuss the ways in which its interests can be protected.
3. What are the information needs of the customers? How can they access their needs?
4. Discuss the salient features of the Consumer Protection Act 1986.
5. Critically examine the role of institutional investors in promoting corporate governance.
6. Discuss briefly:
   (a) Corporate governance and creditors and
   (b) Corporate governance and the government.

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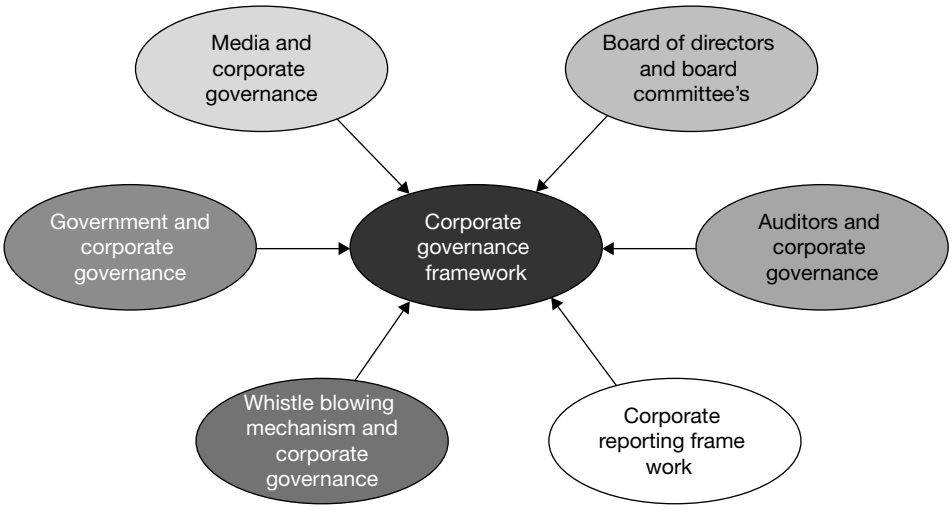
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The Role of Board of Directors in Corporate Governance

CHAPTER OUTLINE

- Introduction
- The Role of Board in Ensuring Corporate Governance
- Views of Various Committees on the Role of BOD in Corporate Governance
- Governance Issues Relating to the Board
- The Role of Directors
- Independent Directors
- Directors' Remuneration
- Indian Companies Act 2013 on the Role of BOD
- Role of BOD in Family Owned Businesses
- Shell Companies
- Some Pioneering Boards

Corporate Governance Framework



Introduction

The separation of the ownership from active directorship and management is an essential feature of the company form of organisation. To manage the affairs of a company, the shareholders elect their representatives in accordance with the laid down policy. These representatives are called the "directors" of the company. A number of such directors constitutes the "board of directors" and that is the top administrative body of the corporation. The board may sometimes appoint an executive committee to carry on certain assigned functions under its direction. The board generally has only part-time directors.

Corporate Management Structure

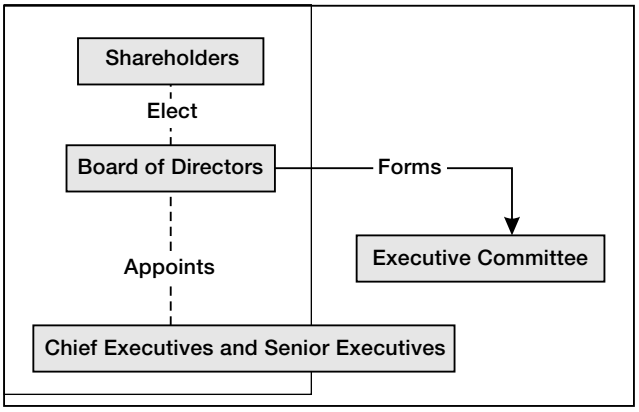
The board may be expected to lay down policies, procedures and programmes, but may not be able to secure their implementation under their guidance and continuous supervision, or communicate their decision to the rest of the staff. To do this, the executive committee consisting of one or more whole-time directors and other top officials is appointed. These appointees of the board are called chief executive officers (CEOs) or managing directors, depending on how the company wants to name them. The chief executives serve as a link between the board of directors on one side, and the operating organisation on the other. Their work consists of interpreting the policy decisions for the benefit of those responsible for their execution and in dealing with the day-to-day problems of business operation. They also place important problems concerning the execution of the work assigned to them before the board and put them wise on issues involved in implementing policies. The CEOs who include managing directors and managers receive instructions from the Board and disseminate them to the executives in charge of various departments. Thus, shareholders delegate a greater part of their authority as owners to the Board, which in turn, passes a substantial part of power to the CEOs and they further delegate powers to the departmental heads

in charge of operations. This structure of corporate management is illustrated in Figure 8.1.

This is the pattern that is adopted by most of the companies in India and elsewhere. From the way the corporates are structured, it can be understood that the control of management is in the hands of the shareholders, the board of directors, and in some cases, the chief executives to whom the board has delegated some of its powers.

Figure 8.1

Corporate management structure



Company Director and the Board

In the eyes of law, a company is an artificial person, who, however, has no physical existence and has neither a body nor a soul. As Cairns puts it clearly: "The company itself cannot act in its own person, for it has no person, it can only act through directors." In the words of Lord Cranworth L.C.: "The directors are a body to whom is delegated the duty of managing the general affairs of the company. A corporate body can only act by agents and it is, of course, the duty of those agents to act as best to promote the interests of the corporation whose affairs they are conducting."

The Supreme Court of India was more lucid when it elucidated the company-director relationship as follows: "A company is in some respects an institution like a State functioning under its basic constitution consisting of the Companies Act and the Memorandum of Association. The members in general meeting and the directorate are described as the two primary organs of a company comparable with the legislative and the executive organs of a parliamentary democracy, where the legislative sovereignty rests with the Parliament, while the administration is left to the executive government, subject to a measure of control by Parliament through its power to force a change of government. Like the government, the directors will be answerable to Parliament constituted by the general meeting."

In many countries, as in India, it is mandatory for a public limited company to have directors and in practice, "the identities of directors and those of their companies are inseparable for good or bad". "With the business units growing in size, corporate affairs becoming more and more complex, at the same time the ownership getting more scattered and dispersed, the role of directors as fiduciaries of shareholders is paramount to the investor protection and the enhancement of shareholder value."[1]

Who is a Director?

Section 2(13) of the Companies Act defines a director as follows: "A director includes any person occupying the position of director, by whatever name called. The important factor to determine, whether a person is or is not a director, is to refer to the nature of the office and its duties. It does not matter by what name he is called. If he performs the functions of a director, he would be termed as a director in the eyes of the law, even though he may be named differently. A director may, therefore, be defined as a person having a control over the direction, conduct, management or superintendence of the affairs of a company. Again, any person, in accordance with whose directions or instructions, the board of directors of a company is accustomed to act is deemed to be a director of the company." However, though this definition seems to be comprehensive, it is vague and ambiguous to some extent, as is pointed out by some authority on the subject: "It is doubtful whether there are any instances in the Indian corporate

A director may, therefore, be defined as a person having control over the direction, conduct, management or superintendence of the affairs of a company. Again, any person in accordance with whose directions or instructions, the board of directors of a company is accustomed to act is deemed to be a director of the company."

history where any person in a company who is not called a director is deemed or reckoned as such by virtue of his functional responsibility."[2]

Section 2(6) of the Companies Act states that directors are collectively referred to as "board of directors" or simply the "board".

Kinds of Directors

A director may be a full time working director, namely, managing or a whole time director covered by a service contract. Managing and whole time directors are in charge of the day-to-day conduct of the affairs of a company and are together with other team members collectively known as "management" of the company. A company may also have non-executive directors who do not have anything to do with the day-to-day management of the company. They may attend board meetings and meetings of committees of the board in which they are members. We can recognise another category of directors as per certain provisions of the Indian Companies Act—"Shadow Directors". These so-called "deemed directors" acquire their status by virtue of their giving instructions, (other than professional advice) according to which "appointed" directors are accustomed to act.[3]

Directors' Appointment

The Articles of Association of a company usually name the first set of directors by their respective names or prescribe the method of appointing them. If the first set of directors are not named in the Articles, the number and the names of directors shall be determined in writing by the subscribers of the Memorandum of Association or a majority of them. If the first set of directors are not appointed in the above manner, the subscribers of the Memorandum, who are individuals, become directors of the company. They shall hold office until directors are duly appointed in the first general meeting. Certain provisions of the Companies Act in India govern the appointment or reappointment of directors by a company in a general meeting.

Legal Position of a Director

It is rather difficult to define the exact legal position of the directors of a company. They have been described variously as agents, trustees, or managing partners of the company, but "such expressions are not used as exhaustive of the powers and responsibilities of such persons but only as indicating useful points of view from which they may for the moment, and for the particular purpose be considered".[4] The legal position of directors as agents and trustees emanate from the fact that a company being an artificial person cannot act in its own person. It can act only through the directors who become their agents in the transactions the company makes with others. Likewise, directors are deemed to be trustees of a company's money and properties. It has become a well-established fact now that directors are not only agents but also act as trustees, as a result of several court decisions in India and England.

Duties and Responsibilities of Directors

Directors have certain duties to discharge. These are: (i) fiduciary duties (ii) duties of care, skill and diligence; (iii) duties to attend the board meetings; (iv) duties not to delegate their functions, except to the extent authorised by the Act or the constitution of a company and to disclose his interest.

With regard to *fiduciaries*, directors must (a) exercise their powers honestly and *bona fide* for the benefit of the company as a whole and (b) not to place themselves in a position in which there is a conflict between their duties to the company and their personal interests. (c) They must not make any secret profit out of their position. (d) Further, the fiduciary duties of directors are owed to the company and not to individual shareholders. Of these four, the first two duties need elucidation. Directors should carry out their duties with reasonable care and exercise such degree of skill and diligence as is reasonably expected of persons of their knowledge and status. However, a director is not bound to bring any special qualification to his office, as for instance, the director of a medical insurance company is not expected to have the expertise of an actuary or the skills of a physician. But if a director fails to exercise due care and diligence expected of him, he is guilty of negligence. The standard of care, skill and diligence depends upon the nature of the company's business and circumstances of the case. Factors such as the type and nature of work, the division of powers between the directors and other executives, general usages, customs and conventions in the line of business in which the company is engaged and whether the directors work gratuitously or for a remuneration will have an impact on the standards of care and diligence expected of the directors.

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Qualifications and Disqualifications of Directors

To be appointed as a director of a company, public authorities prescribe some qualifications. "No corporate, association or firm can be appointed as director of a company." A director must (a) be an individual; (b) be competent to enter into a contract and(c) hold a share qualification, if so required by the Articles of Association. As there are qualifications for being a director, there are some disqualifications too.

The following persons are disqualified for appointment as the director of a company: (i) A person of unsound mind, (ii) an undischarged insolvent or one whose petition for declaring himself so is pending in a Court, (iii) a person who has been convicted by a Court for any offence involving moral turpitude, (iv) a person whose calls in respect of shares of the company are held for more than 6 months have been in arrears; and (v) a person who is disqualified for appointment as director by an order of the Court on grounds of fraud or misfeasance in relation to the company. And, of course, the directors can be removed from office by (i) the shareholders, (ii) the Central (Federal) Government and (iii) the Company Law Board.

The Board of Directors

The board of directors of a company, which includes all directors elected by shareholders to represent their interests is vested with the powers of management. The board has extensive powers to manage a company, delegate its power and authority to executives and carry on all activities to promote the interests of the company and its shareholders, subject to certain restrctions imposed by public authorities.

The board of directors of a company is authorised to exercise such powers and to perform all such acts and things as the company is entitled to. This means that the powers of the board of directors is co-extensive with those of the company subject to two conditions: (i) the board shall not do any act which is to be done by the company in the general meeting of shareholders and (ii) the board shall exercise its powers subject to the provisions contained in the Articles or the Memorandum or in the Federal Acts concerned with the companies or any regulation made by the company in any general meeting. But no regulation made by company in the general meeting shall invalidate any prior act of the board which would have been valid, if the regulation had not been made.

Powers of the Board

Under Section 292 of the Companies Act, it is stipulated that a company's board of directors shall exercise the follwing powers on behalf of the company by means of resolutions passed at the meeting of the board: (a) make calls on the shareholders in respect of money unpaid on their shares, (b) issue debentures, (c) borrow money otherwise (for example, through public deposits), (d) invest the funds of the company, and (e) make loans.

Furthermore, there are certain other powers specified by the Companies Act under various sections which shall be exercised by the board of directors only at the meeting of the board. These powers include: (a) to fill vacancies in the board; (b) to sanction or give assent for certain contracts in which particular directors, their relatives and firms are interested; (c) to receive the notice of disclosure of directors' interest in any contract or arrangement with the company; (d) to receive the notice of disclosure of shareholdings of directors; (e) to appoint as managing director or manager a person who is already holding such a post in another company and (f) to make investments in companies in the same group.

Every resolution delegating the power to borrow money, other than debentures, shall specify the total amount outstanding at any time upto which money may be borrowed by the delegate. Likewise, every resolution delegating the power to invest the funds of the company shall specify (a) the total amount upto which the funds may be invested and (b) the nature of the investments which may be made by the delegate. So, every resolution delegating the power to make loans shall specify: (a) the total amount upto which loans may be made by the delegate; (b) the purposes for which the loans may be made and, (c) the maximum amount of loans which may be made for each such purpose in individual cases.

However, the general meeting of shareholders is competent to intervene and act in respect of a matter delegated to the board of directors in cases where (i) the directors act *mala fide*; (ii) the directors themselves are wrongdoers; (iii) the board as a whole is found to be incompetent, when for instance, all directors are interested in a transaction with the company; (iv) there is a deadlock in management and, (v) there is a fit case for the shareholders to exercise their residuary powers.

The board of directors can also exercise certain other powers as listed below with the consent of the company in the general meeting, as in the case of an amalgamation scheme:

(a) To sell, lease or otherwise dispose of the whole or substantially the whole of the undertaking of the company.
(b) To remit or give time for repayment of any debt due to the company by a director except in the case of renewal or continuance of an advance made by the banking company to its director in the ordinary course of business.
(c) To borrow in excess of capital.
(d) To contribute to any charitable and other funds not relating to the business of the company or the welfare of its employees beyond a specified amount.
(e) To invest the compensation amounts received on the compulsory acquisition of any of the company's properties.
(f) To appoint a sole selling agent.

The above provisions regarding the powers of the board of directors are applicable subject to any restriction contained in the Articles of Association and specific agreements. The powers of the board are to be exercised in the best interests of the company. It should always be ensured that in the exercise of these powers, the company's interest is kept above the self-interests of the directors.

Nominee Directors

A nominee director is generally appointed in a company to ensure that the affairs of the company are conducted in a manner dictated by the laws governing companies and to ensure good corporate governance. A nominee director, as an affiliated director, is nominated to ensure that the interests of the institution which he or she represents are duly or effectively safeguarded. In India, the Companies Act does not distinguish between other directors and a nominee director with regard to liabilites for violations of laws by companies. In the case of a nominee director appointed to represent a financial institution in an assisted company, normally the statute governing the concerned financial institution contains special provisions in this connection. For instance, Section 27 of the State Financial Corporations Act seeks to empower the concerned financial institution to appoint nominee directors on the boards of assisted companies and grants immunity to such directors from liabilities for the company's defaults and contraventions."Such appiontments are valid and effective notwithstanding anything to the contrary contained in the Companies Act, 1956, or in any other law for the time being in force or in the Memorandum or the Articles of Association or any other instrument relating to an industrial concern."[5] The terms of appointment, the number of such directors, their removal from office, their substitution by others are all matters to be decided by the financial institution concerned. In this context, it is pertinent to note that in India, in the numerous instances of corporate frauds which came to light, the concerned company boards did have one or two nominee directors who could have, had they done their duties and carried out their responsibilities, prevented the misdeeds of the companies and their errant directors, and could have saved the poor shareholders' hard-earned money. The nominee directors did nothing to stop the frauds and yet they could not be proceeded against because of the immunity they enjoyed.

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To prevent such an unsavoury situation from arising, the SEBI-appointed Kumar Mangalam Birla Committee on corporate governance suggested that financial institutions should not have their representatives on the boards of assisted companies. This would not only prevent their involvement in such mismanaged companies, but also can avoid the unpleasant situation of their being privy to the unpublished, price-sensitive information. Otherwise, it could easily expose these institutions and their nominess to the charges of insider trading when they deal in the securities of such companies. Though there is a strong case for a lending institution to have a nominee on board of a company as a creditor to protect their interests, their direct involvement would implicitly mean that the nominee directors share equal responsibility for wrong decisions as any other director of the company.

Liabilities of the Directors

Directors of a company may be held liable under the following situations:

(i) The Directors of a company may be liable to third parties in connection with the issue of a prospectus, which does not contain the particulars required under the Companies Act or which contains material misrepresentations;

(ii) The Directors may also incur personal liability under the Act on the following conditions:
   (a) On their failure to repay application money, if the minimum subscription has not been subscribed.
   (b) On an irregular allotment of shares to an allottee (and likewise to the company), if loss or damage is sustained.

Directors of a company may be held liable (i) to third parties in connection with the issue of a prospectus, which does not contain the particulars required under the Companies Act or which contains material misrepresentations; (ii) under the act on the following conditions: (a) On their failure to repay application money of minimum subscription has not been subscribed. (b) On an irregular allotment of shares to an allottee if loss or damage is sustained. (c) On their failure to repay application money if the application for the securities to be dealt in on a recognised stock exchange is not made or refused, and (d) On the failure by the company to pay for the goods wherein the name of the company is not mentioned legibly.

(c) On their failure to repay the application money if the application for the securities to be dealt in on a recognised stock exchange is not made or refused and,

(d) On the failure by the company to pay a bill of exchange, hundi, promissory note, cheque or order for money or goods wherein the name of the company is not mentioned in legible characters.

The directors responsible for fraudulent trading on the part of the company may, by an order of the Court, be made personally liable for the debts or the liabilities of the company at the time of its winding up.

(iii) Apart from the liability of the director under the Companies Act, he or she has certain other liabilities which are independent of the Act. Though a director as an agent of the company, he is not personally liable on contracts entered into on behalf of the company, there could be some exceptional circumstances that may make him liable. For instance, (i) by signing a negotiable instrument without the company's name and the fact that he is signing on behalf of the company, he is personally liable to the holder of such an instrument; (ii) besides, if a director enters into a contract, which is *ultra vires* the Articles of the company, the director is personally liable for the breach of implied warranty of authority; (iii) any director who personally committed a fraud or any other tort in the course of his duties is liable to the injured party. The contract of agency or service cannot impose any obligation on the agent or servant to commit, or assist in the committing of a fraud or any other illegality. The company also be held liable, but it does not exonerate the concerned director.

The Directors' Liability to the Company

Directors are also liable to the company under the following heads: (1) *ultra vires* acts, (2) negligence, (3) breach of trust and (4) misfeasance. Directors should carry out several statutory duties most of which relate to the maintenance of proper accounts, filing of returns or observance of certain statutory formalities. If they fail to perform these duties, they render themselves liable to penalties.

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1. **Ultra vires acts:** Directors are personally liable to the company in matters of illegal acts. For instance, if directors pay dividend out of capital or when they dissipate the funds of the company in *ultra vires* transactions, they are jointly and severally liable.
2. **Negligence:** A director may be held liable for the negligence in the exercise of his duties. Though there is no statutory definition of negligence, if a director has not shown due care and diligence, then he is considered negligent. However, it is essential in an action for negligence if the company has suffered some damage. Negligence without damage or damage without negligence is not actionable.
3. **Breach of trust:** Since the directors of a company are trustees of its money and property, they must discharge their duties in that spirit to the best interest of the company. They are liable to the company for any material loss on account of the breach of trust. Likewise, they are also accountable to the company for any secret profits they might have made in transactions carried out on behalf of the company.
4. **Misfeasance:** Directors are liable to the company for misfeasance, i.e., wilful misconduct. For this purpose they may be sued in a Court of Law.

Liability for Breach of Statutory Duties

The Directors should carry out several statutory duties most of which relate to the maintenance of proper accounts, filing of returns or observance of certain statutory formalities. If they fail to perform these duties, they render themselves liable to penalties.

The Companies Act imposes penalty upon the directors for not complying with or contravening the provisions of the Act, which include sections on criminal liability for mis-statements in prospectus, penalty for fraudulently inducing persons to invest money, purchase by a company of its own shares, concealment of names of creditors entitled to object to reduction of capital, penatly for default in filing with the Registrar for registration of the particulars of any change created by the company. In all these sections, the person, sought to be made liable is described as an "officer who is in default". The expression "officer in default" includes a director also.

Liability for Acts of His Co-directors

A director is not liable for the acts of his co-directors provided he has no knowledge and he is not a party to it. His co-directors are not his servants or agents who can by their acts impose liability on him. Likewise, if a director is fraudulent, his co-directors are not liable for not discovering his fraud in the absence of circumstances to arouse their suspicion.

Moreover, when more than one director is alleged to have neglected his duties of care, all the directors are jointly and severally liable. If an action is brought by the company against only one of them, he is entitled to contribution from other directors.

Disablities of Directors

In order to protect the interest of a company and its shareholders, the Companies Act has placed the following disabilities on the directors:

(i) Any provision in the Articles or an agreement which exempts a director (including any officer of the company or an auditor) from any liability on account of any negligence, default, misfeasance, breach of duty or breach of trust by him shall be wholly void.

(ii) An undischarged insolvent shall not be appointed to act as director of any company or in any way to take part in the management of any company.

(iii) No person shall hold office at the same time as a director in more than 15 companies.

(iv) A company shall not, without obtaining the previous approval of the central government in that behalf, directly or indirectly make any loan to (i) any director of the lending company or of a company which is its holding company or a partner or a relative of such a director, (ii) a firm in which such a director or a relative is a partner, (iii) a private company of which such a director is a director or a member, (iv) a body corporate at a general meeting of which not less than 25 per cent of the total voting power may be exercised or controlled by such a director; or (v) a body corporate, the board of directors, managing director, or manager whereof is accustomed to act in accordance with the directions or instructions of the Board, or of a director or directors of the lending company.

(v) Except with the consent of the board of directors of a company, a director of the company or his relative, a firm in which such a director or a relative is a partner, any other partner, in such a firm, or a private company of which the director is a member or a director, shall not enter into any contract with the company (a) for the sale, purchase or supply of goods, materials or services or (b) for underwriting the subscription of shares in, or debentures of, the company.

The Companies Act has placed the following disabilities on the directors: (i) Any provision in the Articles or an agreement which exempts a director from any liability on account of any negligence, default, misfeasance, breach of duty or breach of trust by him shall be wholly void. (ii) An undischarged insolvent shall not be appointed to act as director of any company. (iii) No person shall hold office as director in more than 15 companies. (iv) A company shall not, without due approvals make any loan to any director of the lending company or of a company which is its holding company or a partner or relative of such a director.

The following persons shall not, hold any office except with the consent of the company accorded by a special resolution: (i) director of the company, (ii) (a) a partner or relative of such a director, (b) firm in which such a director or his relative is a partner, (c) private company of which such a director is a director or member or a director or manager of such a company if the office of profit carries a total monthly remuneration of such sum as may be prescribed.

Further, in the case of a company having a paid-up share capital of not less than ₹ 1 crore, no such contract shall be entered into except with the previous approval of the central government.

(vi) A director shall not assign his office. If he does, the assignment shall be void.

(vii) The following persons shall not hold any office or place of profit in a company except with the consent of the company accorded by a special resolution: (i) director of the company, (ii) (a) a partner or relative of such a director, (b) firm in which such a director or his relative is a partner, (c) private company of which such a director is a director or member or a director or manager of such a company if the office of profit carries a total monthly remuneration of such sum as may be prescribed.

Views of Various Committees on the Role and the Functions of the Board of Directors in Corporate Governance

Almost all the committees on corporate governance at the global and national level has highlighted the role and the importance of the board of directors and the board committees in this respect. Among the three aspects considered by the Cadbury Committee the first were the structure, the role and the responsibilities of board of directors, followed by the role of auditors and the responsibility of accounting profession and the rights and the responsibilities of the shareholders in a company as investors. In this aspect the committee examined the issue of, board composition, board structure, role of independent directors, internal control system, board committees, Chairman's role, Secretary's role, training to the board of directors, etc., and made the following recommendations:

- The board must compose of an optimum number of executive and non-executive directors. The executive directors must have good knowledge of business and the non-executive directors have a broader view about the activities of the company and the environment in which the company is working.
- The executive and the non-executive directors must work together with one objective of maximizing the shareholder's wealth.
- All board members will have equal responsibility in the actions of company board.
- The Non-executive directors will have additional responsibilities of reviewing the performance of the executive directors in addition to reviewing the performance of the board as such and must take a lead when potential conflict of interest arises.
- The Chairman is primarily responsible for the working of the board and also in ensuring that all executive and non-executive directors are encouraged to play their full role.
- The Non-executive directors should bring an independent judgment on the issues of strategy formulation, performance resource use and fixing the standard of performance.
- There should be a formal selection process of the non-executive directors to ensure the independence of them through a nomination committee.
- The independent directors must be appointed for a specific period and the formal appointment letter must be given clearly mentioning their rights, duties, terms of appointment and responsibilities.
- The independent directors must be allowed to seek outside professional advice on issues related to the company at the company's cost, wherever necessary.

- Sufficient training must be given to the directors for improving their performance.
- The board should recognize the importance of the finance function by making it the designated responsibility of a non-executive director who should be a signatory of the annual report and accounts on the behalf of the board.
- There must be board committees such as audit committee, nomination committee, remuneration committees, etc., for the effective functioning of these activities.
- The Audit committee should be formally constituted to ensure that they have a clear relationship with the boards to whom they are answerable and to whom they should report regularly. They should be given written terms of reference which deal adequately with their membership, authority and duties, and they should normally meet at least twice a year.
- The audit committee must have three independent directors only.
- The company secretary has a key role in ensuring that the board procedures are strictly followed.
- The remuneration of both the executive and the non-executive directors must be clearly disclosed in the annual report.
- The Financial report should be presented in a balanced and understandable manner to the shareholders and should ensure the highest level of disclosure. The Financial Reporting Council must develop a format for this purpose and all listed companies must follow it.
- The director's service contracts should not exceed 3 years without the approval of the shareholders.
- The nomination committee should have a majority of non-executive directors on it and be chaired either by the Chairman or a non-executive director.
- The Directors need in practice to maintain a system of internal control over the financial management of the company, including procedures designed to minimize the risk of fraud. There is, therefore, already an implicit requirement on directors to ensure that a proper system of internal control is in place.

The Greenbury Committee: The terms of reference of the Greenbury Committee was to identify good practices in determining the director's remuneration and prepare a code of such practices for use by public limited companies in the UK. Though the Committee's work was focused on big public limited companies directors it is equally applicable to other senior executives in the public limited companies and the directors of small listed and unlisted companies. The Committee focused the deliberations on remuneration policy, service conditions and compensation of directors, functioning of a remuneration committee, disclosure of director's compensation and a code of best practices in this respect. The Committee made the following major recommendations:

- There must be a remuneration committee consisting of non-executive directors, on behalf of the shareholders.
- The board must formulate a remuneration policy to attract, retain and motivate directors with the required quality.
- Regarding the disclosure and the approval provisions the Committee recommended that the remuneration committee should make a report each year to the shareholders on behalf of the board. The report should form part of, or be annexed to, the company's annual report and accounts. It should be the main vehicle through which the company accounts to the shareholders for the Directors' remuneration are communicated.
- Regarding the service contracts and compensation the Committee suggested that the remuneration committees should consider what compensation commitments their Directors' contracts of service, if any, would entail in the event of early termination, particularly for the unsatisfactory performance.

The Committee also recommended that all listed companies registered in the UK should comply with the code to the fullest extent practicable and include a statement about their compliance in the annual reports to shareholders by their remuneration committees or elsewhere in their annual reports and accounts. Any areas of non-compliance should be explained and justified.

The Committee further recommends that the London Stock Exchange should introduce the following continuing obligations for the listed companies:

1. An obligation to include in their annual remuneration committee reports to the shareholders or their annual reports a general statement about their compliance with section A of the code which should also explain and justify any areas of non-compliance.
2. A specific obligation to comply with the provisions in section B of the code which are not already covered by existing obligations, and with provisions of the code, subject to any changes of working which may be desirable for legal or technical reasons.

The Hampel Committee's View on the Role of Directors in Corporate Governance

The Hampel Committee on corporate governance made the following recommendations with respect to the board of directors and the committee of board of directors.

A. **Regarding the appointment and composition of the board of directors, the Committee recommended the following.**
   - Executive and non-executive directors should continue to have the same duties under the law.
   - Boards should appoint only those executives as the executive directors who can take a broad view of the company's overall interests.
   - The majority of the non-executive directors should be independent and boards should disclose in the annual report which of the non-executive directors are considered to be independent. This applies for companies of all sizes
   - There is an overwhelming support in the UK for the unitary board and virtually none for the two tier board. To be effective, the non-executive directors need to make up at least one third of the membership of the board should be independent directors.
   - Separation of the roles of Chairman and Chief Executive Officer is to be preferred, other things being equal, and companies should justify a decision to combine their roles.
   - Companies should set up a nomination committee to make recommendations to the board on all new board appointments.
   - All the directors should submit themselves for re-election at least every three years and companies should make any necessary changes in their Articles of Association as soon as possible.
   - The Names of directors submitted for re-election should be accompanied by biographical details.
   - There should be no fixed rules for the length of service or the age of non-executive directors, but there is a risk of their becoming less efficient and objective with the length of service and the advancing age, and the boards should be vigilant against this.

B. **Regarding the director's remuneration, the Committee recommended the following.**
   - The boards should set as their objective the reduction of directors' contract periods to one year or less, but recognize that this cannot be achieved immediately.
   - The boards should establish a remuneration committee, made up of independent non-executive directors, to develop policy on remuneration and devise remuneration packages for individual executive directors.
   - The decisions on the remuneration packages of the executive directors should be delegated to the remuneration committee; the broad framework and the cost of executive remuneration should be a matter for the board on the advice of the remuneration committee. The board should itself devise remuneration packages for the non-executive directors.
   - The disclosure of individual remuneration packages should be retained; but the Committee considers that this has become too complicated.
   - The Committee considers that the requirement to disclose details of individual remuneration should continue to apply to overseas based directors of the UK companies.
   - The shareholder approval should be sought for the new long-term incentive plans.

In the Securities Exchange Commission's code of corporate governance, Principle one to seven deals with it under the head "**The board's governance responsibilities**".

Principle 1: The company should be headed by a competent, working board to foster the long-term success of the corporation, and to sustain its competitiveness and profitability in a manner consistent with its corporate objectives and the long-term best interests of its shareholders and other stakeholders.

Principle 2: The fiduciary roles, responsibilities and accountabilities of the board as provided under the law, the company's articles and by-laws and other legal pronouncements and guidelines should be clearly made known to all the directors as well as to the stockholders and other stakeholders.

Principle 3: The board committees should be set up to the extent possible to support the effective performance of the Board's functions, particularly with respect to audit, risk management, related party transactions and other key corporate governance concerns, such as nomination and remuneration. The composition, the functions and the responsibilities of all committees established should be contained in a publicly available Committee Charter.

Principle 4: To show full commitment to the company, the directors should devote their time and attention necessary, to properly and effectively perform their duties and responsibilities, including sufficient time to be familiar with the corporation's business.

Principle 5: The board should endeavour to exercise objective and independent judgment on all corporate affairs.

Principle 6: The best measure of the board's effectiveness is through an assessment process. The board should regularly carry out evaluations to appraise its performance as a body and assess whether it possesses the right mix of backgrounds and competencies.

Principle 7: Members of the board are duty-bound to apply high ethical standards, taking into account the interests of all stakeholders.

The OECD View of the Role of Board of Directors in Corporate Governance

In the OECD Principles of corporate governance, Principle VI deals with the responsibilities of the board of the directors in corporate governance.

The Principle says that, "The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board and the board's accountability to the company and the shareholders".

A. The board members should act on a fully informed basis, in good faith, with due diligence and care and in the best interest of the company and the shareholders.

B. Where board decisions may affect different shareholder groups differently, the board should treat all the shareholders fairly.

C. The board should apply high ethical standards. It should take into account the interests of the stakeholders.

D. The board should fulfil certain key functions, including:

1. Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.
2. Monitoring the effectiveness of the company's governance practices and making changes as needed.
3. Selecting, compensating, monitoring and when necessary, replacing key executives and overseeing succession planning.
4. Aligning key executive and board remuneration with the longer term interests of the company and its shareholders.
5. Ensuring a formal and transparent board nomination and election process.
6. Monitoring and managing potential conflicts of interest of the management, the board members and the shareholders, including the misuse of corporate assets and abuse in related-party transactions.
7. Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control and compliance with the law and the relevant standards.
8. Overseeing the process of disclosure and communications.

E. **The board should be able to exercise objective independent judgment on corporate affairs.**

1. The boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, the review of related-party transactions, the nomination of board members and key executives and the board remuneration.
2. When the committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed by the board.
3. The board members should be able to commit themselves effectively to their responsibilities.

The Birla Committee's view on the role of director board in corporate governance: In the words of Birla Committee on corporate governance, the three key constituents of corporate governance are the Shareholders, the Board of Directors and the Management and it has attempted to identify in respect of each of these constituents, their roles and responsibilities as also their rights in

the context of good corporate governance. With regards to the board of directors, the committee of the board their role duties, responsibilities and remuneration packages the Committee made the following mandatory recommendations.

The Role of Board: The Committee recognizes that the board of a company provides leadership and strategic guidance, an objective judgment independent of management to the company and exercises control over the company, while remaining at all times accountable to the company. The Board of directors thus directs and controls the management of a company and is accountable to the shareholders.

The Board composition: The Committee is of the view that the composition of the board of directors is critical to the independent functioning of the board. Hence, the Committee recommends that the boards must comprise an optimum combination of executive and non-executive directors, with not less than fifty per cent of the board being the non-executive directors. The number of independent directors would depend on the nature of the chairman of the board. In case a company has a non-executive chairman, at least one-third of board should comprise independent directors and, in case a company has an executive chairman, at least half of board should be independent. The Committee has also given a comprehensive definition of independent director which states that "Independent directors are directors who apart from receiving director's remuneration do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the judgment of the board may affect their independence of judgment".

Nominee Directors: Besides the above categories of directors, there is another set of directors in the Indian companies who are the nominees of the financial or investment institutions to safeguard their interest. The nominees of the institutions are often chosen from among the present or retired employees of the institutions or from outside. The Committee recommends that when a nominee of the institutions is appointed as a director of the company, he should have the same responsibility, be subject to the same discipline and be accountable to the shareholders in the same manner as any other director of the company.

The Audit Committee: The Committee identified the critical role of auditing in corporate governance and recommends that a qualified and independent audit committee should be set up by the board of a company and recommended an audit committee having minimum three members, all being non-executive directors, with the majority being independent and with at least one director having financial and accounting knowledge. The chairman of the committee should be an independent director. Finance director and head of internal audit and when required, a representative of the external auditor should be present as invitees for the meetings of the Audit Committee. The Company Secretary should act as the secretary to the committee. The Audit Committee should meet at least **thrice a year**. The quorum should be either two members or one-third of the members of the Audit Committee, whichever is higher and there should be a minimum of two independent directors. The Committee also specially recommended the powers and functions of Audit Committee.

The composition of remuneration committee and quorum: The Committee recommends that to avoid conflicts of interest, the remuneration committee, which would determine the remuneration packages of the executive directors should comprise at least three directors, all of whom should be non-executive directors, the chairman of committee being an independent director.

The disclosure of remuneration package: Regarding the disclosure of remuneration package, the Committee recommends that all the elements of remuneration package

including the fixed and the performance-based salary, bonus, stock options, service contract period, etc., should be specified in the annual report in a clear manner.

The Board Procedures: Regarding the conduct of board meetings, procedure, frequency and periodicity the Committee recommends that the board should meet at least four times in a year with a maximum time gap of four months between two meetings. Further it is recommended that a director should not be a member of more than ten committee and a chairman of more than five companies across different companies.

Effectiveness of the Board of Directors

The board is recognised legally as the top layer of management with the responsibility of governing the enterprise, yet, in actual practice, the board of directors delegates most of its managerial power to chief executives.

Though the board is recognised legally as the top layer of management with the responsibility of governing the enterprise, yet, in actual practice, the board of directors delegates most of its managerial power to chief executives—say, the managing director or manager. In many cases, the board appoints many committees and clothes them with its power. The most common is the executive committee, though there may be other committees, is connected with various phases of management. However, these committees cannot make radical changes in the policy of the company. In recent years, the board of directors has come to rely more and more on the chief executives for the management of the company. The chief executives, being wholetime officers of the company, naturally devote greater time and attention to the matters connected with the management of the company. Their continuous and close contact with the operation of the company places them in a far more advantageous position in respect of the management of the company's affairs than the board which meets only occasionally. As Newmen puts it: "It is the full-time executive who must carry the responsibility for the basic exploration and analysis of present and future problems."

Under the present arrangements, after a thorough and detailed study of the problems and circumstances, chief executives formulate objectives and policies and take important managerial decisions. The realistic functions of the board may, therefore, be enumerated as follows:

(a) Confirming management decisions on major changes in objectives, policies, and those transactions which will have a substantial effect on the success of the company.
(b) Providing constructive advice to the executives through discussion on important matters such as business outlook, new government legislation, wage policy, with a view to guiding the executives when the policies are still in the process of formation.
(c) Selecting chief executives and confirming the selection of other executives in the company made by the chief executives.
(d) Reviewing the results of the company's current operations.

Thus, as per the current practice, the initiative in the management of companies has passed into the hands of chief executives. Peter Drucker, while discussing this issue, remarks thus: "In reality, the board as conceived by the lawmakers is at best a tired fiction. It is perhaps not too much to say that it has become a shadow king.'' This should not be taken to mean that the board has no important function to perform. As it is, the ultimate responsibility under the present set-up of company management rests with the board of directors. It has, therfore, to perform the important function of approving the company's objectives and policies, of looking critically at the "profit planning" of the company, of acting as an arbiter and judge in regard to organisational problems and of keeping its hand on the pulse of the company. To quote Drucker again: "It is an organ of review, of appraisal, of appeal. Only in a crisis, it becomes an organ of action."

That the top executives carry out a good deal of homework for the benefit of the board of directors, is indeed an encouraging sign, particularly in view of the increasing complexity of company operations and the other preoccupations of company directors. However, problems can arise if the board were to become a mere rubber stamp, particularly, when the company management is dominated by bureaucrats who cannot take a detached and objective view of company operation because they are too much involved with them.

Even more serious is the problem of the board of directors not acting as free agents in the discharge of their duties. For too long in India, managing agents controlled the boards of directors of companies and used them as mere tools. Even after the abolition of the managing agency system, there is a danger of their being pressurised by corporate groups and big industrial houses. It is only through democratically elected boards consisting of professional men of deep insight into business affairs that the state of company management can be improved.

Board in Ensuring Corporate Governance

Role of the Board

The clear message from the series of corporate debacles that occurred in America and several parts of the world, is simple that the board of directors is increasingly being recognised as a critical success factor for corporations, be they large or small, private or public. This understanding and appreciation of the role of the boards as being valuable has resulted in several recommendations to boost their contributions to the success of companies by innumerable committees that have been appointed by governments and public spirited organisations all over the world.

Company laws enacted by various countries stress that the duty of a statutory board is to protect and represent the interests of shareholders, work out business strategy and address big issues, ensure that the management works in the best interests of the corporation and the shareholders to enhance corporate economic value.

Company laws enacted by various countries make it a point to stress that the duty of a statutory board is to protect and represent the interests of the shareholders. The board cannot and does not run the company. There are executives who run the day-to-day affairs of the company as dictated by the board. The role of the board is to work out business strategy and address big issues. A board's role is evolved from law, custom, tradition and current practice, while it gets its authority from the shareholders as their representatives to run the company's mission. It is the broader responsibility of the board to ensure that the management works in the best interests of the corporation and the shareholders to enhance corporate economic value.

It is now clearly understood that no set of systems with a checklist and the laws of state governing them can ever ensure good governance. The quality of directors, their competence, commitment, willingness and ability to assume a high degree of obligation to the company and its shareholders as members of the board alone drives the value of any board. A strategic board with broad governing responsibilities rather than one that acts in response to the demands of the CEO has become the need of an intensely competitive world. To strengthen their position and capacity to guide the company and protect the long-term shareholder's value, many big corporates are turning to advisory boards to draw on the collective wisdom of several professionals. All of these decisions will, of course, depend on the policy, its critical needs and long time goal of the company.

Susan F. Shultz, founder of SSA Executive Search International, author of several best sellers on the subject and a member of several boards of directors condenses her experiences and research in the following summation.[6]

How can a strategic board ensure good governance?
1. If the board is smaller, the director's involvement will be greater. 2. Independence is the essence of strategic boards. 3. Diversity (of board) means that a company has access to the best. It also means that the company is not arbitrarily limited to a single subset of its global constituency. 4. If the board is not informed appropriately, intelligently and comprehensively, it cannot function. In simple words, the output is only as good as the input. 5. The board has a broader responsibility to the long-term shareholder value than the CEO, who is necessarily focussed on day-to-day operations.

The above chart summarises how a strategic board can be built to ensure better governance practices.

1. **Small size of the board:** The smaller the size of the board, the greater will be the involvement of its members. This will lead to a more cohesive functioning and decision-making could be expedited, all of which will add to the efficiency of the organisation.
2. **Independence of the board:** Independence should be the essence of strategic boards. To achieve this end, it is advisable to have less number of insiders and more of outsiders. As Susan F. Shultz points out, this kind of composition of the board will add to the "proactiveness of the company's board. Further, an insider's allegiance is likely to be to his or her boss and not necessarily to the company's shareholders. Another downside to an insider dominated board is that not only can the CEO intimidate insiders, but insiders can also inhibit the CEO".[7] Managements have a vested interest to prefer insiders as directors to the board as they are likely to continue the *status quo* in policies and procedures that they themselves have helped to create and retain the present senior managers.
3. **Diversity of the board:** It is of great importance that the board is composed of members with varied experience and expertise and diverse professional qualifications, but also of people with different ethnic and cultural backgrounds. "With markets in general, and shareholders in particular becoming active in governance issues, the pressures are intensifying on companies to diversify and broaden board membership. And thankfully, the phenomenon is not restricted to just the US and the UK, this increased activism is forcing companies worldwide to reform their boards in tune with the rapid globalisation of businesses."[8]

   In India, for instance, with the Cadbury Committee Report and the worldwide interest on corporate governance issues, several scams that have highlighted regulator's failures on this front, have brought to the centrestage the importance of the board of directors with a sizeable number of non-executive directors.
4. **A well-informed board:** It goes without saying that the effectiveness and efficiency of the board of directors depends on the intelligent, timely and accurate information it gets from the management.The information they get should be appropriate and comprehensive.Various committees on corporate governance have recommended that even non-executive, independent directors should have access to a free flow of information on various issues in which they are called upon to decide. They should be allowed to have professional advice, if needs be, and the cost of it should be borne by the company.
5. **The board should have a longer vision and broader responsibility:** The very objective and the composition of the board dictate the need for a broader responsibility and longer vision than those of chief executives. The CEO has a specific and focussed mission of running the enterprise as a profitable one by concentrating on its day-to-day transactions. While the concerns of the CEO will centre around his immediate tasks on hand to enable a company solve its problems and tackle issues that would lead to the profitability of the firm during

a financial year, the board, especially when it is composed of several outside directors, will work out long term strategies, take investment decisions and such other policy perspectives that would ensure not only the secular interests of the firm, but also of all its stockholders.

Governance Issues Relating to the Board

There are several vexed issues relating to the board of directors that are being hotly debated on several fora on the corporate governance. Though these issues have generated a series of on-going discussions on familiar lines and the final verdicts have yet to be pronounced, there are certain common perceptions that have arisen which find general acceptance. These are discussed in the following pages:

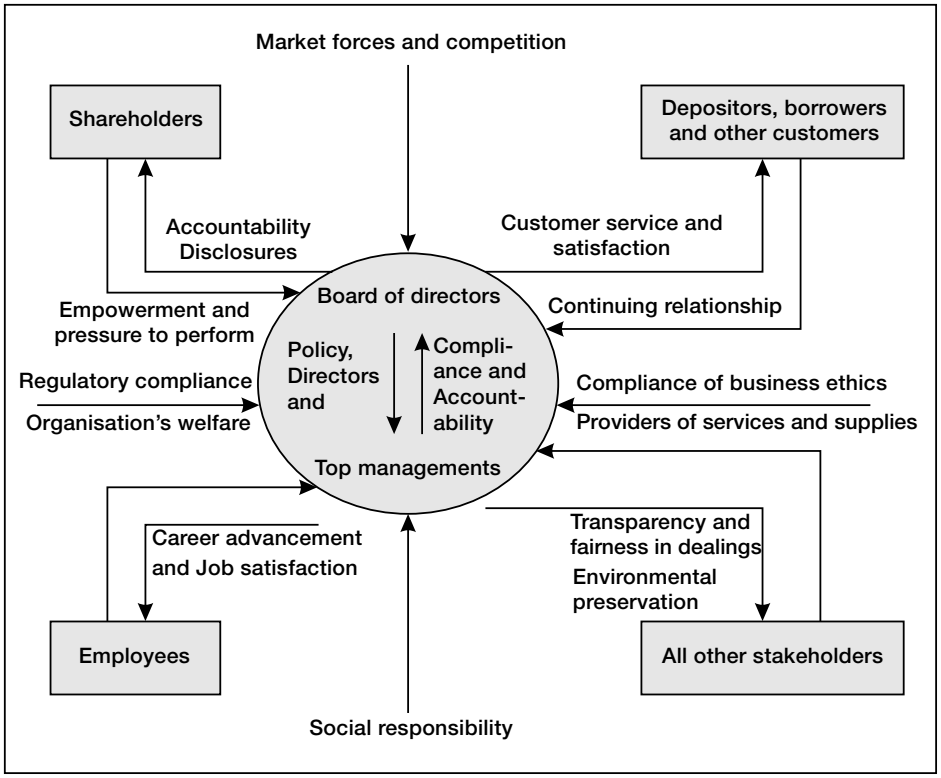
Board of Directors and Corporate Governance

There is an increasing awareness that corporates owe their existence to the shareholders and the long-term sustainability of companies depends on winning their confidence through disclosures and the transparency in the operations and the accountability for their actions to them. This is achieved through voluntary actions on the part of board of directors and through regulatory framework such as stock exchanges, securities and exchange board and other regulatory bodies. These principles are codified as principles of corporate governance. The following diagram clearly illustrates how board of directors and the top management are placed in the structure of corporates to interface, interact and intervene, when necessary, to carry on the running of the company efficiently.

Corporates owe their existence to the shareholders and the long-term sustainability of companies depends on winning their confidence through disclosures and transparency in operations and accountability for their actions to them. These principles are codified as principles of corporate governance.

Figure 8.2

Role of the board in the dynamics of corporate governance



The board should for better governance ensure: directors should exhibit total commitment to the company; directors should steer discussions properly; directors should make clear their stand on issues; directors' responsibility to ensure efficient CEOs; challenges posed by decisions on acquisitions; a board should anticipate business events; and directors should have longterm focus and stakeholder interests.

The Role of Directors

As discussed earlier, the board has to shoulder a larger responsibility than the CEO, whose role is limited to being actively engaged with routine management functions. However, "There are many boards that overlook more than they oversee". This is more so in the family-owned enterprises which are common in Asia and Latin America. In India, for instance, it is common to find family-owned concerns being run by promoters as their personal fiefdoms.Though their investments may be meagre, they manage the firms, holding positions of CEOs, managing directors, chairmen and menbers of the board of directors. In such a set-up, the board acts more like a rubber stamp, rather than shouldering large responsibilities. For better governance, the board should function as follows:

1. **Directors should exhibit total commitment to the company:** An efficient and independent board should be conscious of protecting the interests of all stakeholders and not concerned too much with the current price of the stock. According to Roz Ridgway, the hallmark of a good director is that he or she attends and actively participates in the meetings. This requires a cent percent commitment.
2. **Directors should steer discussions properly:** Another important function of the director is to set priorities and to ensure that these are acted upon. The directors should see that all important issues concerning the company's business are discussed and decision taken, and nothing trivial dominates and bogs them down. A good director rarely dominates or hijacks the discussion to his line of thinking, but steps in when the discussion needs to be directed or adds newer thoughts after letting others have their say.
3. **Directors should make clear their stand on issues:** A director is also expected to have the courage of conviction to disagree. A good, responsible and duty-bound director should be willing to register dissent, when and where needed. The management led by the CEO should know that they are being challenged, should be kept on alert and should not take things for granted. Directors should also be alert to any deteriorating situations in the functional areas of finance, stock market, sales, personnel, and especially those relating to moral issues.
4. **Directors' responsibility to ensure efficient CEOs:** Directors have great responsibility in the matter of the employment and the dismissal of the CEO. The board as a whole, should recruit the best CEO they can probably hire, based on antecedents and market reports, evaluate objectively on a continuing basis his or her implementing effectively or otherwise the strategic planning devised by the board. "Great boards are those which proactively govern, help avoid big mistakes, strategies and most importantly the best leadership is in place with the resources to lead". [9]
5. **Challenges posed by decisions on acquistions:** One of the toughest challenges confronted by boards arises while approving acquisitions. It so happens in most cases that the board takes up the issue of acquisition only when the process has been set in motion and substantially gone through by the management. It will lead to a terrible embarrassment both to the CEO and the board, if the half-way-gone-through proposal has to be shelved. More of these none-too-worthy proposed acquisitions have to be accepted because of these predicaments.
6. **A Board should anticipate business events:** An efficient board should be able to anticipate business events that would spell success or lead to disaster if proper measures are not adopted in time. The directors should be alert to such ensuing situations and be ready with the strategy to meet them so that either way the company stands to gain.

7. **Directors should have long-term focus and stakeholder interests:** Directors have a duty to act *bona fide* for the benefit of the company as a whole. This duty is owed to the company, that is, the separate legal person that incorporation brings into existence, and not to any individual or group of individuals. This would imply, as per the current laws, that directors are required to act in the interests of the shareholders, but at the same time, to consider such interests with a long time focus. They ought to help build productive relationships between the company and its employees, customers and suppliers, or any other kind of invesment that would serve the long term interests of its shareholders.
8. **Promoting overall interests of the company and its stakeholders are of paramount importance:** In recent times, those who advocate reform of laws governing corporate practices stress the importance of reformulation of the concepts behind these laws. For instance, John Parkinson in his article "Reforming Directors' Duties" opines that while accepting that directors should not be required to do anything that would be contrary to the interest of shareholders, stresses that these interests should be understood as long term ones. This reformulation of the concept should encourage managers to pay great attention to the relationships that are the source of long term value. Once this becomes accepted, it will be logically consistent for the directors to exercise their powers in order to promote the success of the company as a business enterprise. By doing so, they shall have regard to the interests of shareholders, employees, creditors, customers and suppliers. Stretched further, it would become imperative that directors guide the company to be a socially responsible organisation. Social responsibility in this context should be seen as a means of not only compensating the society for anti-social corporate behaviour such as causing ecological damages, making money at the cost of patients by launching fully untested medicines. but also for making use of the resources created by the society such as trained manpower markets for the supply of inputs and for the disposal of produced goods and services.

Promoting overall interests of the company and its stakeholders are of paramount importance. In recent times, those who advocate reform of laws governing corporate practices stress the importance of reformulation of the concepts behind these laws.

These are some of the duties and responsibilities expected of a proactive, sincere and committed board of directors who by their actions and decisions will be able to promote the interests of not only the shareholders, but all the stakeholders of the company.

The three caselets discussed below reveal how corporate boards and courts of law are holding the CEOs accountable for their sins of commission and omission.

Hot Seat Gets Hotter for American CEOs

Accountability of Directors Becoming a Critical Issue

Case 1: A former top executive at Boeing was sentenced to four months in prison in March 2005 for illegally negotiating a $250,000 a year job for an air force procurement officer who was over-seeing a potential multibillion-dollar contract for the company.

The Former Boeing chief financial officer, Michael Sears pleaded guilty in November 2004 on a single count of aiding and abetting illegal employment negotiations. Specifically, Sears negotiated to hire Darleen Druyun at the same time Druyun held sway over a contract sought by Boeing that was worth billions of dollars. Federal sentencing guidelines called for a prison term of up to 6 months. Sears' lawyers sought probation.

The US District Judge Gerald Bruce Lee said jail term was appropriate, though he acknowledged that Sears' conduct wasn't as severe as that of Druyun, who initiated the job negotiations. "Yours is not equal to hers", Lee said. Druyun is serving a 9-month sentence at a minimum-security prison camp for female offenders in Marianna, Florida.[10]

Case 2: American corporate boards fired 103 CEOs in February 2005. Corporate boards are shedding their sleepy images and becoming more ruthless when something's not quite right at the top. The result: Top US executives are being knocked off their

pedestals faster than ever. Boards are asking high-level company officers to hit the road for anything, ranging from financial scandals, lacklustre results, improper insider trades or even an affair with another executive.

According to Challenger, Gray & Christmas, an outplacement and employment research firm, the US companies announced 103 CEO changes in February 2005, as compared to 92 in January 2005.

It was the fourth consecutive increase in monthly turnover and the first time in 4-years that more than 100 CEO changes were announced. "A few years ago, most Boards only rubber-stamped the decision of the executive team, but today, they are flexing their muscles and digging into every area of the company," said John Challenger, the firm's chief executive.

"They are scrutinising results and second-guessing even decision the CEO makes," he added. During the previous month, Hewlett-Packard's board dismissed its Chairman and CEO Carly Fiorina as HP's merger with Compaq Computer had failed to deliver results. Office Max also ousted its CEO in February after less than 4 months on the job after a billing scandal at an office products retailer.

This continued further and there was no sign of the trend getting slow. In March 2005, Boeing's Harry Stonecipher was ousted for his romance with a female executive, while Fleetwood Enterprises fired its CEO following lacklustre results and a bleak outlook.

One reason for the no-nonsense attitude is the increasing independence of Boards from management. New rules mandated by the New York Stock Exchange (NYSE), the Nasdaq Stock Market and the Sarbanes–Oxley law require greater Director independence and expertise. Directors are becoming more fearful of facing legal action if they let fraudulent behaviour go unchecked.

Case 3: Ten former directors of WorldCom were set to pay $18 million out of their own pockets to settle an investor class-action lawsuit. But the deal fell apart in early February 2005, when a federal judge ruled that a key part of the settlement was illegal. WorldCom, a star of the late 1990s telecommunications boom, collapsed in '2002 in the largest bankruptcy in the US history, facing $41 billion in debt and $11 billion accounting scandal.

"Boards are going to be much more apt to move quickly these days if they are not happy about something", said Mr Joe Griesedieck, the head of CEO recruiting at Korn/Ferry International. Korn/Ferry is planning a boot camp for the new CEOs in May 2005. One issue in focus will be the importance of building a constructive relationship with Boards. Another reason boards are adopting a tough stance is the flak they are getting about the compensation they pay to top executives.[11]

In this respect N. R. Narayana Murthy Committee on corporate governance says the following:

"All compensation paid to the non-executive directors may be fixed by the Board of Directors and should be approved by the shareholders in the general meeting. Limits should be set for the maximum number of stock options that can be granted to the non-executive directors in any financial year and in aggregate. The stock options granted to the non-executive directors shall vest after a period of at least one year from the date such non-executive directors have retired from the board of the company. The companies should publish their compensation philosophy and statement of entitled compensation in respect of the non-executive directors in their annual report. Alternatively, this may be put up on the company's website and reference drawn there to in the annual report. Companies should disclose on an annual basis, details of shares held by non-executive directors, including on an 'if-converted' basis. Non-executive directors should be required to disclose their stock holding (both own or held by/for other persons on a beneficial basis) in the listed company in which they are proposed to be appointed as directors, prior to their appointment. These details should accompany their notice of appointment".

Directors' Remuneration

In the wake of several corporate failures, excessive and disproportionately large payments to directors have almost become a scandal. It has also become one of the most visible and politically sensitive issues of corporate governance.

As usual, there are divergent views on the subject. Some experts on the subject are of the view that directors are generally underpaid for their work and the onerous responsibilities they shoulder. They argue that "constructive boards are responsible for untold millons going to the bottomline. The value of a single idea of strategic succession planning, of risk avoidance, and the value one mistake prevented is incalculable".[12]

On the other hand, critics argue about the hefty fees directors receive for attending meetings, millions of dollars paid as severance payments, huge payouts as bonus and other perquisites. A major criticism is that executives and directors are not properly controlled in their virtual self-awards of stock options. Executive compensation linked to share performance through share options has resulted in encouraging a focus on short term growth with destructive long term consequences.

The Indian Companies Act 2013 and Corporate Governance

The Indian companies Act 2013 extensively deals with the role of board of directors in the corporate governance. They are broadly classified under the following heads.

- Number of directors
- Composition of director board
- Independent directors
- Woman director
- Limit in the directorship
- Tuner of independent directors
- Formal letter of appointment of directors
- Performance evaluation of Independent directors
- Separate meeting of independent directors
- Training of directors
- Compensation of non-executive directors
- Director board meeting procedure
  (Details are given in the Chapter 5 titled Legal and Regulatory Aspects of Corporate Governance)

Remuneration Committee

It is now an universally accepted proposition of corporate governance practice that boards appoint appropriately composed remuneration committees to work out executive remuneration on their behalf. The combined code of the United Kingdom says that the remuneration committee will be responsible for working out remuneration packages "to attract, retain and motivate executives of the quality required". The committee should decide where to position their company relative to other companies, and take account of comparable remuneration and relative performance.

The UK's combined code says that the remuneration committee will be responsible for working out remuneration package "to attract, retain and motivate executives of the quality required."

With regard to the composition of the committee, an overwhelming majority of guidelines suggest that it be composed exclusively of independent non-executive directors. The committee would make its well considered recommendations to the board for the final decision. The following responsibilities are normally assigned to a remuneration committee, which should have a written terms of reference:

(a) Remuneration packages and service contracts of the CEO and other senior executives.
(b) Remuneration packages for non-executive directors.
(c) Remuneration policies and practices for the company.
(d) Any company share and other incentive schemes.
(e) Company superannuation and pension arrangements.

Severance Payments

In industrially advanced countries such as the US, the UK and Australia, the issue of severance payments to executives has received considerable attention in recent times and is being debated in the context of acceptable corporate governance practices.

There had been huge serverance payments made to the executives which found wide publicity in the media and received critical comments from the public. Severance payments are made to a departing executive for the time remaining on his contract. Critics adversely comment on large payments in this regard because executives removed for poor performance are being rewarded too generously.

These payments, when effected under a contract the company had entered into with the executive could not be faulted. But it is the "rolling contract" that is adversely commented upon. In such an arrangement, it would imply, for instance, an executive being eased out for poor performance would be entitled for payments for 3-years even after termination of his services with the company, if the contract contained such a clause covering a 3-year period. Obviously, such a contract is considered unfair to the company and its shareholders. Institutional investors in the UK has been exerting considerable pressure on corporates in the matter of severance payments and they refuse to vote in favour of the re-election of directors whose appointments contained rolling service contracts.

Other Remuneration Packages

Executive directors are employees of the company, and as such, they receive a salary package. Shareholders' approval is not required while their salary package is fixed by the board of directors. It would be a healthy practice, however, that the board fixes the salary on the recommendation of the remuneration committee and that the concerned executives themselves have no say on the matter.

With regard to the remuneration for the non-executive directors, the board has the responsibility to fix their remuneration and to determine the appropriate allocation of the aggregate remuneration between different directors. Under such schemes, larger amounts would be allocated to those directors who shoulder greater responsibilities such as chairperson and members of committees. It is important to note that shareholders' approval would be necessary in fixing the remuneration packages of the non-executive directors.

Another issue of payments to directors that has caused some amount of distaste to the advoactes of corporate governance is the question of pensions to directors. This question is debated like this: If a director is made eligible to draw pension after certain years of service on the Board, he might not like to jeopardise his chances of a life-long pension by questioning the management or resigning his job prematurely. This is likely to affect his independent judgement, and thus militate against good governance of companies. As such, the practice of pension,

which is in vogue in Australia and England, is not good. There is a very strong policy case to be made against granting pensions to the non-executive directors.

Directors' Remuneration in India

Section 198 of the Companies Act 1956 deals with overall maximum managerial remuneration, and managerial remuneration in case of absence or inadequacy of profits. According to this Section:

(i) The total managerial remuneration payable by a public limited company or a private company which is a subsidiary of a public company, to its directors and its managers in respect of any financial year shall not exceed 11 per cent of the profits of that company for that financial year, except that the remuneration of the directors shall not be deducted from the gross profits.

(ii) The 11 per cent shall be exclusive of any fees payable to directors.

(iii) With the limits of the maximum remuneration specifed in sub-section (1), a company may pay a monthly remuneration to its managing or whole-time director.

(iv) Notwithstanding anything contained above if, in any financial year, a company has no profits or its profits are inadequate, the company shall not pay to its directors, including any managing or whole-time director or manager, by way of remuneration any sum exclusive of fees payable to directors, except with the previous approval of the central government.

Remuneration in this Context Shall Include

(a) Expenditure incurred by the company in providing a rent-free accommodation, or any other benefit or amenity in respect of accommodation free of charge, to a director or a manager.

(b) Expenditure incurred by the company in providing other benefit or amenity free of charge or at a concessional rate to any of the person aforesaid.

(c) Expenditure incurred by the company in respect of obligation, or service, which but for such expenditure by the company, would have been incurred by any of the persons aforesaid.

(d) Expenditure incurred by the company to effect an insurance on the life of, or to provide pension, annuity or gratuity for, any of persons aforesaid or his spouse or child.

The managing agency system was the harbinger for the industrial development of the country in the early 20th century. Family-owned companies too have come a long way in India. After Independence, though the Industrial Policy Resolution gave a step-motherly treatment to the private sector, some of the family-owned companies built their own industrial empires successfully and have weathered all those onslaughts and have grown beyond the most sanguine expectations of their humble promoters—Tatas, Birlas, Ambanis, Mafatlal, Thapars, Singhanias and TVS—some of them being classic examples with different degrees of professionalisation thrown in.

Prohibition of Tax-free Payments

According to Section 200 of the Companies Act 2013:

1. No company shall pay to an officer or employee thereof, whether in his capacity as such or otherwise, remuneration free of tax, or otherwise calculated by reference to, or varying with, tax payable by him, or the rate or standard rate of such tax, or the amount thereof.
   In this instance, the expression "tax" comprises any kind of income tax including super tax, if any.
2. By virtue of a provision in force immediately before the commencement of this Act, whether contained in the company's or in any contract made with the company, or in a resolution passed by the company in general meeting or by the company's board of directors, an officer or employee of the company holding an office at the commencement of this Act is entitled to remuneration in any of the modes prohibited by sub-section (1), such provision shall have

effect during the residue of the term for which he is entitled to hold such office at such commencement, as if it provided instead for the payment a gross sum subject to the tax in question, which after deducting such tax, would yield the net sum actually specified in such provision.

3. This section shall not apply to any remuneration
   (a) which fell due before the commencement of this Act.
   (b) which may fall due after the commencement of this Act, in respect of a period before such commencement.

Role of Board of Directors in Family-owned Businesses

Family-owned businesses and industrial enterprises abound in India as well as in other parts of Asia and Latin America. India provides a classic case of these concerns growing out of the highly indigenous and successful managing agency system that was the harbinger for the industrial development of the country in the early twentieth century. Family-owned companies have come a long way in India. After Independence, though the Industrial Policy Resolution gave a step-motherly treatment to the private sector, and the licensing policy all but suppressed their growth, some of the family-owned companies built their own industrial empires successfully and have weathered all those onslaughts and have grown beyond the most sanguine expectations of their humble promoters—Tatas, Birlas, Ambanis of Reliance, Mafatlals, Thapars, Singhanias and TVS—some of them being classic examples with different degrees of professionalisation thrown in.

In the early period of Independence and even right into 1980s, these family-owned firms were as good or as bad as any other anywhere in the world. Capital, *albeit* low, was provided by the promoter families, with government-controlled financial institutions and the shareholding public contributing the most. The board of directors, including chairmen and managing directors, consisted of family members with a couple of directors from funding financial institutions and perhaps a couple of outside "passive" directors. The board acted more like a rubber stamp than an active body that supervised and guided the work of the management on behalf of the shareholders whose representatives they were supposed to be. In such structures, even succession was not an event. Transitions in ownership occur over time. This apart, when a family enterprise changed its chief executive it is different from a professionally managed company in a crucial way. The family must approve this change. All these, of course, are gradually, but surely, changing, thanks to the Cadbury Report, a series of scams that shook the collective conscience of the nation and called for reforms in corporate structures and policies, recommendations of various corporate governance committees that aroused public awareness, and above all, economic liberalisation aided and abetted by the integration of the Indian economy with that of the world, have all brought about sea-saw changes in the way companies look at themselves and their structures. In a highly competitive and surcharged environment, family-owned concerns are changing for the better. Various government and SEBI initiatives and those of industry associations have given a clear message. The message for listed corporations and their boards is clear: "Improved governance is no longer just a preferred objective of the limited few, but the harsh reality of the market place."[13]

Prof. N. Balasubramanian, in his article: "Economic Reforms, Corporate Boards, and Governance" provides a profile of the post-reforms corporate board, which is a stark contrast to what was obtained in the family-owned companies of pre-reforms era.

1. **Market forces and competition force professionalisation:** Family concerns will turn professional in order to face successfully competition and market

forces. This does not imply that family-owned business will come to an end, but the demarcation between the ownership and the control, on the one hand, and the management on the other, will be much more evident. The Chennai-based family-owned Murugappa group, for instance, took a conscious decision a few years ago to induct professionals on the board and management. Likewise, the TVS group of companies, though closely-held, is well-known for having professionalised their boards and managements. In such a scenario, it is obvious that those members of the family who are professionals, with the required business acumen and astuteness alone will find a place on the boards and management.

In a highly competitive and surcharged environment, family-owned concerns are changing for the better. Some of the following factors are responsible for such a change—market forces and competition force professionalisation; emergence of board committees, transparency in reporting and full financial disclosures and independent and competent auditors doing their jobs.

2. **Independent directors will have a say:** Members of the board will be persons with technical and managerial capabilities "Who can guide and oversee operating management in the discharge of their functions?" The boards will have a number of (upto 50 per cent) independent external directors who can advise, admonish and control operating management, without fear or favour, on the issues of policy and performance.
3. **The topman will not wear two hats:** The practice of one person combining in himself both the positions of the Chairman and the CEO will sooner rather than later, come to an end.
4. **Rubber-stamp boards will be replaced by proactive boards:** Rubber stamp boards will be a relic of the past; prompted and goaded by the SEBI and its guidelines, the board members would be expected to devote more time and show commitment. The role of the board will be clarified, with its function becoming more exacting and detail-specific and issue-based.
5. **Emergence of board committees:** Boards delegating specific tasks such as audit, remuneration and appointments to committees with members having professional expertise will be a normal phenomenon.
6. **Transparency in reporting and full financial disclosures:** Transparency in reporting and full disclosures will be the norms. The board has to ensure adoption of appropriate accounting standards in the preparation of company's accounts, and material changes during the financial year are fully discussed and justified.
7. **Independent and competent auditors will do their designated jobs:** Guidelines on corporate governance all over the world insist on independence of audit, and this will be observed by the boards in India too. The boards will have to ensure unattached and professionally competent auditors to audit the company's accounts. "The board or its audit committee will have to discuss with such auditors any concerns they may have about the credibility of financial, not only on the acceptability but also the appropriateness of the accounting and reporting practice." The boards will have to ensure that an objective and transparent system of internal audit is in place.
8. **Long term stakeholder interests will be ensured:** The highest priority of the boards would be to ensure long-term maximisation of shareholder value and wealth. Better corporate performance through legitimate and transparent policies will enrich shareholders. Accountability to shareholders does not mean, however, that other stakeholders such as customers and employees would have to be excluded, as the respective objectives are not naturally exclusive.
9. **Boards members' commitment ensured through adequate compensation:** Since boards will have to shoulder greater responsibility, bear risk and manage uncertainty with a great deal of pressure on them to perform, both from internal and external sources, their members would have to be compensated adequately and appropriately. Profit-based commissions, stock-options related to performance, etc. would be available to directors for their commitment and effort to run the company profitably.

10. **Boards will be committed to corproate social responsibility:** Corporate' social responsibility concerns would become part and parcel of the duties of the boards of directors. They who draw so much from the society in terms of resources, trained manpower, law and order, public health, infrastructure and well-developed markets to do their business and make profits, have a moral and social responsibility to share with the society at least a part of what they earn and gain, by their ethical practices and catering to the basic needs of communities they operate in, supplementing wherever possible, the efforts of public authorities. "Corporates would have to provide demonstratable evidence of their concern for the issues that confront those constituencies."
11. **Corproates will have their vision, values and responsibilities well defined:** The Companies in India emulating the examples of western countries, would have their own corporate governance rules that clearly describe their vision, value systems and board responsibilities. Based on the rules, directors and executives would be fairly remunerated and motivated to ensure success of their companies.
12. **Whistle blower policy will be in place:** Companies would in due course put in place an appropriate whistle blower policy enabling both the board and senior management take corrective measures to stem the rot, if any, in good time. Though SEBI under listing agreement (LA) with stock exchanges made whistle blower policy in the revised clause 49 non-mandatory, corporate governance advocates point out that sooner than later the Indian regulator would be prompted to make mandatory the whistle blower policy through which a company might establish a mechanism for employees to report to the management concerns about unethical behaviour, actual or suspected fraud, or violation of the company's code of conduct or ethics policies.

Shell Companies

Corporate form of business is widely misused by people for illegal activities like tax evasion, black money business, money laundering and even for terror funding in different parts of the world. In India also some people are using corporate form of business for such activities. Recently, the Ministry of Corporate Affairs has identified about 2.09 lakhs out of 15 lakhs companies registered in India without undertaking any legal economic activities of manufacturing or marketing of products or services. They are mainly engaged in black money business, tax evasion, money laundering, etc. Such companies are called 'Shell Companies'.

What is a Shell company? A shell company is a non-trading company used as a vehicle for various financial manipulations such as black money business, tax evasion, money laundering, etc., or kept dormant for future use in some other capacity.

Steps have been taken by the Ministry of Corporate Affairs to cancel the registration of such companies under section 248 of the Companies Act 2013. The Ministry has also identified 1.06 lakh directors of such companies for disqualification under Section 164(2)(b) of the Companies Act. Under this section a director in a company that has not filed financial statement or annual returns for consecutive three financial years would not be eligible for reappointment in that company or any other company for five years. The following is the regionwise such directors identified for disqualification.

Regions	*Number of directors facing disqualification*
Delhi	74920
Mumbai	66851
Hyderabad	41156
Ernakulam	14000
Cuttack	13383

The Government has also initiated, the 'Name and Shame' policy to curb such activities by publishing the name of such directors facing disqualification in public domain.

Some Pioneering Indian Boards

Though Indian corporates were late starters in the matter of introduction of healthy corporate governance practices due to a variety of historical and operational reasons, some of them did not lack far behind in emulating the worthy examples of their contemporaries in the US and Europe. Increased public awareness and heightened sensitivity in the wake of a series of scams, the wake-up call of the Cadbury Report, gradual imbibing of wholesome international corporate practices, the opening of the Indian economy to foreign capital and influences, the emergence of mutual funds and institutional investors with their insistence on the adoption of better corporate culture and practices, followed by the mandatory provisions of the Kumar Mangalam Birla Committee, have all brought about dramatic changes in the way some of the prominent Indian boards have been functionoing. Boards of Infosys, Dr.Reddy's Laboratories, ICICI Bank, Asian Paints, Marico, Orchid Chemicals and Pharmaceuticals, Godrej Consumer Products and Hindalco, to name only a few, have pro-active and conscientious boards that have made praiseworthy progress in the direction of corporate governance. Even before SEBI'S directions, some of them have independent members and professionals in their boards. Dr Reddy's Laboratories has now a scientific advisory board while some others have inducted professors of management sciences in their boards. Many companies have started the healthy exercise of reviewing the contributions of the whole boards and peer group reviews of individual directors. Board administration is being democratised and dissent and criticism are accepted, and where needs be, acted upon. Given below are some of the examples of creditworthy corporate practices:

Increased public awareness and heightened sensitivity in the wake of a series of scams, the wake-up call of the Cadbury Report, gradual imbibing of wholesome international corporate practices, the opening of the Indian economy to foreign capital and influences, the emergence of mutual funds and institutional investors with their insistence on adoption of better corporate culture and practices, followed by the mandatory provisions of the Birla Committee, have all brought about dramatic changes in the way some of the prominent Indian boards have been functioning.

1. **The Infosys technologies' proactive board:** The foray of Infosys Technologies into consultancy and business process outsourcing (BPO) from its original profile of just a services company was prompted by its proactive board.
2. **The ICICI's active board and its initiatives:** The Industrial Credit and Investment Corporation of India Ltd. (ICICI), has an active board. The board initiated and helped actively the merger of the ICICI and its banking arm. The board with a number of independent directors has been advising ICICI to manage its risk more scientifically, instead of being bogged down with its non-performing assets (NPAs) and move on to engage actively small and medium enterprises. The ICICI Bank also insists that its middle level managers make presentations to the board regularly.
3. **The Orchid chemicals' bold board:** The board of the fast-growing Chennai-based pharmaceutical company, Orchid Chemicals and Pharmaceuticals Ltd, directed its managing director to seek the advice of the international consultant, Mckinsey & Co. on his growth strategy for the company. His growth plan was accepted by the board only after changes suggested by the consultant were incorporated in it.
4. **The Polaris board's advice to management:** The board of Chennai-based Polaris Software Lab. forced its chairman and managing director not to acquire any new business at the peak of dotcom boom, but instead to consolidate the company's business. It is of significance to note that in Polaris, the directors participate along with the employees in the annual goal-setting exercise.
5. **The Board of Godrej Consumer Products and the CII:** Godrej Consumer Products consulted the Confederation of Indian Industry (CII) for forming

Some of the examples of creditworthy corporate practices are (1) Infosys Technologies' proactive board; (2) The ICICI's active board and its initiatives; (3) Orchid chemicals' bold board; (4) Polaris board's advice to management; (5) Board of Godrej consumer products' and the CII; (6) The shining example of Colgate Palmolive; and (7) Professionalism exhibited by Tata boards.

its board. The CII advised the company to choose independent professionals and not industrialists. The company agreed and the new directors promptly suggested a reorganisation of the company's business along product lines.

6. **The shining example of Colgate Palmolive:** The board of directors of Colgate Palmolive believes strongly that good corporate governance accompanies and greatly aids the company's long-term business success. This success has been the direct result of Colgate's key business strategies, including its focus on core product categories and global brands, people development programme that highlights "pay for performance" and the highest business standards. The Colgate's board has been at the centre of these key strategies, helping to design and implement them, and seeing that they guide the company's operations.

   The Colgate-Palmolive board believes that the company has consistently been at the forefront of good corporate governance. Reflecting its commitment to continuous improvement, the board reviews its governance practices on an ongoing basis to ensure that they promote the shareholder value. This review has resulted in several recent enhancements, in which Business Integrity Initiatives as highlights of the company's corporate governance programme. The board supports the company's effort to effectively communicate its commitment to ethical business practices. To further this goal, 2,500 supervisors, managers and executives throughout the Colgate have completed "Business Integrity: Colgate Values at Work" Programme. This training experience ensures a thorough and consistent understanding of the company's ethical business standards as expressed in Colgate's Code of Conduct.

7. **Professionalism exhibited by the Tata boards:** The Tata group of companies have a clearly defined document articulating the values and principles that have governed the manner in which the Tata group of companies and their employees have conducted themselves over the past 125 years. This document serves as a guide to each employee on the values, ethics and business principle expected of him or her. The board of each of the Tata companies has committed in all its actions to benefit the economic development of the countries in which it operates and would not let the company engage in any activity that would adversely affect such objectives. The boards ensure that the business affairs are conducted in accordance with economic development and foreign policies, objectives and priorities of the nation's government.

A Tata company is fully committed to the establishment and support of a competitive open market economy in India and abroad. It shall not engage in activities, which will make unfair and misleading statemenets, generate or support monopolies, dominant market positions, cartels and other unfair trade practices. It shall not make unfair and misleading statements about competitor's product and services. This is an article of faith laid down by the founder of the group, Jamsetji Tata, followed scrupulously by J. R. D. Tata and Ratan Tata as the heads of the boards of several Tata group of companies.

There are many other boards too where catalytic changes are taking place in the realm of corporate governance. The ones cited above are only a sample of board room changes that are slowly but surely taking place in India.

CONCLUSION

In the new era, the board of directors has to shoulder larger responsibilities to meet the increasing demand of the market place. Running a corporation only to earn profits for the shareholders is a concept that is dead as a dodo. In today's world, the corporate as a social entity, has to look beyond its shareholders, to embrace all stakeholders and to perform its ethical and social obligations to society through corporate governance practices.The need to have proactive, socially conscious and upright board of directors to guide and run corporations is keenly felt not only in the United States, Europe and Australia, but also in developing countries like India and South Korea. Several corporate bodies such as Tata Steel, Infosys Technologies, ICICI, Dr. Reddy's Labs and Orchid Chemicals not only project but also promote corporate governance practices all around them by their shining examples. The board of directors is expected to play a powerful role in such a metamorphosis the world is waiting to see happen.

KEYWORDS

- Breach of statutory duties
- De facto
- De jure
- Directors' remuneration
- Disabilities
- Executive pay
- Family-owned businesses
- Fraudulent persons
- Governance issuses relating to the board
- Independent directors
- Liabilities of directors
- Liability to the company
- Management structure
- Nominee directors
- Performance hurdles
- Powers of the board
- Remuneration committee
- Reward for performance
- Severance payments
- Shell companies
- Tax-free payments
- Undesirable persons
- Unlimited liability
- Unsettled issue
- Validity of Acts

DISCUSSION QUESTIONS

1. Who is the director of a company? What qualifications should a person have to be eligible to be appointed as a director?
2. How is a director appointed in a company? What are the duties and the responsibilities of a director?
3. Discuss the position of a nominee director in a public limited company. What are the qualifications and disqualifications of directors?
4. Discuss the liabilities of directors. Also explain their disabilities.
5. Discuss critically the role of the board in ensuring corporate governance.
6. Who is an independent director? What are the major recommendations of various committees with regard to the desirability of independent directors in the boards of companies?
7. Discuss the role of BOD in corporate Governance as per Indian Companies Act 2013.
8. Explain the cadburg committee views about board of directors in corporate Governance.
9. Explain the Birla committee recommender for about the role of Board of directors in corporate Governance
10. What do you understand by shell companies?

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The Role of Auditors in Corporate Governance

CHAPTER OUTLINE

- Introduction
- Types of Auditors
- Duties and Responsibilities of Auditors
- View of Various Committees on the Role of Auditors
- Indian Companies Act 2013 and the Role of Auditors
- Corporate Governance and Internal Auditors
- Cost Audit Methodology
- Quality Audit

Introduction

Auditors who are expected to be the watchdogs of the organisation are often bought in by the managements through some profitable assignments. The allegation that annual reports presented by companies today lack truthfulness and transparency need not be stressed. Instances galore where obliging auditors have helped companies falsify accounts and in the window-dressing for small monetary gains.

Ethics and values get short shrift in business in two ways; first, by the failure of the management and second, by the failure of auditors. Auditors who are expected to be the watchdogs of the organisation are often bought in by the managements through some profitable assignments. This has led to the rise of the concept of corporate governance which is about promoting corporate fairness, transparency and accountability relating to the various participants of organisations.[1] Recent unearthing of the corporate frauds both in the developed countries and the developing and the transitional economies revealed the fact that auditors had failed to do what they were assigned to do. They involved themselves in unethical practices and failed to whistle-blow when things went wrong in the organisation. To have a check on the auditors' role and to prevent them from the unethical practices, the Indian government and the regulatory bodies elsewhere have come out with many regulations, re-establishing the corporate accountability and reinforcing the investor confidence.

The Role of Auditors

The allegation that the annual reports presented by companies today lack truthfulness and transparency need not be dealt with in great details here. "Window-dressing, manipulation of profit and loss accounts, hedging and fudging of unexplainable expenditures and resorting to continuous upward revaluation of assets to conceal poor performance are malpractices companies resort to with the help of the obliging auditing firms".[2]

The role of auditors who are expected to certify the veracity of accounts maintained by companies for the benefit of all stakeholders of the company including fair and transparent governance leaves a lot be desired. Instances are galore where the obliging auditors have helped companies falsify accounts and in window-dressing for small monetary gains.

Defining Audit

The Institute of Chartered Accountants of India (ICAI) has defined audit as, "...The independent examination of any entity, whether profit-oriented or not and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon".[3] In other words, auditing is the process by which a competent independent person objectively obtains and evaluates evidence regarding the assertions about an economic activity or event for the purpose of forming an opinion about and reporting on the degree to which the assertion conforms to an identical set of standards.

Objectives of an Audit

As per Standard Auditing Practices (2) of the Institute of the Chartered Accountants of India: "The objective of an audit of financial statements is to enable an auditor to express an opinion on the financial statements which are prepared within a framework of recognised accounting policies and practices and relevant statutory requirements."

Types of Audit

We can identify three types of audits,[4] namely,

There are three types of auditors, namely, internal auditors independent auditors and government auditors.

1. Financial statement audit
2. Compliance audit
3. Operational audit.

Financial statement audit: An audit of financial statements is conducted to determine whether the overall financial statements are stated in accordance with the specified criteria. The financial statements commonly audited are the balance sheet, the income statement, the cash flow statement and the statement of stockholders' responsibility.

Compliance audit: The purpose of compliance audit is to determine whether the auditee is following specific procedures, rules or regulations set down by some higher competent authority.

Operational audit: An operational audit is a review of any part of an organisation's operating procedures and methods for the purpose of evaluating effectiveness and efficiency.

Defining Auditor

An auditor is defined as a person appointed by a company to perform an audit. He is required to certify that the accounts produced by his client companies have been prepared in accordance with the normal accounting standards and represent a true and fair view of the company. Usually, chartered accountants are appointed as auditors.

An auditor is a representative of the shareholders, forming a link between the government agencies, the stockholders, the investors and the creditors.

Types of Auditors

There are three types of auditors,[5] namely,

(1) internal auditors, (2) independent auditors, and (3) government auditors.

Internal auditors: Internal auditors are employed by the organisation for which they perform audits. Their responsibilities vary and may include financial statement audits, compliance audits and operational audits. They may assist the external auditors in completing the financial statement audit or perform audits for use by management within the entity. Internal auditors must have no operating involvement in the activities they audit. An organisation may have a small or very large internal audit staff. They cannot be independent as long as the employer-employee relationship exists. Independence is often accomplished by giving the highest ranking person in internal auditing the status of vice president and having that person report directly to a committee of the board of directors.

Independent auditors: Independent auditors are usually referred to as CPA (Certified Public Accountants) firms. The opinion of an independent auditor about the financial statements makes the statements more credible to such users as the investors, the bankers, the labour unions, the government agencies and the general public.

Government auditors: Government auditors work in various local, state and federal or central government agencies performing financial, compliance and operational audits. Local and state governments, for example, employ auditors to verify whether businesses collect and remit sales taxes and excise duties as required by law.

Duties of an Auditor

The duties of an auditor are defined under Section 227 (1A) of the Companies Act 1956. It says that an auditor can enquire[6]

- Whether loans and advances made by the company on the basis of security have been properly secured.
- Whether transactions of the company which are represented merely by the book entries are not prejudicial to the interests of the company.
- Where the company is not an investment company within the meaning of Section 372 or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company.
- Whether the loans and the advances made by the company have been shown as deposits.
- Whether the personal expenses have been charged to revenue account
  In other words, the auditor is responsible for.
- Verifying that the statements of accounts are drawn up on the basis of the books of business.
- Verifying that the statements of accounts drawn up on the basis of the books exhibit a true and fair state of affairs of the business.
- Confirming that the management has not exceeded the financial/administrative powers vested in it by the Articles of Association of the Company and/or the resolutions of shareholders.

Responsibilities of Auditors

The Institute of Chartered Accountants of India (ICAI) has issued the Standard Auditing Practices and Auditing and Accounting Standards with emphasis on effective auditing practices. It talks about the integrity, the objectivity, the independence, the confidentiality and the responsibility of an Auditor.[7]

As per the Standard Auditing Practices (2), an auditor has the following responsibilities:

- He is responsible for forming and expressing his opinion on the financial statements. He assesses the reliability and the sufficiency of the information contained in the underlying accounting records and other source data by making a study and evaluation of accounting systems and internal controls.
- He determines whether the relevant information is properly disclosed in the financial statements by comparing the financial statements with the underlying accounting records and other source data to see whether they properly summarise the transactions and the events recorded.
- He has to ensure that his work involves exercise of judgment, e.g., in deciding the extent of audit procedures and in assessing the reasonableness of the judgments and estimates made by management in preparing the financial statements.
- He is not expected to perform duties which fall outside the scope of his competence, e.g the professional skill required of an auditor does not include that of a technical expert for determining the physical condition of certain assets.

Responsibilities of an Audit Firm

An audit firm needs to implement appropriate quality control policies and procedures to ensure that all audits are carried out in accordance with Statements on Standard Auditing Practices, cited earlier.

The objectives of the quality control policies to be adopted by an audit firm will ordinarily incorporate the following:

1. **Professional requirements:** Personnel in the firm are to adhere to the principles of independence, integrity, objectivity, confidentiality and professional behaviour.
2. **Skills and competence:** The firm is to be staffed by personnel who have attained and maintained the technical standards and professional competence required to enable them to carry out their responsibilities with due care.
3. **Assignment:** Audit work is to be assigned to personnel who have the degree of technical training and proficiency required in the circumstances.
4. **Delegation:** There has to be sufficient direction, supervision and review of work at all levels to provide reasonable assurance that the work performed meets appropriate standards of quality.
5. **Consultation:** Whenever necessary, consultation within or outside the firm is to occur with those who have appropriate expertise.
6. **Acceptance and retention of clients:** An evaluation of prospective clients and a review on an ongoing basis, of existing clients is to be conducted. In making a decision to accept or retain a client, the firm's independence and ability to serve the client properly are to be considered.
7. **Monitoring:** The continued adequacy and operational effectiveness of quality control policies and procedures are to be monitored.

An audit firm needs to implement appropriate quality control policies and procedures to ensure that all audits are carried out in accordance with statements on Standard Auditing Practices.

Audit Failures Leading to Corporate Scams

In December 2001, in what is termed as the biggest bankruptcy in the US history, Houston-based transnational trader of natural gas and power, Enron Corporation, filed for bankruptcy under Chapter 11, and downward restatement of earnings of $500 million. Enron was believed to have created a Special Purpose Vehicle (SPV) which involved setting up partnership firms to mask its losses.

The mega corporation's auditor, Arthur Andersen, the fifth largest audit and consultancy firm worldwide and a member of the Big Five league, also faced investigation by the Securities and Exchange Commission (SEC) for fudging official documents and for not being able to detect accounting jugglery undertaken by Enron. However, Arthur Andersen blamed Enron for not providing complete information.

Arthur Andersen also allegedly colluded with the Enron officials and destroyed some financial documents related to its audit. Consequently, the auditor was asked by a US Congressional Committee to explain how it had missed large-scale fudging of profits in the accounts of Enron over many years and also the destruction of documents.

Besides conducting the statutory audit for Enron, Arthur Andersen offered consulting services. It was said to have collected $25 million as audit fees and another $27 million for consultancy services in fiscal 2000. Arthur Andersen had to face a slew of litigations, crippling damages, tarnished reputation, regulatory action by the SEC, a Congressional Enquiry and, last but not the least, sacking by Enron.

Shockingly, the US-based Deloitte & Touche, another accounting firm in the Big Five league, gave a clean chit to Arthur Andersen, asserting that it had met all quality control standards for accounting and auditing practices established by the American Institute of Certified Public Accountants, prompting observers to comment that it was a game of mutual back-scratching.

There seems to be a deviant steak running through the history of the audit firms as shown by the following shocking incidents:

- In May 2001, Arthur Andersen connived with its client, Sunbeam Corporation for financial fraud and fudging of accounts.
- In June 2001, an American Superior Court fined Arthur Andersen towards damages to the shareholders for certifying false statements of accounts of Waste Management Inc. Three of Arthur Andersen's partners were fined between $30,000 and 50,000 each and banned from auditing work for 3–5 years.
- Deloitte & Touche also landed in trouble in 2002 for applying a valuation model for fast-food franchisees which misled bankers into extending credit to unworthy clients and incurring a colossal bad debt of $10 billion.
- In 1999, another reputed US based accounting firm, Ernst & Young paid $335 million to settle a lawsuit related to accounting problems to a client.
- Another American auditing firm, KPMG attracted censure from the SEC for engaging in improper professional practice. While serving as an audit firm for Short Term Investment Trust, it also made substantial investments in it. Its money market account opened in May 2000 with an initial deposit of $25 million, constituted 15% of the fund's net assets at one point of time.

"Audits are Not Designed to Detect Frauds"

Samuel A. D. Piazza Jr., CEO Price Waterhouse Coopers, was interviewed by the correspondents of the *Economic Times* (18 February 2003). He was asked: How would you define the role of an auditor? Is it fair to expect auditors to detect all frauds?

According to him, who is the CEO of the famous global audit firm:
"Generally, audits are not designed to detect fraud. They are designed to assess the financial position of a company. While doing that we look very carefully to see if there are things that appear unusual and yes, at times we may uncover fraud. Material fraud like you had in WorldCom would, I agree, generally surface in an audit. As to how the fraud at WorldCom went undetected, I would be very hesitant to explain that to your readers as I don't know any more than what you do from the reports in the newspapers. All I can say is that we were not their auditors.

I must add it is also not fair to expect that all cases of fraud would come to light in an audit. But I agree, there is an expectation issue here—the public thinks we should be able to detect fraud and so we believe we have to increase our focus on fraud. It is this gap between what the public expects us to do and what we actually do that is partly responsible for the present crisis of confidence. But in the process of trying to address this issue, we need to be realistic. Because, if we pursue audits with the objective of unearthing all frauds which might have taken place, the audit fees would go up ten to 20 times. So, the risk-reward trade-off has to be evaluated.

On our part, we have told our people that when something looks out of the line, they've got to follow it up and then if they are not satisfied, we push it higher and higher within the company and in our organisation until we get a satisfactory answer. It is of course, a question of materiality, but our auditors are told to be sceptical, ask questions, track anything suspicious and never leave any questions unanswered."[8]

The Enron Debacle

A Fortune-500 company with reported revenues touching $100 billion in 2000, Enron had enjoyed a market capitalisation of $63 billion and a stock price close to $90. It was then ranked number 7 on Fortune-500 list of the biggest US corporations. But from a peak of $90.56 in August 2000, the stock price slumped 85 per cent to 61 cents ($0.6) in November 2001, and further to 30 cents ($0.3) in December 2001 as the financial scandal unfolded. Its market capitalisation sank to $200 million. It has laid off 1,100 workers, constituting more than 80% of its workforce in Britain.

The collapse of Enron, indicated by a corresponding collapse in the market capitalisation, is not solely due to the losses incurred; the real reason is the collapse of public confidence in the process of examining a company's health by the auditors the because the audit firms are considered to be the watchdogs of a company's financial and accounting practices and their certification considered to be the "true and fair value" of financial statements.

With the financial world still reeling from the collapse of Enron, and the conviction of its former auditor, Andersen for obstruction of justice, world financial markets were sent into further turmoil by allegations of massive fraud by global telecom, WorldCom.

The disgraced firm, Andersen, attacked former WorldCom Chief Financial Officer, Scott Sullivan, for withholding vital information, as it faced up to accusations of an alleged billion accounting fraud. The firm pointed the finger at the resigned CFO Sullivan as the telecom company WorldCom stated it would have to restate its financial results to account for billions of dollars in improper book-keeping. And then, the US financial watchdog, the Securities and Exchange Commission (SEC) charged the US telecommunications giant with fraud.

Thus, an important point which has raised its ugly head post-Enron fiasco is the role of auditors and the unholy nexus between them and the audited companies. The focus is also on the ethics of audit firms and their failure to detect companies' accounting jugglery.

The problem is more acute in the case of smaller audit firms which are unable to invest in improving upon quality standards, thus hampering the overall quality of financial reporting, because, the concept of audit has moved from detailed audit to checking of systems which can work efficiently only for companies with sound internal controls.

The SEC, on its part, has taken the required steps to repair the damage which has been done by the Enron debacle. To put a full stop to this scam series, President Bush passed a law on 30 July 2002, the Sarbanes–Oxley Act of 2002. The Act which applies in general to the publicly-held companies and their audit firms dramatically affects the accounting profession and impacts, not just the largest accounting firms, but any CPA actively working as an auditor of, or for, a publicly traded company.

Audit firms in the US have been debarred from offering consultancy services. Besides, the SEC has a rule which mandates audit firms to report their discovery of violating clients to the regulator.

The Role of Auditors in Corporate Governance as per Indian Companies Act 2013

The Indian Companies Act 2013 gives a detailed explanation about the role and responsibilities of auditors in corporate governance. The following aspects are discussed in detail in Chapter 5 titled "Legal Aspects of Corporate Governance."

- Appointment and reappointment of auditors
- Terms of appointment
- Mandatory rotation of auditor
- Power and duties of auditors

- Auditor,s liabilities in case of unlawful acts
- Disclosures
- Liabilities relating to the contents of the prospectus
- Duties and responsibilities and liabilities in case of the material misstatement
- Punishment for contravention
- Prosecution by NFRA (National Financial Reporting Authority)

Views of Various Committees on the Role of Auditor's in Corporate Governance

Among the three areas looked into by **Cadbury Committee,** one is related to the role of auditors and the responsibility of accounting profession and the recommendation focused on the control and the reporting function of the boards and the role of auditors related to financial reporting and accounting. Enhancing the objectivity and the effectiveness of external auditing is one of the main recommendations of the Committee with regards to external audit. The Committee also recommended the need of are external auditor's presence in the Board meeting finalizing annual report and accounts, reporting of frauds deducted while auditing to appropriate authorities, ensuring transparency in reporting to fee paid to auditors for audit duties and other duties, need of introducing auditor rotation system and strict adherence of accounting standards while finalizing annual accounts.

In respect of auditors duties and responsibilities, the Hampel Committee has made the following recommendation.

- Each company should establish an audit committee of at the least three non-executive directors, at least two of them independent. But shareholders may show some flexibility in considering cases of difficulty on their merits.
- The Companies should consider reducing from 10 per cent the limit on the proportion of total income which an audit firm may earn from one audit client.
- The audit committee should keep under review the overall financial relationship between the company and its auditors, to ensure a balance between the maintenance of objectivity and value for money.
- The auditors should report on internal control privately to the directors, which allows for an effective dialogue to take place and for best practice to evolve.
- The Directors should maintain and review controls relating to all relevant control objectives, and not merely financial controls.
- The Companies which do not already have a separate internal audit function should from time to time review the need for one.
- The requirement on directors to include a 'going concern' statement in the annual report should be retained.
- Auditors are inhibited from going beyond their present functions by concerns about the law on liability. An Account should be taken of these concerns by those responsible for the professional standards and in taking decisions on changes in the law.

In the US Securities Exchange Commission's Code of Governance, Principle 9 deals with auditors and Corporate Governance. This principle says that "The Company should establish standards for the appropriate selection of an external auditor, and exercise effective oversight of the same to strengthen the external auditor's independence and enhance audit quality". In this aspect, the code recommended the following:

1. The audit committee should have a robust process for approving and recommending the appointment, the reappointment, the removal, and the fees of the external auditor. The appointment, the reappointment, the removal,

and the fees of the external auditor should be recommended by the audit committee, approved by the board and ratified by the shareholders. For the removal of the external auditor, the reasons for removal or change should be disclosed to the regulators and the public through the company website and the required disclosures.

2. The audit committee charter should include the audit committee's responsibility on assessing the integrity and the independence of the external auditors and exercising effective oversight to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant Philippine professional and regulatory requirements. The charter should also contain the audit committee's responsibility on reviewing and monitoring the external auditor's suitability and effectiveness on an annual basis.
3. The company should disclose the nature of non-audit services performed by its external auditor in the Annual Report to deal with the potential conflict of interest. The audit committee should be alert for any potential conflict of interest situations, given the guidelines or policies on the non-audit services, which could be viewed as impairing the external auditor's objectivity.

Among the Indian committees on corporate governance the Birla Committees and the N. R. Narayana Murthy Committee focused their deliberation on the constitution of audit committee of board of directors and their functioning while the Naresh Chandra Committee made several recommendations about the statutory audit and auditors. According to the Birla Committee, "The Committee identified the critical role of auditing in corporate governance and recommends that a qualified and independent audit committee should be set up by the board of a company and recommended an audit committee having minimum three members, all being non-executive directors, with the majority being independent and with at least one director having financial and accounting knowledge. The Chairman of the committee should be an independent director. The Finance director and the head of internal audit and when required, a representative of the external auditor should be present as invitees for the meetings of the audit committee. The Company Secretary should act as the secretary to the committee. The audit committee should meet at least thrice a year. The quorum should be either two members or one-third of the members of the audit committee, whichever is higher and there should be a minimum of two independent directors. The Committee also specially recommended the powers and functions of the audit committee."[9]

Corporate Governance and Internal Auditors

Internal Audit/Cost Audit

The subject matter of cost audit can never be studied independently of the cost accounting framework. The evolution of cost management domain in our country can be traced to four stages in brief:

1. **The first stage: The decade of 1950s and 1960s:** This was the period of setting up of industrial activities and cost plus regime. The genesis was the demand for very many products for which the government administered Fair Prices. This was the time when the Tariff Commission and the Bureau of Industrial Costs and Prices were set up by the government. The ICWAI itself came into being during this time.

2. **The second stage: The period between 1970 and 1985:** The period between 1970s and mid-1980s was an era of cost, volume and profit analysis, as an integral part of the cost accounting function. This was the time when the country was in the sellers' market.
3. **The third stage: The years between 1985 and 1990:** During the period between mid 1980s and early 1990s, the concept of Zero Base Budgeting, Capacity Utilisation and Product Profitability gained importance with the onset of global competition. This was also a period when the quality movement started gaining momentum with an entirely structured methodology departing from a quality control syndrome to a quality management paradigm.
4. **The fourth stage: The era since 1991:** The period starting from early 1990s onwards has witnessed the dawn of an era of liberalisation and global competition in the strictest sense. This brought in the necessity to move towards market-driven prices, where the end price was determined by the customer in the domestic and the international markets.

The now well-known target-costing became the mantra in the business and the industry in the domestic as well as the international markets. The full impact of global competition came into play during this period and what we find today is that the entire business activity revolves around cost, quality and delivery—be it manufactured goods or services. The country is already on its mission of restructuring on the above parameters for being on the world class wavelength.

Cost Audit Methodology

The Cost Audit methodology as structured originally under Section 233B of the act bill has the following two perspectives:

- The attestation of cost structure.
- The efficiency review perspective, which is more methodology driven.

In a period of price control and administered interventions attested cost structure had a major role to play and hence the attestation perspective got the emphasis. The profession had to play a major role of verifying and validating the cost figures in selected industries before they were submitted to the government. The efficiency review was relatively less emphasised and, therefore, did not receive much impetus in the form of new auditing techniques and methodology. We now need to develop a new vision and strategy for the cost audit mechanism.

With the economy moving away from being a centrally controlled model to a competitive, a relatively free market model, the role of cost, quality and timely delivery have become the basis for survival. The role of efficiency review from the angles of quality, cost and delivery has assumed utmost importance today.

The concept of corporate governance, which has been attracting a lot of hype and public attention these days is nothing new and quite a few of the progressive firms even in our country have voluntarily been practising good corporate governance. SEBI has enlisted the services of CRISIL and ICRA for rating good corporate governance.

Desirable corporate governance and practices need legal support as well as evolution of internal standards—where the more progressive elements and the corporate sector design best practices that are constantly updated to complement and enhance legal provisions. Nations that have good corporate practices do

not rely exclusively upon law. Conversely, those with poor records have never evolved internal codes of best practice. The question before us now is as to how the objectives of cost audit can be revisited to suit the corporate governance and evolve related practices with or without the required legal support.

The quality movement has gained momentum with new techniques of quality management as well as refinement of the existing practices in the Indian industry. Quality audits have been accepted as a value-adding framework and industry is concerned about non-conformity. Quality practices are being benchmarked with world class standards and focus on bridging quality gaps is accepted as a part of corporate governance.

Quality Audit

The quality movement has gained momentum with new techniques of quality management as well as refinement of the existing practices in Indian industry. Quality audits have been accepted as a value-adding framework, and industry is concerned about non-conformances. Quality practices are being benchmarked with world-class standards and a focus on bridging quality gaps is accepted as a part of corporate governance. This has happened not through legal provisions, but with a pseudo-mandatory force of mechanisms such as the ISO 9000, ISO 14000, QS 9000, TQM, Deming Awards, Malcolm Baldridge Awards, etc.

A similar story has to be repeated for cost as well by taking advantage of the existing framework, instead of scrapping it without wisdom. In the comity of nations, India alone has the advantage of having envisaged a scheme of cost audit. What needs to be done is to redefine the audit objectives without losing the legal backup and the mandatory force it gives for compliance. This is something similar to the compliance framework we see in the quality management domain. Instead a of the attestation perspective, which was emphasised earlier for price control, the efficiency review aspect should be blown in full force to enable a better corporate governance. This will make the entire mechanism a value adding framework in today's context of challenges of competitiveness. Ultimately, the cost audit should augment the cost competitiveness of Indian business and industry. The profession and the industry should accept this challenge and evolve mutually acceptable audit objectives as per the changed context.

Annually unitised cost structure attestation and its review will not be meaningful for the industry, which is now focussing even on hourly variations in the process for cost control. The concepts such as Zero Defect, PPM and Six Sigma are gaining credence in the manufacturing sector. We need to revisit the current methodologies and reporting frameworks.

Most of the organisations have well-oiled cost and management accounting system mainly used for the budget formulation, the performance review reporting and identifying cost leaks and price fixing. Cost audit is selective in the sense that it is not applicable to all industrial units such as statutory audit and to this extent can be construed as an infirmity. Independent of this, the cost practitioner, whether he is a cost manager or cost auditor, should be fully equipped to subserve the management's objectives of ensuring the operational effectiveness and make risk assessment and compliance control at various internal processes. In its broad scope, the focus is not only on improving operational efficiencies, but strategic as well, having to cull out and provide information for managerial decisions on the optimum utilisation of resources on a continuous basis and aid the organisation's growth objectives. Cost practitioners, aspiring for a rightful place in the corporate sector, would inevitably involve enlarging their vision and business outlook without confining themselves to the rights and the privileges of the profession through legislative support.

CONCLUSION

Recently, at a conference of the Institute of Internal Auditors, a view was expressed that in some ways the accountancy profession in the last few decades has not kept pace with the developments in other branches of knowledge such as engineering or marketing and that control and compliance aspects have been overemphasised while ethical values have not gained greater importance in the conduct of business. The board of directors, the audit committee or the senior management, the internal auditors, and the statutory auditors form the foundation on which effective corporate governance has to be built. For the statutory auditors, the essential driving force has been the legislative and regulatory requirements to make independent verification and attestation as to the true and fair view of the financial state of affairs for the benefit of the shareholders and the financial community. Internal auditors, being well-versed in the organisation's culture, structure and policies and procedures are essentially called upon by senior management to continuously review operations and obtain an assurance as to the level of efficiency and profit improvement. It is here that the cost auditor, as a part of internal audit function, has a unique role to play.

KEYWORDS

- Audit partner rotation
- Auditors' responsibilities
- Chief Accounts Officer
- Cost Audit Methodology
- Disclosures
- Disqualification of auditors
- Formation of boards
- Fraduluent auditing practices
- Independence of auditors
- Internal auditors
- Mis-statement of financial statements
- Monitoring audit process
- NFAR
- Non-audit services
- Oversight Board
- Prohibited services
- Quality audit
- Role of auditors
- The Enron debacle

DISCUSSION QUESTIONS

1. Define the function of auditing. What are the types of audit?
2. Who is an auditor? Discuss the different types of auditors.
3. What are the duties of an auditor? Also explain the responsibilities of auditors with regard to the mis-statement of financial statements.
4. What are the responsibilities of auditors with regard to the mis-statement of financial statements?
5. What are the responsibilities of audit firms? Give a couple of examples leading to corporate scams in India.
6. To what extent would you concur with the statement that "Audits are not designed to detect frauds"?

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PART THREE

Components and Facilitators of Corporate Governance

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Financial Reporting and Corporate Governance

CHAPTER OUTLINE

- Importance of Financial Reporting
- Corporate Communication to Stakeholders
- Views of Various Committees on Financial Reporting
- Reporting Framework as per ICA 2013
- Reporting Practices of Indian Companies
- IFRS
- Convergence of Indian Accounting Standards with IFRS
- American GAAP

Introduction

Existence of a good financial reporting system, providing essential financial information about the company to its shareholders and other stakeholders, needs to be reliable, free from bias and should enable comparison on the basis of common benchmarks.

One of the hallmark principles of good corporate governance is transparency and disclosure of corporate affairs to all stakeholders on time. Existence of a good financial reporting system, providing essential financial information about the company to its shareholders and other stakeholders, needs to be reliable, free from bias and should enable comparison on the basis of common benchmarks. This, in turn, necessitates an appropriate financial reporting system that incorporates sound accounting principles and reflects a true and fair view of the financial health of the company while ensuring legally enforceable accountability. This will not only prevent corporate frauds but also enhance the corporate image and value in the eyes of the stakeholders. As it has been stated earlier, in any corporate organisation there will be several stakeholders with complementary and conflicting interest. When decisions are taken in such situations it is the duty of the BOD to inform all the decisions to all stakeholders. Transparency in this context means an openness, a willingness by the company to provide clear information to all the stakeholders especially on the financial performance which is truthful and accurate. Disclosure of all material matters concerning the organisation's performance and activities should be timely and accurate to ensure that all the investors have access to a clear, factual information which reflects the financial social and environmental position of the organisation. It should also clarify and make publicly known the role and responsibilities of the board and the management to provide the shareholders with a level of accountability. It will ensure that stakeholders have confidence in the decision making and management process of the company. In the words of Singapore Chartered Accountant's Association, "to facilitate effective monitoring of management and safeguarding of minority and other interests, there needs to be transparency and disclosure of accurate and reliable up-to-date information. Integrated reporting enhances transparency and disclosure by emphasizing concise communication of performance, risks and opportunities and the future outlook for the organisation. By highlighting the connectivity between an organisation's strategy, governance, performance and prospects, various stakeholders will be more informed and able to gain a deeper understanding and more effectively assess the combined impact of diverse factors affecting the organisation".

This provides greater confidence and trust in the organisation's ability to create value over time. Beyond transparency and disclosure of material information, the Integrated Reporting Framework encompasses different ways to protect the stakeholder interests and enhance performance.

Firstly, integrated reporting promotes an emphasis on internal processes, among others, to understand the needs and interests of different stakeholders. Through the identification of stakeholders and their expectations, organisations adopting integrated reporting are better and able to identify how they create value for their stakeholders. For example, good supplier relationships are a social capital that is captured in integrated reporting. Secondly, the connectivity of information, including those looking towards the future, embedded in integrated reporting can enhance corporate governance. The focus on the connectivity will facilitate better strategic planning and resource allocation by those charged with strategic decision-making within the organisation, while encouraging an organisation to take a longer-term perspective may help reduce excessive risk taking to obtain short-term gains. Thirdly, integrated reporting provides a systematic approach to identify the risks and the opportunities for the organisation and more importantly, how these are addressed rather than merely articulating them. Such an approach facilitates better risk management. To achieve the benefits of integrated reporting in enhancing corporate governance, organisations must embrace both integrated reporting and corporate governance in substance or spirit, and not just in form. A balance must be struck between complying with regulations and a market-

driven need for good corporate governance, without it being too onerous for organisations. In a similar vein and given that the integrated reporting is a market-led voluntary initiative, it is important for organisations to embrace the spirit of integrated reporting, value the process, and communicate their own story because it is beneficial for them to do so. Organisations should not adopt a compliance perspective where one simply ticks all the boxes.[1]

Corporate Communication to Stake holders

Internal stakeholders	*External stakeholders*
Financial statements	Annual reports
Policies and procedures	Press release
Hierarchy of responsibility	Promotional campaigns
Meeting	Social activities
Direct communications	Advertisements
Budgets	Social medias
	Public documents such as prospectus, etc.

In the OECD code of corporate governance, Principle V deals with 'Disclosure and Transparency'. This principle says that **the corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership and governance of the company.** Further the code also elaborately says the following.

A. Disclosure should include, but not be limited to, material information on:
   1. The financial and operating results of the company.
   2. Company objectives.
   3. Major share ownership and voting rights.
   4. Remuneration policy for members of the board and key executives, and information about board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board.
   5. Related party transactions.
   6. Foreseeable risk factors.
   7. Issues regarding employees and other stakeholders.
   8. Governance structures and policies, in particular, the content of any corporate governance code or policy and the process by which it is implemented.

B. Information should be prepared and disclosed in accordance with the high quality standards of accounting and financial and non-financial disclosure.

C. An annual audit should be conducted by an independent, competent and qualified auditor in order to provide an external and objective assurance to the board and the shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects.

D. External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit.

E. Channels for disseminating information should provide for equal, timely and cost efficient access to relevant information by users.

F. The corporate governance framework should be complemented by an effective approach that addresses and promotes the provision of analysis or advice by analysts, brokers, rating agencies and others, that is relevant to decisions by investors, free from material conflicts of interest that might compromise the integrity of their analysis or advice.[2]

Views of Various Committees' on Financial Reporting Issues

The Cadbury Committee gave the highest emphasis on the need of transparency and timeliness in reporting the financial aspect to stakeholders.

The Cadbury Committee gave the highest emphasis on the need of transparency and timeliness in reporting the financial aspect to stakeholders. The basic approach of the Committee was that compliance with a voluntary code coupled with disclosure will be more efficient than a statutory code of corporate governance. Hence, the Committee emphasizes on 'Comply or explain' principle. All the listed companies in the London Stock exchange are bound to comply and give reason for non-compliance of any aspects. The Committee also focused on control and reporting functions of board and the role of auditors related to financial reporting and accounting. In the words of the Committee, 'If long-term relationships are to be developed, it is important that the companies should communicate its strategies to their major shareholders and that the shareholders should understand them. It is equally important that shareholders should play their part in the communication process'.

The Greenbury committee which focused its deliberations on the remuneration policy, service conditions and the compensation of directors, the functioning of a remuneration committee, the disclosure of director's compensation and code of best practices in this aspect recommended the following for reporting under the head **disclosure and approval provisions:**

- The remuneration committee should make a report each year to the shareholders on behalf of the Board. The report should form a part of, or be annexed to, the company's annual report and accounts. It should be the main vehicle through which the company accounts to the shareholders for the Directors' remuneration are communicated.
- The report should set out the Company's policy on executive remuneration, including levels and individual components. Performance criteria and measurement, pension provision, contracts of service and compensation commitments on early termination must also be specified.
- The report should state that, in framing its remuneration policy, the committee shall give full consideration to the best practice provisions set out in the report. The report should also include full details of all elements in the remuneration package of each individual director by name, such as basic salary, benefits in kind, annual bonuses and long-term incentive schemes including share options.
- Information on share options should be given for each director in accordance with the recommendations of the Accounting Standards Board's Urgent Issues Task Force Abstract 10 and its successors.
- If grants under executive share option or other long-term incentive schemes are awarded in one large block rather than phased, the report should explain and justify. Also the report should specify pension entitlements earned by each individual Director during the year, calculated on a basis as recommended by the Faculty of Actuaries and the Institute of Actuaries. If annual bonuses or benefits in kind are pensionable, the report should explain and justify. The amounts received by and commitments made to each Director.
- Any service contracts which provide for, or imply notice periods in excess of one year (or any provisions for predetermined compensation on termination which exceed one year's salary and benefits) should be disclosed and the reasons for the longer notice periods explained.
- Shareholdings and other relevant business interests and activities of the Directors should continue to be disclosed as required in the Companies Acts and the London Stock Exchange Listing Rules.

- The Shareholders should be invited specifically to approve all new long-term incentive schemes (including share option schemes) whether payable in cash or shares in which Directors or senior executives will participate which potentially commit the shareholders' funds over more than one year or dilute the equity.

The Birla Committee on Corporate Governance made the following recommendations in accordance with the reporting the affairs of corporate activities to stakeholders.

1. **Disclosure of remuneration package:** Regarding the disclosure of remuneration package, the Committee recommends that all elements of remuneration package including fixed and performance based salary, bonus, stock options, service contract period, etc., should be specified in the annual report in a clear manner.
2. **Accounting standards and financial reporting:** Regarding the observance of accounting standards and financial reporting pattern the Committee recommends that (1) full disclosure about the affairs of the subsidiary companies must be given in the consolidated accounts of the parent company, (2) Segment reporting is essential, in case the company with several business, to ensure the financial viability of each product/service offered by the company (3) all related-party transactions should be reported clearly and (4) all deferred taxation must be reported in the annual reports.
3. **Management related disclosure:** The Committee recognizes the paramount role of management in the successful conduct of business and recommends that as a part of the director's report in the annual report, the industry structure and developments, opportunities and threats, product-wise and segment-wise performance, risk, internal control system, financial and operational performance, HR practices and the number of employees, etc., must be specified subject to the limit set by the disclosure affecting the competitive position of the company in the industry.

While discussing the corporate governance philosophy, the N. R. Narayana Murthy Committee observed that it is essential that the business must be conducted ethically and be governed in a fair and transparent manner protecting the interest of all stakeholders. It is a key element in improving economic efficiency of the firm. The Committee emphasises transparency as an important principle of good governance and made the following mandatory recommendations in its report.

1. **Audit report and audit qualification:** In case a company has followed a treatment different from that prescribed in an accounting standard, the management should justify why they believe such an alternative treatment is more representative of the underlying business transaction. The management should also clearly explain the alternative accounting treatment.
2. **Related-party transactions:** A statement of all transactions with the related parties including their bases should be placed before the independent audit committee for formal approval/ratification. If any transaction is not on an arm's length basis, the management should provide an explanation to the audit committee justifying the same. The term 'related party' shall have the same meaning as contained in Accounting Standard 18, Related Party Transactions, issued by the Institute of Chartered Accountants of India.
3. **Risk Management:** There must be a mechanism to inform the Board members about the risk assessment and the minimization the procedures. These procedures should be periodically reviewed to ensure that the executive management controls risk through means of a properly defined framework. The Management should place a report before the entire Board of Directors

every quarter documenting the business risks faced by the company, measures to address and minimize such risks and any limitations to the risk taking capacity of the corporation. This document should be formally approved by the Board.

4. **Proceeds from IPO:** Companies raising money through an Initial Public Offering ('IPO') should disclose to the Audit Committee, the uses/applications of funds by major category (capital expenditure, sales and marketing, working capital, etc.), on a quarterly basis. On an annual basis, the company shall prepare a statement of funds utilized for purposes other than those stated in the offer document/prospectus. This statement should be certified by the independent auditors of the company. The audit committee should make appropriate recommendations to the Board to take up steps in this matter.
5. **Code of contact to executives:** It should be obligatory for the Board of a company to lay down the code of conduct for all board members and the senior management of a company. This code of conduct shall be posted on the website of the company. All board members and senior management personnel shall affirm compliance with the code on an annual basis. The annual report of the company shall contain a declaration to this effect signed off by the CEO and the COO.
6. **Internal policy on access to audit committee:** Personnel who observe an unethical or improper practice (not necessarily a violation of law) should be able to approach the audit committee without necessarily informing their supervisors. Companies shall take measures to ensure that this right of access is communicated to all employees through means of internal circulars, etc. The employment and other personnel policies of the company shall contain provisions protecting 'whistleblowers' from unfair termination and other unfair prejudicial employment practices**.**
7. **Whistleblowing policy:** Companies shall annually affirm that they have not denied any personnel access to the audit committee of the company (with regard to matters involving alleged misconduct) and that they have provided protection to 'whistle blowers' from unfair termination and other unfair or prejudicial employment practices. The appointment, the removal and the terms of remuneration of the chief internal auditor must be subject to review by the Audit Committee. Such affirmation shall form a part of the Board report on Corporate Governance that is required to be prepared and submitted together with the annual report**.**
8. **Reporting the activities of subsidiary company in the annual report of parent company:** The Board report of the parent company should state that they have reviewed the affairs of the subsidiary company also.
9. **Disclosure in reports issued by a security analyst:** The SEBI should make rules for the disclosure in the report issued by a security analyst whether the company that is being written about is a client of the analyst's employer or an associate of the analyst's employer and the nature of services rendered to such company if any.

India Companies Act 2013 and Reporting Framework

Recognizing the need of transparency in the governance system to prevent corporate frauds and ensuring good governance, The Indian Companies Act 2013 included several measures and made them compulsory for all listed companies. Some of the major provisions relating to corporate reporting are as follows:

- Contingent liabilities and capital commitment.
- Statement showing computation of net profit for the computation of managerial remuneration.
- Reporting of related-party transactions.
- Reporting of accounting treatment.
- Disclosure of director's remuneration.
- Disclosure of director's resignation.
- Report on the profile of new directors.
- Disclosure of the training imparted to independent directors, the remuneration policy and the evaluation criteria and the establishment of vigilance mechanism in annual report.
- Disclosure of the proceeds received from public issue of shares, right issue of shares, preferential issue of shares, etc.
- CEO/CFO Certification.
- Report on corporate governance.
- Report on compliance of corporate governance.
- Reporting of risk management.
- Management discussion and analysis report, and
- Media scrutiny report on corporate governance.

(Details of the above are given in the Chapter 5 dealing with Legal and Regulatory Aspects of Corporate Governance)

Reporting Practices of Indian Companies

With regards to financial reporting practices of Indian companies, most of the Indian companies act in accordance to the statutory reporting requirements as per law. They follow the reporting requirements as per the Indian Companies Act 2013 and clause 49 of the listing requirements. Greater diversity is also observed in the reporting pattern of different companies. The annual reports of some reputed companies contain almost all information (both mandatory and non-mandatory) necessary for various stakeholders to take appropriate decisions. Also the quality of information provided by some of the high valued companies has improved significantly. It is almost at par with that of the top global companies because the management has realized that good quality reporting will enhance the value of the firm. But, at the same time, in some companies even many of the mandatory requirements are not provided. There is a vide scope of improving the reporting framework of many companies in India and the role of management in this area is very important since the ultimate responsibility rests with the management of the company. Annual financial statement and report are the primary means of reporting the performance of the entity during the period and the external stakeholders extensively depend on it. In India, in general, the annual financial statement and report contain the following information:

1. Notice of Annual General Meeting
2. Chairman's report
3. Summary of financial results
4. Financial highlights of number of years
5. Directors' report
6. Management discussion and analysis
7. Corporate governance report
8. Auditor's report
9. Balance sheet of the company
10. Profit and loss account for the financial year

11. Cash flow statement
12. Significant accounting policies
13. Schedules and notes of accounts
14. Supplementary statements, if any
15. C&AG's comment on accounts in case of government companies
16. Audited consolidated financial statement
17. Report on the human resources of the company
18. Value addition statement
19. CSR report
20. Environment report
21. Information on brand/intangibles
22. Business responsibility report and
23. Media scrutiny reports

Indian Accounting Standards (IAS or the Indian GAAP)

In India, like many other countries, the accounting standards used for preparation of annual financial accounts and reporting framework are developed under the supervision and control of Indian Accounting Standard Board (IASB) under the control of Institute of Chartered Accountancy (ICA). It also consists of representatives of government, academicians, ASSOCHAM, CII, FICCI, etc. These standards are recommended to the Ministry of Corporate Affairs for notifying their implementation. Based on these standards corporate financial statements are prepared and published.

The details of Indian Accounting Standards and its convergence are presented in comparative statement of AS and IAS.

IFRS (International Financial Reporting Standards)

International Financial Reporting Standards (IFRS) is a set of accounting principles used by companies to prepare financial statement, a critical source of information published by the company indicating the summary of financial activities useful to various stakeholders such as the shareholders, the creditors, the clients, the governments, etc. It specifies how particular types of transactions and other events are reported in financial statements to ensure stability, transparency and efficiency. It is developed by an independent, non-profit organisation called International Accounting Standard Board (IASB).

IFRS is a set of accounting principles used by companies to prepare financial statement, a critical source of information published by the company indicating the summary of financial activities useful to various stakeholders such as the shareholders, the creditors, the clients, the governments, etc.

The goal of IFRS provides a global framework for public companies prepare and disclose their financial statements. IFRS provides general guidelines for the preparation of financial statements rather than setting the rules for industry specific reporting. With the globalization of business and movement of capital across nations it becomes necessary for companies to prepare their financial statements on a common framework; because this is the basic document giving a fair view of the affairs of the company to investors. If individual countries have different sets of financial reporting framework, country-wise variations in the capital market policies, variations in the legal systems of each country, government policies and systems, variation in the type and scale of economic activity, from agricultural to financial services and from developing economies to industrialized economies; variation in

the degree of international influence and openness of an economy, etc., will influence the financial reports which will make the global comparison very difficult.

Using a single framework of principles not only increases the comparability of financial statements across borders, but also reduces the cost of preparing the consolidated financial statements of groups made up of companies conducting business all around the world. Moreover access to global financial market will also be easy if a common pattern is followed. Adopting a single set of worldwide standards will simplify accounting procedures by allowing a company to use one reporting language throughout. A single standard will provide investors and auditors with a cohesive view of finances. Currently, over 100 countries permit or require IFRS for public companies, with more countries expected to transition to IFRS in the coming years. All member states of the EU are required to use IFRS as adopted by the EU for listed companies since 2005. All other major economies have initiated a process to consider convergence or adoption of IFRS in the near future, even the United States (US GAAP as developed by the Financial Accounting Standards Board (FASB) being the other most prefered standards) where cross-listed firms on the US stock markets have been permitted to file statements prepared under IFRS since 2007.

Financial reporting standards have been in the spotlight since the banking crisis which requires measurement of financial assets. In September 2009, G20 nations in Pittsburgh asked the accounting standard setters IASB and its US counterparts, the FASB to work together towards a single set of high quality global accounting standards by June 2011. Convergence, however, is proving challenges and is likely to push back. Initially, IFRS begun as an academic project aimed at creating a single set of global standards, their actual use kick-started by the European Union.

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Objectives of IFRS

The main objectives for which IFRS foundation was established are as follows:

(a) To develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions;

(b) To promote the use and the rigorous application of those standards; and

(c) In fulfilling the objectives associated with (a) and (b), to take account of, as appropriate, the special needs of small and medium-sized entities and emerging economies; and

(d) To bring about the convergence of national accounting standards and International Accounting Standards and International Financial Reporting Standards to high quality solutions.

Standard IFRS Requirements

IFRS covers a wide range of accounting activities. There are certain aspects of business practice for which IFRS set mandatory rules.

- Statements of financial position: This is also known as a balance sheet. IFRS influence the ways in which the components of a balance sheet are reported.
- Statement of comprehensive income: This can take the form of one statement, or it can be separated into a profit and loss Statement and a statement of other income, including property and equipment.

- Statement of changes in equity: Also known as a statement of retained earnings, this documents the company's change in earnings or profit for the given financial period.
- Statement of cash flow: This report summarizes the company's financial transactions in the given period, separating cash flow into Operations, Investing, and Financing.

In addition to these basic reports, a company must also give a summary of its accounting policies. The full report is often seen side by side with the previous report, to show the changes in profit and loss. A parent company must create separate account reports for each of its subsidiary companies.

IFRS vs. American Standards (GAAP)

Differences exist between IFRS and other countries' Generally Accepted Accounting Standards (GAAP) that affect the way a financial ratio is calculated. For example, IFRS are not as strict on defining revenue and allow companies to report revenue sooner, so consequently, a balance sheet under this system might show a higher stream of revenue. IFRS also have different requirements for expenses; for example, if a company is spending money on development or an investment for the future, it doesn›t necessarily have to be reported as an expense (it can be capitalized).

Another difference between IFRS and GAAP is the specification of the way inventory is accounted for. There are two ways to keep track of this, first in first out (FIFO) and last in first out (LIFO). FIFO means that the most recent inventory is left unsold until the older inventory is sold; LIFO means that the most recent inventory is the first to be sold. IFRS prohibits LIFO, while the American standards and others allow participants to freely use either.

Convergence of Indian Accounting Standards with IFRS

With the globalization of Indian business and increased dependence of international financial markets for raising capital and starting of foreign subsidiaries/joint ventures, India also initiated to integrate the Indian Accounting Standards with the international standards (IFRS) which is known as Ind AS. Convergence means alignment of the standards of different standard setters with a certain rate of compromise, by adopting the requirements of the standards either fully or partially

What is Ind AS? Ind AS are set of accounting standards notified by the Ministry of Corporate Affairs (MCA), converged with International Financial Reporting Standards (IFRS). These accounting standards are formulated by Accounting Standard Board (ASB) of Institute of Chartered Accountants of India (ICAI). Indian Accounting Standards are almost similar to TFRS but with a few changes to fit into the global environment. Till date ICA has integrated and the Ministry of Corporate Affairs has notified 35 Ind AS. Initially, the adoption of the integrated Ind AS was voluntary, now the MCA has fixed 1 April 2016 for mandatory adoption of the new standards for the preparation of financial statement by companies whose equity and debt securities are listed or are in the process of listing on any stock exchanges in India or outside India and having a net worth of ₹500 crore and above. For the listed companies having a net worth of less than ₹500 crores and unlisted companies having worth of ₹250 crores or more but less than ₹500 crores and the mandatory adoption date is 1 April 2017.

Need for Convergence

The convergence of Indian Accounting Standards with the international standards is necessitated due to the following reasons:

- **Ensure better comparability:** By following a common set of standards the stakeholders can compare the performance of the organisations globally.
- Ensure higher transparency: The users of financial statement will be benefited by convergence as the same accounting standards will help the users to understand the fundamentals of the organisation which will generate better transparency.
- **Time and cost savings:** When different accounting standards are used by companies operating in different countries as holding company/subsidiary company/joint venture, etc., duel sets of accounts are to be prepared one with the local standard and the other with global standard which will be time consuming and costly. This problem can be solved by developing one single set of standard applicable throughout the globe. For example: Coco Cola operating in more than 200 countries through their subsidiaries has to prepare 200 accounts by following the standards of each country.
- **Attract foreign investment:** FIIs and FDIs always depend on financial statements of companies for investment. If it is prepared as per different standards it will not be possible to understand the true state of affairs of the investing company to the investors. On the other hand, convergence will facilitate an easy understanding and attract foreign investment to good companies. Due to the transition to IFRS, many companies are now attracted for setting up subsidiaries in India.
- **Globalization:** Another important reason for accounting standards convergence is the globalization drive initiated all over the world during the last twenty years. Globalization involves free movement of goods and services, technology, capital and manpower. Trade integration between nations through bilateral and multilateral agreements and the formation of WTO also warranted some uniformity in financial reporting and hence convergence.
- **Listing of securities in International markets:** Raising capital from the international market has become a common feather in the globalized era. For listing securities in foreign capital markets accounting convergence is an essential requirement. Moreover it will also improve the corporate image and value.

Comparative Statement of AS and IAS

AS	*Title*	*IAS/IFRS*	*Title*
IAS 01	Disclosure of accounting policies	1	Presentation of financial statements
IAS 02	Valuation of inventories	2	Inventories
IAS 03	Cash flow statements	7	Cash flow statements
IAS 04	Contingencies and events occurrence after the balance sheet date	10	Events occurring after the balance sheet date
IAS 05	Net profit or loss for the period. Prior period items and changes in accounting policies	8	Net profit or loss for the period, fundamental errors and changes in accounting policies

(*Continued*)

AS	*Title*	*IAS/IFRS*	*Title*
IAS 06	Depreciation accounting		Corresponding IAS has been withdrawn since the matter is now covered by IAS and IAS 38
IAS 07	Construction contracts	11	Construction contracts
IAS 08	Accounting policies (withdrawn by ICAI)		
IAS09	Revenue recognition	18	Revenue
IAS 10	Accounting for fixed assets	16	Property, plant and equipment
IAS 11	Effect of changes in foreign exchange rates	21	The effect of changes in foreign exchange rates
IAS 12	Accounting for government grants	20	Accounting for government grants and disclosure of government assistance
IAS 13	Accounting for investment		Corresponding IAS has been withdrawn since the matter is now covered by IAS 32, 39, and 40 and IFRS 7
IAS 14	Accounting for amalgamations	IFRS 3	Business combinations
IAS 15	Accounting for retirement benefits in the financial statements of employers	19	Employee benefits
IAS 16	Borrowing costs	23	Borrowing costs
IAS 17	Segment reporting	14/IFRS 8	Segment reporting
IAS 18	Related party transactions	24	Related party disclosures
IAS 19	Lease accounting	17	Leases
IAS 20	Earnings per share	33	Earnings per share
IAS 21	Consolidated financial statements	27	Consolidated and separate financial statements
IAS 22	Accounting for taxes on income	12	Income taxes
IAS 23	Accounting for investments in associates in consolidated financial statements	28	Investments in associates
IAS 24	Discontinuance of operations. Further, AS 10 deals with accounting for fixed assets retired from active use.	IFRS 5	Non-current assets held for sale and discontinued operations
IAS 25	Interim financial reporting	34	Interim financial reporting
IAS 26	Accounting of intangible assets	38	Intangible assets
IAS 27	Financial reporting of interest in joint ventures	31	Interest in joint ventures
IAS 28	Impairment of assets	36	Impairment of assets
IAS 29	Provisions , contingent liabilities and contingent assets	37	Provisions, contingent liabilities and contingent assets
IAS 30	Financial instruments- Recognition and Measurement	39	Financial instruments: Recognition and measurement
IAS 31	Financial instruments- presentation	32	Financial instruments: Presentation
IAS 32	Financial instruments – Disclosure	26	Accounting and reporting by retirement benefit plans
		29	Financial reporting in Hyper-inflationary economies

(*Continued*)

AS	Title	IAS/IFRS	Title
		40	Investment property
		41	Agriculture
		IFRS 1	First time adoption of IFRS
		IFRS 2	Share based payment
		IFRS 4	Insurance contracts
		IFRS 6	Exploration for and evaluation of mineral resources
		IFRS 7	Financial instruments: Disclosures

Some of the Leading Accounting Fraud Corporate Scams of Recent Period

Case 1: Enron Corporation (2001)

The sudden collapse of Enron Corporation is the best example of inappropriateness of a series of accounting disclosure which questioned the quality of current accounting and reporting standards. It raised many questions such as how management hid debts, inflated profits to support the market price of stock that is considerably higher than the real worth; how the management was able to use unethical accounting practices for revenue recognition, market to market accounting, creation of special purpose vehicle for to hold assets, borrow money, and hedge fluctuations in the value of its investment activities and diverting funds from the parent company to themselves, friends and family, why it did not disclose the activities of SPV in the annual report of the parent company, use of a metric developed to measure the likelihood of earning management, how it misused the accounting practices to reduce tax liabilities, credit rating, how it hid off balance sheet accounting of subsidiaries, etc., for several years before its bankruptcy. It also raised a question as to how Enron Senior Management used complex accounting schemes and why it was not noticed by the sophisticated investors, the professional security analyst and the market regulators.[3]

Case 2: WorldCom (2002)

WorldCom was started as a long distance telecommunication company in Mississippi, Mr Bernad Ebbers was the CEO, it was the second biggest telecom company in the world with a $4.4 billion market capitalization and $39 billion revenue in 2001, it stood 42nd in the Fortune 500 companies. It acquired MCI, UUNet, and CompuServe during the last 10 years and it failed in July 2002. The main business reasons contributed for the failure are strong growth strategy through aggressive acquisitions, raising money continuously by high cost debt, over supply of telecommunication capacity resulting in low capacity utilization, high cost and low revenue. More than this the CEO and few directors could cheat the shareholders and even the auditor Arthur Anderson classifying the line cost which is a revenue expenditure payable to other networks as capital expenditure. The company overstated the earning of 2001 and Q1 of 2002 by more than $3.8 billion by manipulating the reserves by $3 billion and around $9 billion in false or unsupported accounting entries made to magnify the results. By the end of 2003, it was estimated that the company's total assets had been inflated by about $11 billion. Finally, the stock price fell from $64.5 per shares to $1.0 per share in 2002. The CEO was sent to jail for 25 years and the company was liquidated. This made the WorldCom scandal the largest accounting fraud in American history.

Case 3: Lockheed Martin Bribery Case

Lockheed Martin an American aerospace, company, was founded in 1912. The company is known for the production of the Unites States military aircraft. They have produced airplanes for over 100 years. These aircrafts are highly accurate in the time of war and have technology that no ordinary American will ever see in his or her lifetime. The company gets 80 per cent of the revenue from the US government especially the Pentagon. Before the 1970's, Lockheed Martin's productions of airplanes were the talk of the century. They upgraded the planes as new ideas and technology came across their desks. Many planes like the Model 14, L-049 Constellation and the famous P-38 used for the attack on Japan after the attack on the Pearl Harbour, brought much success to Lockheed. However, the production of the L-1011 Tri-Star airliner caused the beginning of Lockheed's financial trouble. Because of commercial failure, Lockheed fell into a debt that they could not pay. This one aircraft failure almost ruined Lockheed. But Lockheed had an answer to their financial difficulties. They would bribe other countries to buy future production of aircrafts to keep Lockheed above water. They called on Italy, West Germany, Japan, the Netherlands and Saudi Arabia. Theses bribes add up to $22 million to government officials for the upcoming F-104 Star fighter planes. It bribed West Germany's Minister of Defence, $10 million for the purchase of 900 F-104G Star fighter Japan's Prime Minister Kakuei Tanaka $3 million, the Netherlands Prince Bernhard $1.1 million and Saudi Arabia's, Adan Khashoggi, $106 million as commission. Daniel Haughton, Lockheed chairman of the board, and Carl Kotchian vice chairman and president admitted to this and resigned on 13 February 1976. The US Government bailed out the company in 1976 by guaranteeing $195 Million.

Case 4: Xerox's Accounting Manipulation Case

Xerox Corporation is one of the biggest documentation management company established fifty years ago in the US and doing business in over 180 countries with $18 Billion revenue (in 2015). The company's 41 per cent of the revenue comes from document technology business, 56 per cent from document service business and 3 per cent from other activities. Geographically, 69 per cent of the revenue contributed from the US business, 21 per cent contributed from European business and 9 per cent from other parts. The company has more than 30,000 employees consisting of 7500 sales professional, 12,800 management service employees and 12,900 technical service employees. It was ranked as one of the most admired companies in the computer industry by Fortune magazine's annual reputation survey.

In July 2002, Xerox revealed that over the past five years it improperly classified over $6 billion in revenue, leading to an overstatement of earnings by nearly $2 billion. The Securities and Exchange Commission (SEC) began an investigation that ended in April of that year. The SEC charged the producer of copiers and related services with accounting manipulations. It was estimated that the amount involved was about $6 billion. A settlement was eventually reached that included a $10 million fine. According to Paul Berger, the SEC's associate director of enforcement, 'it falls under the scope of our original investigation.... We found what we considered to be a pattern of pervasive fraud'.

There were two basic manipulations that formed the basis for the SEC investigation. The first was the so-called 'cookie jar' method. This involved improperly storing revenue off the balance sheet and then releasing the stored funds at strategic times in order to boost the lagging earnings for a particular quarter. This is a widely used manipulation. Earlier the Microsoft also done the same type of manipulation and settled an investigation by the SEC into similar practices.

The second method and what accounted for the larger part of the fraudulent earnings was the acceleration of revenue from the short-term equipment rentals, which were improperly classified as long-term leases. The difference was significant because according to the Generally Accepted Accounting Principles (GAAP)—the standards by which a company's books are supposed to be measured, the entire value of a long-term lease can be included as revenue in the first year of the agreement. The value of a rental, on the other hand, is spread out over the duration of the contract.

The effect of the manipulation was that Xerox could count as earnings what essentially future revenue was. This boosted the short-term profits which allowed the company to meet profit expectations in 1997, 1998 and 1999, though it had the effect of reducing earnings during the past two years. In 1998 Xerox reported a pretax income of $579 million, while it should have reported a loss of $13 million. On the other hand, the $137 million loss for 2001 would become a $365 million gain after the manipulation was reversed. The $1.9 billion total that would be subtracted from revenue reported from 1997–2001 would be added to future reports.

Thus, unlike some of the other scandals that have emerged over the past several months, Xerox has not been accused of falsely creating unearned income. Rather it spread its income out in a fraudulent manner. To the same end, WorldCom improperly capitalized about $4 billion in ordinary expenses in order to allow the company to deduct the expense over a period of decades rather than writing it off all at once. Both these methods serve to boost the short-term profits. The reason for these types of manipulation, according to SCE investigation, was 'the compensation of Xerox senior management depended significantly on their ability to meet [earnings] targets'. Because of the accounting manipulations, the top Xerox executives were able to cash in on stock options valued at an estimated $35 million. Xerox stock rose to a peak of $60 a share in mid-1999, when the company was carrying out the accounting fraud. It had since declined sharply and reached to $7 immediately.[4]

Case 5: Toshiba Accounting Scandal Case

In July 2015, the chief executive officer of Toshiba Corporation (Toshiba) Hisao Tanaka announced his resignation in the face of an accounting scandal tied to about $1.2 billion in an overstated operating profit that shocked the world. Details of the scandal emerged when an independent investigative panel released a report describing the accounting improprieties in detail. This had taken place over the course of seven years, bringing two former CEOs in the scandal alongside Tanaka. The investigative report revealed that the CEOs did not directly instruct anyone to falsify the books of account but rather placed immense pressure on subordinates and waited for the results they wanted. The company's stock prices came down by 38 per cent after the accounting probe was announced and the company withdrew the dividend that had been declared earlier. These setbacks challenged the company investors, who had always regarded Toshiba as a reputable company. The investors were wondering as everyone else watching the scandal unfold, as to how a company with a 140-year history could do this and why?

Toshiba Corporation started in Japan to 1875 with an expanding catalog of unique and innovative products including semiconductors, personal electronics, infrastructure, home appliances and medical equipment. Toshiba began selling products in foreign markets during this period and continued to expand its businesses across the globe during the following decades. By 2015, the company was operating business units on a worldwide scale in a variety of diverse industries. It had net global sales of more than $63 billion by the end of March 2015 with a manpower of more than 200,000 people worldwide.

Investigation revealed direct evidence of unethical and inappropriate accounting practices followed by the company leading to overstated profits in different Toshiba business units, including the visual products unit, the PC unit and the semiconductor unit. The techniques employed varied from on business unit to another. This includes booking future profits early, pushing back losses, pushing back charges and other similar techniques that resulted in overstated profits. Although the techniques varied, the investigative panel identified a single set of direct and indirect causes to explain how the inappropriate practices took place across the conglomerate.

This practice started under the CEO Atsutoshi Nishida in 2008 amidts its efforts to overcome the global financial crisis that seriously affected Toshiba's profitability. The practice continued unabated under the next CEO, Norio Sasaki, and eventually ended in a scandal under Tanaka. Investigation reports blamed the corporate culture and governance practice followed by the company such as fixing strict profit targets and not accepting the shortfall for whatever the reason as a major challenge, to business unit presidents. Even in some cases, quarterly Challenges were handed down near the end of the quarter when there was no time left to materially affect the unit performance. The unit's heads were compelled to follow fraudulent practices to achieve these challenges. Further the investigation team concluded that Toshiba's corporate culture, which demanded obedience to superiors, was an important factor forcing the emergence of such frauds in accounting practices. It also concluded that weak corporate governance and a poor internal control system was responsible for such incidents. Internal controls in the finance division, the corporate auditing division, the risk management division and in the securities disclosure committee did not function properly to identify and stop the fraudulent behaviours. The report also recommended for the withdrawal of the challenging targets fixing system, the reforming the corporate culture of silent obedience, the establishment of a good internal control system and the introduction of a good whistle blowing system with which the whistleblower can report anything without fear in order to prevent this types of scams.[5]

Case 6: Olympus Corporation Accounting Scandal

Olympus Corporation, a Japanese company was founded in October 1919 in Tokyo producing high quality photography and audio equipment. Michal Woodfords, a British citizen who worked for more than 30 years in the company was appointed as the CEO in early 2011. He examined some of the questionable financial activities and fraud worth $1.5 billion, one of the biggest accounting scandals in Japan. The created strategies to shift losses off the balance sheet by purchasing companies located Cayman Island with exorbitant price. As a consequence to this investigation he was removed in October 2011 from the post of the CEO, but continued to serve in the board of directors.

The company was involved in hiding loss, inflate net worth, secretly provided large sums to some advisors in company acquisitions, which resulted in a very significant asset impairment charges in the company's accounts. In 2011 Olympus purchased Gyrus in which $687 million was paid to a member of Gyrus family for no specified reason. Similar payment was also made to someone not directly involved in acquisition. On 26 October, Kikukawa was replaced by Shuichi Takayama as chairman, president, and CEO. On 8 November 2011, the company admitted that the company's accounting practice was 'inappropriate' and that money had been used to cover losses on investments since 1990s. The company blamed the former president Tsuyoshi Kikukawa, auditor Hideo Yamada and the executive vice-president Hisashi Mori for the inappropriate accounting.

By 2012 the scandal had developed into one of the biggest and longest-lived loss-concealing financial scandals in the history of corporate Japan. It had wiped 75–80% off the company's stock market valuation, it led to the resignation of the board and eventually it led to investigations across Japan, the UK and the US and the arrest of 11 past or present Japanese directors, senior managers, auditors and bankers of Olympus for alleged criminal activities or cover-up. This has raised considerable turmoil and concern over Japan's prevailing corporate governance practice and the Japanese financial markets.

Woodford received a reported £10 million ($16 m) in damages from Olympus for defamation and wrongful dismissal in 2012. Around the same time, Olympus also announced it would shed 2700 jobs (7 per cent of its workforce) and around 40 per cent of its 30 manufacturing plants by 2015 to reduce its cost base. The involvement of Tsuyoshi Kikukawa, the former president of the company, Hido Yamada the auditor and Hisashi Mori the executive vice president was established beyond doubt. A Tokyo court found Kikukawa and five others liable for $529 million. The ruling came six years after the former chief executive Michael Woodford exposed his colleagues for falsifying accounts to conceal losses of $1.7 billion. Kikukawa and two other executives who pleaded guilty never went to jail. Instead, they were given suspended sentences of upto three years.[6]

Case 7: Tyco International Accounting Scandal Case

Tyco International Ltd., is a diversified manufacturing and service company headquartered in West Windsor, New jersey, USA founded by Arthur Rosenbery, with five main operating groups in 1960. They are Tyco Fire and Security generating 31 per cent of total revenues as a world leader in the design, manufacture, installation, monitoring and service of fire detection, protection and suppression systems, as well as being the world leader in electronic security services. The other divisions are Tyco Electronics contributing 28 per cent of revenues, one of the world's largest suppliers of electronic components, Tyco Healthcare contributing 23 per cent of revenues manufactures and distributes a wide variety of medical devices and supplies, Tyco engineered products and services contributing 13 per cent of revenues is the world's leading maker of industrial valves and controls, serving the petroleum, chemical, petrochemical, power generation, water management, pharmaceutical, pulp and paper, food and beverage, commercial construction, and other industries. Tyco Plastics and Adhesives contributing 5 per cent of revenues, is the number one producer of plastic trash bags in the United States. The company has operations in over 100 countries with an annual turnover of $10.52 billion and 70,000 employees. Dennis Kozlowsike was the CEO of the company, Marks Swartz the CFO and Mark Belnick the chief corporate council.

The company made about 40 acquisitions under the leadership of the above three executives during the period from 1995–2002. Large scale accounting and financial frauds took place in the company by falsifying company records, concealing illicit company loans, evading sales tax of $1 million and stealing more than $170 million from the company and pocketing $430 million from illegal stock sales by these people and a major part of the money was transferred to Kozlowsiki's account. In January, the next investigation started and all the three top people in the company resigned. All of them were charged for falsification of accounts, tax evasion and enterprise corruption. They were also charged with giving thousands of interest free loans disguised as bonuses, sale of company's stock without informing investors, not showing the books of accounts to directors, loans sanctioned as business loans for personal purchase of property and jewellery, payment of bonus to workers who did not avail loans (workers were not aware about it) and paid handsomely to those who suspected the management.

All the three were found guilty for falsification of company's accounts, taking bonus without approval, abusing employees loan scheme, tax evasion, illegal transfer of money to their personal accounts, etc., and convicted for imprisonments for 25 years. The company also appointed Mr Edward Brown as the new CEO, elected new board of directors and created a new code of contact as Tyco Guide to Ethical Conduct with strong ethical leadership, accounting and behavioural tacking process.[7]

Case 8: AIG Insurance Accounting Fraud Case

AIG, the world's largest insurance and financial services company, has business spread over in 130 countries with 88 million customers and 93,000 employees. The company has the shareholder's equity of $95.8 billion (2007), it encompasses a net income of $6.2 billion and premium of $59.8 billion. It was established in 1921 and owned by Warren Buffet's Berkshire Hathaway, now led by Maurice Greenburg. The three core businesses of the company are, AIG Property Casualty, AIG Life and Retirement and United Guaranty Corporation (UGC). AIG Property Casualty provides insurance products for commercial, institutional and individual customers, AIG Life and Retirement provides life insurance and retirement services in the United States and UGC focuses on mortgage guarantee insurance and mortgage insurance. AIG also focuses on global capital markets operations, direct investment and retained interests. The company was ranked as the 40th largest company in the 2014 Fortune 500 list. According to the 2014 Forbes Global 2000 list, AIG is the 42nd largest public company in the world. As of 1 June 2014, it had a market capitalization of $78.48 billion, as per Google Finance.

When Martin J. Sullivan became CEO of the company, AIG took tens of billions of dollars of risk associated with mortgages. It insured tens of billions of dollars of derivatives against default, but did not purchase reinsurance to hedge that risk. Secondly, it used collateral on deposit to buy mortgage-backed securities. When losses hit the mortgage market in 2007-2008, AIG had to pay out insurance claims and also replaced the losses in its collateral accounts. Meanwhile AIG purchased the remaining 39 per cent, that it did not own, of online auto insurance specialist 21st Century Insurance in 2007 for $749 million (61 per cent where with AIG earlier). With the failure of the parent company and the continuing recession in late 2008, AIG rebranded its insurance unit to 21st Century Insurance.

In 2001 SEC learnt that AIG had assisted a client company in bolstering its balance sheet through a bogus insurance transaction. After an investigation it was found true and the SEC and the Justice Department settled with $10 Million Civil Penalty. Subsequently, in 2004, the Federal Grand Jury began the investigation of AIG's income smoothing products on bid–rigging complaint filed against AIG and others. While releasing the earning for 2004–05 in 30 March 2005, AIG disclosed that reinsurance deal with Gen Re should have been accounted for as a deposit and released restatement amounted of net income of $1.32 Billion for 2004.

On 27 May 2005 a civil suit was filed against AIG saying that, "AIG engaged in misleading accounting and financial reporting, projecting an unduly positive picture of AIG's underwriting performance for the investing public". In particular, it engaged in 'two sham insurance transactions' that gave investors the impression the company had larger reserves for claims than it did.

On February 2006, the SEC files complaint in the US District Court against AIG. According to the SEC, "this case is not about the violation of technical accounting rules. It involves the deliberate or extremely reckless efforts by senior corporate officers of a facilitator company (Gen Re) to aid and abet senior management of an issuer (AIG) in structuring transactions having no economic substance, which was designed solely for the unlawful purpose of achieving a specific and false, accounting effect on the issuer's financial statements". In February

2006, SEC and the Justice Department finished the settlement case with AIG for $1.6 billion related to alleged improper accounting, the bid–rigging and the practices involving workers compensation funds.

On 11 June 2008, three stockholders, collectively owning 4 per cent of the outstanding stock of AIG, delivered a letter to the Board of Directors of AIG seeking to oust CEO Martin Sullivan and make certain other management and Board of Directors changes. On 15 June 2008, after the disclosure of financial losses and subsequent to a falling stock price, Sullivan resigned and was replaced by Robert B. Willumstad, Chairman of the AIG Board of Directors since 2006. Willumstad was forced by the US government to step down and was replaced by Edward M. Liddy on 17 September 2008. AIG's board of directors named Robert Benmosche as the CEO on 3 August 2009 to replace Mr Liddy, who earlier in the year announced his retirement. On 17 March 2009, AIG announced that they were paying $165 million in executive bonuses, President Barack Obama, who voted for the AIG bailout as a Senator, responded to the planned payments by saying it's hard to understand how derivative traders at AIG warranted any bonuses, much less than $165 million in extra pay. How do they justify this outrage to the taxpayers who are keeping the company afloat". The company faced an extreme liquidity crisis and government bailout to the extent of $85 billion. Finally the US government bailed out AIG.[8]

Case 9: Lehman Brother Accounting Fraud Case

Lehman Brothers founded in 1844 a small trading company selling grocery, dry fruits, etc., that switched over to commodity broking in cotton trading business by a German immigrant and his two brothers. In 1877 the firm became a member of the New York Stock Exchange which laid the foundation of Lehman Brother that grew into one of the largest investment banks on the Wall Street. By 1990 it became the 4th largest US investment company with 25,000 employees. It did business in investment banking, equity and fixed income sale, trading, investment management, private equity and private banking. It survived many crises such as the Rail Road bankruptcy of 1800, the Great depression of 1930, two World Wars, the American Express case 1994 and the Russian debt case of 1998. By 2007 its Market capitalization reached $60 billion. It became for the 42nd time the 'Best in Class' award-winner for excellence in prime brokerage and the No. 1 prime broker in Japan and Europe.

Lehman Brothers acquired 5 mortgage lender companies BNC mortgage and Aurora Loans. During the Housing boom of 2004, its revenue increased by 56 per cent and a net income of $4.2 billion out of $19.3 billion revenue. The company followed aggressive lending without insisting on proper asset backing. Within two years a huge amount of the company assets became toxic assets and the company used the balance sheet manipulation to hide the non performing toxic assets. In the words of Dubinsky, the investigator, 'liabilities were not recorded for these asset transactions, but rather assets were taken off its balance sheet and the cash received was then used to repay other debt, effectively lowering its leverage'. It diverted $50 Billion of toxic assets and sold it to banks in the Cayman Island with the intention of buying it back later. The firm's accountant had recorded it as sales which allowed the firm to look like they had $50 billion in sales.

The transaction of selling toxic assets with an intention of buying it later is perfectly legal but it has to be written as a loan. But this time the company recorded it as sales. This had created a false impression that the business was in a better position than it really was. Consumers, the SEC and the shareholders were unaware of the actual state of the company. Lehman Brothers was able to complete their due diligence by finding a legal firm that would give an okay to these sales despite the accepted accounting standards in the US. According to Dubinsky, "No

law firm in the US wanted to give an opinion on what they wanted, so Lehman's went opinion-shopping". They travelled across the pond and found a UK law firm to provide the opinion letter they needed. Ernst & Young, a British auditing firm certified the financial statement with the knowledge that the transactions were not recorded properly. Ernst and Young was asked to pay $10 million to the state of New York to settle the claims of Lehman Brother for concealing the real financial difficulties. In September 2008, the company filed bankruptcy petition with $639 assets and $919 billion liabilities which led to US subprime crisis which led to the loss of $10 trillion in market capitalization.[9]

Case 10: Kmart Accounting Scandal Case

Kmart is a leading US discount retailer, besides the Wal-Mart, the Target, and the Kohl's. It sells goods in its own named brand and private-label goods mostly to low and mid-income families. It runs about 1150 off-mall stores (including 17 super centres) in 49 US states, Puerto Rico, Guam and the US Virgin Islands. About 270 Kmart stores sell home appliances and some 840 locations house in-store pharmacies. Poor sales have forced its parent, Sears Holdings Corp., to close more than 300 Kmart stores since merging Kmart with Sears in 2005. Kmart also operates the kmart.com website, which includes merchandise from Sears.

Financial performance: Kmart's sales continued their steady descent in year 2014 down 9 per cent as compared to the previous year to $13.2 billion. The retailer blamed its shrinking store count and competition from rival chains, including the Target and the Kohl's, for the decline. Falling same-store sales of 4 per cent in the year 2014 reflected declines across most of its merchandise categories, most notably in the grocery and household, consumer electronics, pharmacy, and toy departments. Kmart reported an operating loss of $351 million in 2014, as compared to a profit of $5 million in 2013.

The accounting fraud is related to 2001's. During this period Kmart faced some intense competition from companies like the Walmart and profit declined heavily. To overcome the situation the CEO Charles Conway made some efforts through creative marketing programs. But the situation did not improve and the loss continued heavily and reached a stage that major suppliers stopped supplying goods to Kmart. Kmart reached a point of bankruptcy in 2002. In the bankruptcy investigation it was revealed that during this time Kmart had used some 'creative Accounting' as pointed out by the bankruptcy investigator to inflate revenue figures by $42.3 million for the second quarter of 2001. It was also pointed out that during the third and fourth quarter also the company had done similar practice to inflate revenue figures of more than $24 million. The promotional allowances paid by the Kmart's vendors to secure shelf space, advertising and keep their own competition off Kmart's shelf had been recorded as the revenue of the quarter whereas the benefit of promotional allowances was spread for a longer period. According to law, because they were subject to pay back provisions, should have been amortize over the life of the contract. By this way Kmart was able to inflate its profit by almost 10 per cent. This was very attractive to the CEO and other management people who wanted to see Kmart's stock prices rise.

The US Securities and Exchange Commission brought the accounting fraud charges against Kmart executives of prematurely booking promotional allowances from suppliers like Coca-Cola Enterprises, PepsiCo and Eastman Kodak, allowing it to increase profits for the fourth quarter of 2001 by $24 million. Representatives of at least four companies selling to Kmart participated in the accounting scheme, the complaint said, by furnishing misleading documents and making side agreements that hid the true nature of their deals from Kmart's auditors and investors. Three former Kmart executives and five representatives of companies

that supplied to Kmart with brand name products were charged with this fraud. Five of the eight people named in the complaint reached separate settlements with the S.E.C., each accepting civil penalties of up to $55,000 without admitting the or denying wrongdoing.[10]

Case 11: Ricoh India Accounting Fraud Case

Ricoh India Limited is a technology company engaged in providing information technology (IT) services and printers and accessories. It specializes in office imaging equipment, production print solutions and document management systems. It is a subsidiary of Japanese entity Ricoh Company Limited. It offers a range of products and solutions, which includes office printers, digital duplicators, production printers, projection systems and video conferencing solutions, and related software technologies. Its products also include Multi-functional, Unified Communication Systems and Interactive Whiteboard. Its services include management services, communication services, business services and production printing services. Its solutions also include device management, cost management and security, workflow and process management and cloud solutions. It can provide a combination of document and IT-related services, addressing business practices surrounding the management of both print and electronic information and communication.

In 2002 Mr Winham joined the Ricoh Group in Europe, the Middle East and Africa (EMEA) as the CFO and was appointed as Executive Vice President, CIO and CFO of Ricoh Europe in 2007. In 2014, he took on a global role as the head of Global Capital Management. In April 2016, he was appointed as the Corporate Vice President of Ricoh Company, Ltd. He worked extensively in India over the last six years. In April 2016, Ricoh India announced that its accounts appear to be have been 'falsified' and estimated to incur a loss of ₹1123 crore for the year ended 31 March 2016 as per an internal investigation carried out to ascertain the financial position and the probable role of some officials of the company. The BSE immediately delisted the company and share trading was suspended. A week after admitting the fraud its Chairman and Director Tetsuya Takano resigned from the company. The company's India MD and CEO Mr Manoj Kumar also resigned from the board after being asked to go on leave amid an audit in the company by a committee. However, Ricoh Company Ltd, a promoter entity of the Indian subsidiary of Japanese imaging and electronics major, proposed to recapitalize the company for the loss. The disclosure by the Indian unit also prompted the promoter to approach National Company Law Tribunal (NCLT) against the BSE-listed firm and its certain officials suspected to have indulged in 'mismanagement'. In its petition, the promoter sought to restrain the statutory authorities from taking any coercing measures against Ricoh India Ltd and restore its share trading, which had been suspended for penal reasons even as a probe was is already on by various agencies and regulators including SEBI into its affairs. A detailed investigation was carried out by M/S PricewaterhouseCoopers and its preliminary report indicated that Ricoh India's financial statements for 1 April 2015 to 30 September 2015 did not reflect a true and fair view of the state of affairs of the company. 'As per the investigation, it appears that the accounts have been falsified and the company's accounting principles and standards have been violated', the company said in a regulatory filing. The company statement on estimated loss also said that such acts of omission and commission have caused a 'grave loss' to the company and its shareholders.

The unaudited estimate of aggregate loss after tax for the financial year ended 31 March 2016 would be ₹1123 crore, the company also estimated that June 2015 quarter registered a profit of ₹40 lakh, followed by losses of ₹147.4 crore (September 2015 quarter) and ₹976.5 crore (October-March 2015). On 18

November 18, 2016 the company announced that "it has been investigating the falsification of its accounts. Following an extensive investigation, the accounts filed today disclose the full extent of the losses suffered by the company and the underlying business performance". In this the company had identified 'one-off/ exceptional items' amounting to ₹683 crore in a case of fraud that surfaced at the company's Indian unit earlier this year. The company, which declared financial results for the year ended 31 March 2016, posted a loss of ₹1118 crore. Excluding the exceptional items, the loss for the year would have been ₹435 crore.

Case 12: Harshad Mehta Stock Scam 1992

Harshad Mehta born in a lower middle class Jain family in Gujarat completed his primary schooling in Mumbai and joined the small business with his father. When his family shifted to Raipur, Chhattisgarh, he continued his studies at higher secondary level from Raipur and joined in New India Assurance Company. In 1980 he quit the job and joined with a BSE affiliated stock broker and subsequently became a Jobber under another stock broker. After gaining good experience as a sub-broker, he and his brother Sudhir started became a full broker of the BSE with the financial support of J. L. Shah and Nandalal Sheth.

By the year 1990, Mehta became a prominent name in the Indian stock market. He started buying shares heavily, the stocks of reputed companies like ACC, Reliance Industries, TISCO, TELCO, etc., at a very high price. With this the price of ACC has jumped by an alarming 4000 per cent in the stock market. He gave a theoretical explanation to this high price bidding by saying that older companies are to be valued on the basis of 'Replacement Cost' basis. The replacement cost theory basically states that older companies should be valued on the basis of the amount of money that would be needed to create another similar company. By the latter half of 1991, Mehta had come to be called the 'Big Bull' as people credited him with having initiated the Bull Run.

The Security Scam of 1992

By taking advantage of many loopholes in the banking system, Mehta and his associates drained off funds from inter-bank transactions. Subsequently, they bought huge amounts of shares at a premium across many industry verticals causing the Sensex to rise dramatically. However, this was not continued as the banks who lent Mehta identified the modus operandi started demanding their money back, causing the Sensex to plunge almost dramatically as it had risen. Mehta was later charged with 72 criminal offences while over 600 civil action suits were filed against him.

What were the Accounting Frauds Committed by Mehta?

Mehta fully utilized the loopholes in our banking system to commit the frauds. In the words of columnist Sucheta Dalal of The Times of India, 'The crucial mechanism through which the scam was effected was the ready forward (RF) deal. The RF is in essence a secured short-term (typically 15-day) loan from one bank to another. It is just like the bank lending against government securities as the local money lender lends against jewellers. The borrowing bank actually sells the securities to the lending bank and buys them back at the end of the period of the loan, typically at a slightly higher price'. In a ready-forward deal, a broker usually brings together two banks for which he is paid a commission. Normally,

the broker does not handle the cash or the securities, but in this case, Mehta has done otherwise. Mehta and his associates used this RF deal with great success to channel money through banks.

The securities and payments were delivered through the broker in the settlement process. The broker functioned as an intermediary who received the securities from the seller and handed them over to the buyer; and he received the check from the buyer and subsequently made the payment to the seller. Such a settlement process meant that both the buyer and the seller may not even know the identity of the other as only the broker knew both of them. The brokers could manage this method expertly as they had already become market makers by then and had started trading on their account. They pretended to be undertaking the transactions on behalf of a bank to maintain a façade of legality.

Mehta and his associates used another instrument called the bank receipt (BR). Securities were not traded in reality in a ready forward deal but the seller gave the buyer a BR which is a confirmation of the sale of securities. A BR is a receipt for the money received by the selling bank and pledges to deliver the securities to the buyer. In the meantime, the securities are held in the seller's trust by the buyer.

For operating the scheme Mehta has identified two banks, Bank of Karad (BOK), Mumbai and the Metropolitan Co-operative Bank (MCB) which are ready to issue fake BRs, or ones without the guarantee of any government securities. The two banks agreed to issue BRs as and when required. Once they issued the fake BRs, Mehta passed them on to other banks, who in turn, lent him money, under the false assumption that they were lending against government securities. Mehta used the money thus secured to enhance share prices in the stock market. The shares were then sold for significant profits and the BR retired when it was time to return the money to the bank.

Mehta continued with his manipulative tactics, triggering a massive rise in the prices of stock and thereby creating a feel-good situation in market. However, upon the exposure of the scam, several banks found that they were holding BRs ₹4000 crores of no value at all. Mehta had been convicted in only one of the 27 cases filed against him out of 72 cases registered against him and his associates at the time of his death in 2002. By this time, Mehta paid an advance tax payment of ₹28 crore for the financial year 1991–92. Several senior officers of the SBI, and many PSBs were dismissed for colluding with Mehta, the scam also exposed the death of the Chairman of the Vijaya Bank who reportedly committed suicide over the exposure. He was guilty of having issued cheques to Mehta and knew the backlash of accusations he would have to face from the public.

Several years after his death, the custodian's report (number 26) was released on 8 January 2016 and according to it, the Harshad Mehta family has assets worth ₹1,723.84 crore and had total liabilities of around ₹16,044 crore. The family has to pay 4662 crore to various banks and about ₹11,174 crore to IT Department (mainly interest accrued and penalties). As on September 2015, the banks were decreed (by Court) to get ₹1,688 crore out of which ₹1,074 crore had already been paid.[11]

Case 13: Satyam Computers Accounting Fraud Case

On 24 June 1987, Satyam Computer Services Ltd (Popularly known as Satyam) was incorporated by B. Ramalinga Raju and his two brothers, B. Rama Raju and B. Suryanarayana Raju, as a private limited company with just 20 employees for providing software development and consultancy services to large corporations. During the year 1996, the company promoted four subsidiaries including Satyam Renaissance Consulting Ltd, Satyam Enterprise Solutions Pvt. Ltd., Satyam Infoway Pvt. Ltd. and Satyam Computer Services Ltd. In 1997, it was selected

by the Switzerland-based World Economic Forum and World Link Magazine as one of India's most remarkable and rapidly growing entrepreneurial companies. In 2001, Satyam became the world's first ISO 9001 company and in 2003, Satyam the started providing IT services to the World Bank and signed up a long term contract with it. It was ranked 3rd in Corporate Governance Survey by Global Institutional Investors. Satyam was ranked as the fourth largest IT Company in India, with 9 per cent market share and $2.1 billion revenue, 53,000 employees. PWC was the auditor of the company.

Problems in Satyam began on 16 December 2008 when its chairman Mr Ramalinga Raju, in a surprise move announced a $1.6 billion bid for two Maytas companies, i.e., Maytas Infrastructure Ltd. and Maytas Properties Ltd. saying he wanted to deploy the cash available for the benefit of investors. These two companies have been promoted and controlled by Raju's family. Investors opposed this move and subsequently share prices plunged by 55 per cent at the first stage and another 14 per cent subsequently reaching the lowest share price over the last four years. The World Bank announced that Satyam has been barred from business with the World Bank for eight years for providing Bank staff with 'improper benefits' and charged with data theft and bribing the staff. The lone independent director since 1991, a US academician Mangalam Srinivasan, announced resignation. B. Ramalinga Raju announced a confession that over ₹7800 crores financial fraud was committed. He revealed in his letter that his attempt to buy Maytas companies was his last attempt to 'fill fictitious assets with real ones' and resigned as chairman of Satyam. In his letter he said, 'It was like riding a tiger without knowing how to get off without being eaten'. Raju brothers were arrested by the Andhra Pradesh police and booked for criminal breach of trust, cheating, criminal conspiracy and forgery under IPC. Satyam's auditors Pricewaterhouse finally admitted that its audit report was wrong as it was based on wrong financial statements provided by the Satyam's management and were arrested. Central government took control of the tainted company and reconstituted Satyam's board that included three-members, HDFC Chairman Deepak Parekh, former Nasscom chairman and IT expert Kiran Karnik and former SEBI member C. Achuthan. Three more directors were added to the reconstituted Board, i.e., CII chief mentor Tarun Das, former president of the Institute for Chartered Accountants (ICAI) T.N. Manoharan and LIC's S. Balakrishnan. Detailed enquiry had been conducted about the affairs of the company which revealed an audit failure from the part of PWC, deceptive reporting practices, lack of transparency in accounting and reporting, ESOPs issued to those who prepared fake bills, excessive interest shown by the directors in maintaining stock prices, high risk deals that went sour, greed and lack of ethical values of promoters and management, falsification of accounts. It also revealed that the company had overstated an Assets of ₹490 crores, shown fake cash balances over ₹5000 crores and understatement of liabilities worth ₹1230 crores in the Balance Sheet. Interest component of ₹376 crores which was shown in the account never flowed into the company's coffers. CFO Srinivas Vadlamani confessed of having inflated the number of employees by 13,000 and drawn ₹20 crores per month from fictitious salary accounts. Apart from Ramalinga Raju and his two brothers, other people were involved in the scam namely former CFO Vadlamani Srinivas, former PW auditors S. Gopalakrishnan and T. Srinivas, former employees G. Ramakrishna, D. Venkatpathi Raju and Ch. Srisailam and former internal chief auditor V. S. Prabhakar Gupta.

At the end, people lost a staggering ₹100 billion in Satyam in market capitalization as investors reacted sharply and dumped shares, pushing down the scrip by 78 per cent. Satyam was taken over by Tech Mahindra at ₹53 per share. Mr Raju and his associates were sentenced to seven years imprisonment by a CBI court.[12]

Case 14: C. R. Bhansali Accounting Fraud Case

C. R. Bhansali, a Chartered Accountant by education, belonged to a lower middle class family belonging to Kolkata. After completing his CA he started a financial consultancy firm called CRB Consultancy. With his personal contact he got huge business of providing issue management services of some well-known companies of Kolkata which enhanced his reputation significantly. He changed the name of the company to CRB Capital market and later converted to a public limited company in 1992. The company started a variety of businesses like merchant banking services, capital market service, bills discounting services, mutual fund business, asset management services, etc. He also started a few new entities such as CRB Mutual Funds and CRB Share Custodial Services. Within a short period these entities raised ₹84 crores equity through three public issues from 1993 to 1995. Through these entities he mobilized almost ₹900 crores from the investors for which he has to pay interest. For interest payment he borrowed funds from banks. The 1995 stock market crash created a bad situation on all the financial institution owned by him and his financial liability increased to ₹1200 crores.

In 1996, as a part of the surveillance activities, regulatory agencies started suspecting the company on the basis of a media report appeared saying that the company's wealth which was ₹2 crore in 1992 has grown to ₹430 crore in 1996. After that a series of reports appeared in the Indian media about the unfair business practices of the company and it played a significant role in unearthing the fraud. C. R. Bhansali was soon charged under various grounds like fraud, cheating, siphoning off funds from the SBI, etc., under various sections of CRPC. It was at that time the major stock scam in India Harshad Mehta incident happened and regulatory attention was directed towards it. By this time, he very cleverly transferred the investor's money worth ₹1200 crore and hide all these illegal actions from the eye of the regulators like the RBI, SEBI, etc. RBI had even considered issuing an in principle license for starting a bank to CRB while rejecting the applications of reputed business houses like TATAs and Birlas.[13]

Case 15: Ketan Parekh Stock Scam

Ketan Parekh, popularly known in the stock market circle as KP is another important name in the India stock market scam of contemporary period along with Harshad Mehta. KP, born in an upper middle class family, involved in stock broking and other connected activities, completed his Chartered Accountancy program and entered the stock broking business in Mumbai. He was very popular in the stock market circle as well as in media circle because of his razor sharp forecasts about stock market developments. Unlike Mehta who was very prominent in media circle and publicity campaign, KP was very subdued and not exposed to the media very much. He was actively involved in dealing in technology company stocks which has started to emerge as a big sector during the period from 1999–2001.

Parekh attracted the attention of market players and they kept track of every move of Parekh as everything he was laying his hands on was virtually turning into gold. As the technology industry began embracing the entire world, India's stock markets started showing signs of hyper-activity. Almost everyone, from investment firms which were mostly controlled by the promoters of listed companies to the foreign corporate bodies and the cooperative banks were eager to entrust their money with Parekh, which he in turn used to inflate stock prices by making

his interest obvious. Stocks of many technology companies increased ten times and twenty times within a few months by price rigging. When the prices of select shares started constantly rising, innocent investors who had bought such shares believing that the market was genuine were to stare at huge losses. These rigged stocks have been dumped in the portfolio of financial institutions like the UTI with his influence. He also formed a network of brokers from small exchanges and mostly purchased technology company shares in benami names for which he borrowed money worth ₹250 crore from The Global Trust Bank, as a reward for rigging its price at the time of its merger with UTI Bank. Parekh also secured ₹1000 crore as loan from the Madhavpura Mercantile Co-operative Bank despite the RBI regulations that the maximum amount a broker could get as a loan was ₹15 crore.

Immediately after the budget of 2001–02 when a huge sell order was placed on his favourite stocks crushed the inflated prices. Even the borrowings of Parekh put together could not rescue his scripts. The Global Trust Bank and the Madhavpura Cooperative were driven to bankruptcy as the money they had lent to Parekh was lost. Sucheta Dalal, the columnist, wrote in Times of India that 'it is yet another black day for capital market'. He was charged for speculation, operating dubious companies, etc., by the CBI which ended his two years of dominance in the stock market. CBI arrested him on the complaint lodged by the Bank of India. In this case, the SEBI also found prima facie evidence that he had rigged prices in the scrips of Global Trust Bank, Zee Telefilms, HFCL, Lupin Laboratories, Aftek Infosys and Padmini Polymer. Finally in 2008, he was convicted for the fraud. The SEBI also debarred him from stock market operations till 2017.

CONCLUSION

Transparency and a full disclosure of the affairs of the company on time to all the stake holders are the hall mark of good corporate governance. In recent years, due to the absence of fair reporting practices or by misuse of existing reporting framework several accounting and reporting frauds have been committed by corporations which led to their ultimate collapse. Organization of Economic Cooperation for Development (OECD) in its principle V says that corporate governance framework should ensure, that timely and accurate disclosure is made on all matters regarding the corporations including the financial situation, performance, ownership and governance of the company. Most of the committees on corporate governance like the Cadbury Committee, the Greebury Committee, the Hample Committee, the Birla Committee, the Narayana Murthy Committee and the latest Uday Kodak Committee also emphasized the need for a good reporting framework for good corporate governance. The Indian Companies Act 2013 gave a comprehensive list of items to be included in the annual reports and accounts while reporting to the stakeholders. Recently with the globalization of business, the need for convergence of reporting patter has emerged and integration work of individual country accounting standards with International Financial Reporting Standards (IFRS) have also started.

KEYWORDS

- AS
- Financial Reporting
- GAAP
- IAS
- IFRS
- Proceeds from IPO
- Related party transaction
- Risk Management

DISCUSSION QUESTIONS

1. Discuss the role of financial reporting in corporate governance.
2. What do you mean by convergence of accounting standards? State its relevance in the present corporate scenario.
3. Explain the medium of corporate communication with its internal and external stakeholders.
3. Explain the Birla Committee recommendation with respect to corporate financial reporting to stakeholders.
4. Explain the major recommendation of Narayan Murthy Committee on corporate governance in the area of financial reporting.
5. Discuss briefly the financial reporting framework under Indian Companies Act 2013.
6. Why financial reporting? State the financial reporting of Indian companies.
7. Briefly explain the financial reporting practices of Indian Companies.
8. What do you mean by IFRS? What are its objectives?

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11



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Whistle Blowing Mechanism and Corporate Governance

CHAPTER OUTLINE

- Introduction to Whistle Blowing
- What is Whistle Blowing?
- Elements of Whistle Blowing
- Why Whistle Blowing?
- Whistle Blowers
- Types of Whistle Blowers
- Whistle Blowing Process
- Whistle Blowing in PSUs
- Impact of Whistle Blowing
- Whistle Blower Act in India
- Whistle Blower Protection Under Clause 49
- Selected Cases of Whistle Blowing in Corporate Governance in India

Introduction

Contemporary corporate governance rests on the whistleblowing mechanism due to the fact that the mechanism itself has saved corporations from the possible failures. The sustainability of organisations is essential to protect the stakeholders and therefore, whistleblowing mechanism protects the stakeholders particularly, the employees and the investors. Corruption is often termed as a malignant growth on organisations leading to irreversible corrections in later stage. Whistle blowing mechanism ensures early detection or the tendency of organization in pursuing undesirable courses like unethical business practices, murky dealings, nepotism, collusion with independent agencies, political favours, flouting the norms of conventions and concepts of accounting. An analysis of a series of cases related to the whistleblowing mechanism across the countries reveal that at the later stage the mechanism itself has been legalized and the person(s) who pursues these kinds of activities are adequately protected. Corruption is a universal phenomenon particularly in the countries that are in a developing stage. Therefore, the United Nation Convention against corruption served as an important initiative towards arresting the menace of corruption and laying the foundation of the whistleblowing mechanism in the world. According to the Article 33 of the UN Convention against corruption, 'Each state party shall consider incorporating into its domestic legal system appropriate measures to provide protection against any unjustified treatment for any person, who reports in good faith and on reasonable grounds to the competent authorities, any facts concerning offences established in accordance with this Convention'.

The Whistleblowing mechanism has to play an important role in checking the corruption and the maladministration of companies.

The Whistleblowing mechanism has to play an important role in checking the corruption and the maladministration of companies. This mechanism is often complex and is more situational. It comes to the notice only when the present or the future rights of individual or individuals are denied due to the maladministration. In India, both at national level and corporate level increased questioning of corruption has taken place and therefore, several incidence of whistleblowing has taken place in this country. The collapse of Satyam Computers (2009), 2G spectrum Scandal (2013) are the classic examples of blatant misuse of power and gained world attention in terms of taking a united stand against corruption. This has reversed the approach of 'taken for granted' for practically everything.

Why Whistle Blowing in the Corporate Governance?

Whistle blowing has to play a greater role in corporate governance. The corporate governance is incomplete without whistleblowing. It creates confidence in the stakeholders and it is also seen as an early warning signal in the imminent threat to organisations on its existence. Many developed countries like the USA; the UK have enacted proactive law in ensuring and encouraging whistleblowing mechanism through the enactment of stringent laws. This is due to the fact that the economic dominance of such countries is built upon the sound and fool proof corporate entities. The employment and the post-employment life of individuals of such countries depend on sound corporations. These corporations have representations in different parts of the globe. A sound and effective whistleblowing mechanism is very much needed in such countries. The past disclosure of corruption in corporate entities came into public attention only through whistleblowing mechanism, and not through the revelations of public confession, or through audit report. Some of the prominent examples of whistle blowing are Sherron Watkins, who was one of the few people inside Enron who voiced concern about accounting five months before its collapse and when Harry Templeton challenging Robert

Maxwell's plundering of the pension fund, better known as 'the Maxwell Saga' in the UK Board of directors discovered the accounting fraud through the efforts of company's whistleblowers. Cynthia Cooper, the internal auditor and her subordinates investigated the unusual accounting entries at WorldCom's wireless division in early 2002. Sankar Sarma of Tata Finance rescued the company from a possible collapse. In some cases, media also came into picture due to the absence of a suitable ecosystem in corporations for bringing into light the unfair practices taking place in organisations.

What is Whistleblowing?

Raising a concern about a malpractice within an organisation or through an independent structure associated with it. Whistleblowing is defined as an act by an individual who believes that the interest of the public overrides the interests of the organisation he or she serves. The act of whistleblowing can have an extraordinary influence on the organisation, on the society and on the whistleblower. There are six elements contained in whistle blowing. These are:

Whistleblowing is raising a concern about a malpractice within an organisation or though an independent structure associated with it. It is an act by an individual who beleives that the interest of the public overrides the interests of the organisation he or she serves.

- The whistle blower
- The disclosure subject (the act that was perceived)
- The act of disclosing the wrongdoing
- The target organisation
- A recipient to whom the disclosure will be made
- An outcome

The Whistle Blower

A whistleblower is an employee or any authorized person who makes an unauthorized disclosure of information about criminal or irregular conduct of business or activities which are detrimental to the functioning of an organisation.

There is no universally accepted definition of whistleblowing. Some definitions of whistleblowing distinguish between an authorized and an unauthorized disclosure. Typically, whistleblowing is seen as an unauthorized disclosure of information when the whistleblowers report wrongdoing in the wrong way, i.e., along the wrong channels; the information is of a sensitive nature; or the person making the disclosure is not considered sufficiently senior in the organisation to make the disclosure, thus relating to the status of the individual. Unauthorized whistle blowing causes negative responses from the organisation. Unauthorized whistleblowing triggers unprecedented ripples in the organisation, setting in motion unpredictable actions from the higher echelons of the organisation. Even though whistleblowing is legalized by some countries, still it causes a feeling that such acts are unauthorized, unwarranted and therefore, administrators in most of the cases take it negatively. People generally believe that whistleblowing has the sanction of the law and has a wider acceptance in the organisation but it is not encouraged, instead it is more regulated or even suppressed. This leads to a situation, where in most of the cases, the whistleblowers opt for the unauthorized route to express the wrong doing on the part of the individuals or the authorities. In some cases the authorities may block the channels of whistleblowing or deliberately create an ecosystem where whistleblowing can not take place. This again takes the whistleblower to an unauthorized rout to expose the wrong doings. These factors may lead to an unauthorized disclosure when a whistleblower is forced to report 'over someone's head', i.e., to go to some external regulatory bodies or the media to try and solve the problem. The whistleblower's report is

then seen as unauthorized disclosure, which is counterproductive, as it usually only leads to further negative responses.

Disclosures may be considered unauthorized for a number of reasons. If the disclosure exposes highly sensitive or classified information (protected by confidentiality agreements or secrecy clauses) to the parties that the organisation believes should not have access to such information, the organisation sees the disclosure as unauthorized.

Perceived Organisational Wrongdoing

Most definitions agree that whistleblowing relates to a perceived organisational wrongdoing. In order for a disclosure to take place, the whistleblower must witness an incident or practice, or set of incidents or practices, as incorrect and improper behaviour. This observation then causes the whistle blower to disclose the perceived wrongdoing and the disclosure may only take place once such a perception exists. However, the wrongdoing must also be perceived as important for the individual to disclose it.

The Disclosure

Most definitions agree that the disclosurer must be an employee or former employee or any other insider or someone closely associated with the organisation within which the wrongdoing has occurred or is occurring. Former employees are included in this definition because individuals often leave an organisation as a result of whistleblowing. It is important to note that because of such individual's prior involvement in the organisation that he or she has developed a perception of organisational wrongdoing. Whistleblowing, whether by an employee or a former employee, is usually directed at an authority that may offer, or facilitate, a solution to correct the wrongdoing. Whistleblowers are typically employees who are subordinates and who aim to change the workplace for the better. As such, they may be seen as political agents who want to change the way things are done within an organisation. Because such subordinates in effect challenge their superiors anticipating harsh retaliation.

Wrongdoing

Most experts see a wrongdoing in an organisation as including unethical, illegal or harmful practices in the organisation of which the whistle blower is a part. Wrongdoing may include '… criminal activity, contravention of any statute, improper or unauthorized use of public and other funds, miscarriage of justice, the abuse of power, maladministration'. Typically, two categories of wrongdoing are found. Firstly, as an organisational crime, that is committed on behalf of the organisation by one or more of its employees, officers or managers or directors with the primary purpose of increasing organisational wealth. Organisational crime may also benefit the individuals involved, for if the organisation benefits, then certain individuals or groups within the organisation will benefit as well. For instance, where there is a contract fraud, money laundering, price fixing, or cost-cutting activities, the organisation and the person committing the wrongful acts feel the threat. This is why many disclosures will be either kept away from reporting the wrongdoing, or treated very harshly if they do report it.

Wrongdoing may include a criminal activity, contravention of any statute, improper or unauthorized use of public and other funds, miscarriage of justice, the abuse of power, maladministration.

Secondly, some occupational crimes include acts of wrongdoing which are purely for self-interest. Occupational crimes are committed primarily to increase individual wealth. It must be noted that syndicates functioning within a company to defraud it for a direct individual and personal benefit may also be viewed as occupational criminals. Counter productive work activities including abuse on the job, coming to work late or leaving early; taking unauthorized work breaks, prohibited personnel practices (such as discrimination and sexual harassment), financial fraud (such as embezzlement and overcharging for business expenses, falsifying time cards), and poor production or service activities (such as defrauding customers by low quality service, abuse of clients) are also considered as wrongdoing.

The Outcome

The goal of whistleblowing exercise and its outcomes sometimes differentiate any disclosure relating to some wrongdoing by a whistleblower from other forms of disclosures. In a whistleblowing, the blower has only good intention of preventing the wrongdoing and protecting the organisation from the harmful effect of such wrongdoing. The whistleblower never acts in a negative manner to defame the organisation and the person(s) who are involved in the wrongdoing. Instead, the whistleblower is always in a positive frame of mind and wants to avoid wrongdoing or repeat the wrongdoing in future leading to corporate failure and consequent loss. Moreover he/she makes a sincere effort in all possible manner with in his/her limit to discourage the person involved in wrongdoing. Only after that he/she makes the disclosure. On many occasions, the person involved in the wrongdoing will not listen to it or some time will oppose what the whistleblower is exposing as the wrong doing and initiate retaliation measures including projecting the whistleblower as a spy or somebody not interested in the welfare of the origination or a person believing in the traditional business models, etc., against the whistleblower. It is basically proactive in nature rather than reactive.

Following are the examples of wrongdoing:

- Misconduct of material gain (such as bribery, corruption, theft of money and property, using official position for services/favours, giving unfair advantage to the contractor, making false/inflated claims for reimbursement, etc.)
- Perverting justice or accountability (such as covering-up corruption, unlawfully altering or destroying official records, hindering an official investigation, etc.)
- Conflict of interest (such as intervening in a decision on behalf of a friend or relative, failing to declare financial interest, etc.)
- Improper or unprofessional behaviour (such as sexual assault and sexual harassment, racial discrimination against a member of the public, being drunk/under the influence of illegal drugs at work, misuse of confidential information, etc.)
- Defective administration (such as producing or using unsafe products, acting against public policy, regulations or laws; incompetent or negligent decision making; endangering public health or safety, etc.)
- Personnel or workplace grievances (such as allowing dangerous or harmful working conditions; racial discrimination against a staff member; favouritism in the selection or promotion, etc.)
- Waste or mismanagement of resources (such as negligent purchase or leases, inadequate record keeping, etc.)
- Non-compliance of laws and regulations.
- Illegal activities, unethical and improper practices relating to financial and accounting matters and standards.

Whistleblowers and Informants

Whistleblowers are usually a category of informants who take utmost risk in bringing out certain undesired happening taking place in organisations. The quantum and the quality of risk taken by them has seldom a parallel in the history of organisation. The interest and intention of the whistleblower is often to mitigate the loss arising out of the wrongdoings of the insiders of organisations. Insiders on the other hand, may have genuine interest and in most of the cases they are nuisance or troublemakers for the organisations. They are usually involved in the unethical affairs and use disclosure of information for clarifying their own role, or reduce their own liability. But common among the whistleblowers and informants are that they work for some category of the stakeholders.

The interest and unkown of whistleblower is often to mitigate the loss arising out of the wrongdoings of the insiders of organisations

Types of Whistleblowers

1. **Peer-reporting:** Whistle blowers may come to act against their superiors or their peers. When the whistleblowing involves the disclosure of information regarding a peer's illegal, immoral or harmful practices, it is referred to as peer-reporting. Research on the group behaviour has found that the members of the organisation generally react more negatively to the peer reporters than to the whistleblowers Peer-reporting usually involves the reporting of individuals committing occupational crime, as such crimes are committed to directly benefit individual(s) who desire to increase their own personal wealth. Peer-reporting can also relate to organisational crime and does not focus on occupational crime only. Newly appointed employees are less likely to report a wrongdoing as they might fear a fellow employee or the group retaliation or being ostracized. Reporting to the proper persons, the Whistleblowers have two ways of reporting the organisational wrongdoing, namely to authorities within the organisation, or regulatory authorities outside the organisation and therefore two main forms of whistleblowing can be identified, namely internal and external whistleblowing.
2. **Internal whistleblowing:** It refers to reporting to people or managers within the organisation who are higher up in the organisational hierarchy. Those who receive internal complaints may be direct line managers, human resource representatives, chief executive officers, members of an executive council or board of directors. Internal whistleblowing may be via existing communication channels such as hotlines or via unauthorized communication channels. For example: e-mail, if that is the only way.
3. **External whistleblowing:** It refers to the disclosure of information outside the organisation and includes media, politicians, public protectors, government bodies, regulatory bodies, interest groups and enforcement agencies. The appropriate whistleblowing procedure is for the whistleblower to report firstly internally, and then, if that does not succeed, to approach an external law enforcement agency and finally, if that does not work, to report to the media, or to the politicians, both of whom may also be considered external complaint recipients. However, where the media and the politicians have received complaints of and exposed wrongdoing, they are not seen as whistleblowers since they are not members of the accused organisations. They are merely a channel through in which the whistleblower, a member or former member of the organisation concerned, can report and hopefully remedy the wrongdoing. Journalists and politicians may also be seen as whistleblowers if they expose crime and corruption within an organisation they belong to or represent. Whistleblowing is said to be authentic when

the disclosure of information is consistent with the greater good, i.e., in the interest of the public. If whistleblowing is seen as a tool to reveal fraud and corruption rather than to gain personal benefit, then it is seen as a prosocial behaviour, since it is in the interest of the public.

Malevolent whistleblowing, on the other hand, is when the whistleblower stands to gain personally, or when the individual engages in whistleblowing to leverage his or her position within the organisation, i.e., when prosocial benefits – if any – are secondary. Whistle blowing is (a) deliberate action(s) that follows on the whistleblower's moral need to protect the organisation and the public from harm.

External disclosures raise legal and ethical issues of business confidentiality. Disclosures also affect the relationships between business, the state and the media. An external disclosure usually involves at least some regulatory intervention, and inconvenience and, at the worst, unjustified negative publicity. This will cause an unnecessary damage and disruption to the organisation, which would have dealt with the matter if it had known about it. In most legal systems, there is no protection for an employee who makes an external disclosure even if it is in good faith, justified and reasonable. Such disclosures are therefore often made anonymously. This raises a number of issues. Anonymity will be the cover preferred by a malicious person. Anonymous reporting also makes it difficult to investigate the matter, and even impossible to rectify it. Anonymity, however, is no guarantee that the source of the information will not be figured out. Where the person is identified, the fact that he or she acted anonymously will often be seen as a sign of bad faith, jeopardizing the person's position, or at the worst, costing the person his or her career. Their plight then attracts media attention, which can only discourage others from disclosing any wrongdoing at all. The near certainty that an external disclosure will lead to serious reprisals means that the matter is often not raised until the employee leaves the organisation. By then the problem may be much worse, the evidence will be outdated, and the whistleblower may allow the information to be used to damage or even blackmail the organisation.

4. **Open and anonymous whistleblowing:** Open whistleblowing is when the identity of the whistleblower is known to the public through the disclosure of the identity, while the anonymous whistleblower whose identity is kept secret as in the case of Mr Shankar Sharma who disclosed the wrongdoings in Tata Finance. Mr Shankar Sharma whose name is still a mystery and the interesting feature is whether such an individual exists or not.
5. **Dutiful and freewill whistleblowers:** Dutiful whistleblowers are those who are generally given the responsibility to bring to light any wrongdoing in the organisation, for example, auditors of the company are expected to report any malpractices in financial statements. Freewill whistleblowers are those who are not bound by any obligation, but they themselves take this step of reporting the wrongdoing.

The Factors Influencing the Whistleblower in Disclosing Wrongdoing

"One stone is enough against fifty clay pots".—Ethiopian proverb

A whistleblower is an employee making an unauthorized disclosure of information about criminal or irregular conduct along avenues that are not specified. This definition implies that a whistleblower is not protected under the

Whistleblowers may blow the whistle on sexual harassment, fraud, inadequate health and safety measures, harmful practices, breaches of regulatory requirements, money skimming, or any other form of corruption.

protected disclosures. Whistleblowers come from all the levels of an organisation and even from outside, although in many countries, legislation does not protect the latter. Whistleblowers may blow the whistle on sexual harassment, fraud, inadequate health and safety measures, harmful practices, breaches of regulatory requirements, money-skimming, or any other form of corruption. The following factors influence the whistleblowing and its possible impacts.

- **The credibility of the whistle blower:** if people are trusted, such an action may be taken seriously.
- **The motivation of the whistle blower:** if there are any suspicions about the reasons why someone chooses to blow the whistle, chances are that the complaint will not be heard.
- **The perceived validity of the evidence:** it is rather than the perceptions or the motivations of the whistleblower should be the most important reason for taking a disclosure of wrongdoing seriously.
- **The position of the whistle blower:** the power and status often influence the capacity of an individual to influence management.
- **Membership of minority groups within an organisation:** females or members of underrepresented ethnic groups may find it harder to be heard.

As stated before, whistleblowers can come from all the levels of an organisation and even from outside the organisation, although some countries do not protect the so called outside whistleblowers. Whistleblowers may expose sexual harassment, fraud, corner-cutting with regard to health or safety, and many other acts that are not in the interest of the organisation or of the public.

The Whistleblowing Process

The whistleblowing process requires that certain steps be followed to '… increase authorized disclosures made in good faith in public sector organisations'. The following five steps are involved in the whistle blowing process:

Step 1: Reduce opportunities to commit unethical or illegal conduct. New employees must be screened effectively and there should be no opportunities that could motivate unethical or illegal conduct. Regular reinforcement should also be done to motivate employees to avoid any wrongdoing through, for example, the enforcement of the Public Service Code of Conduct.

Step 2: Establish if the observed activity is actually wrong. An activity will be wrong if it is illegal, unethical or illegitimate and the decision to report the perceived activity should be determined by the seriousness of the act and if the reporting is effective, there is no other actions that can be taken and that the personal position of the whistle blower do not influence the decision.

Step 3: Use internal mechanisms in the organisation to raise concerns. Critical information systems or internal reporting mechanisms must be in place in the organisation at an appropriate level to ensure that employees follow the correct internal channels and not the damaging external channels, like a regulator or the media.

Step 4: Organisational policies/procedures must be used.
If the correct procedures/policies are used within the organisation, the damage and disruptions can be minimized and the situation is rectified internally and rapidly. Once the whistle has been blown, the organisation should take action and investigate the matter, even if there is a dispute

as to whether or not the activity is legitimate or not. The organisation might choose to take steps or ignore the whistleblower, depending on the policies/procedures of the organisation. Camerer (1996:48) states that there is a danger here in an open door policy run by a corrupt management which might work against the whistleblower and serve the purpose of identifying the troublemaker to be rejected.

Step 5: External whistleblowing

As a last resort, one can justify external whistleblowing if all internal channels have been exhausted, are unavailable or unusable, or when organisational policies/procedures are not in place. Whistleblowers often choose the external channel if they are of the opinion that the case might be treated as more credible and that more attention will be attracted and that corrective actions can be ensured. It is important to thus reduce the opportunities for irregular or criminal conduct to take place; one also needs to determine if the perceived act is in fact incorrect and if so, it must be reported first by making use of internal channels according to prescribed procedures or policies. If the desired effect is not achieved, for example, an approved report from an external auditor or occupational detriment is feared, and then external whistleblowing will be the only alternative. When a person notices an action which might be criminal or irregular, he or she needs to determine if the action is in fact incorrect. Once it has been determined that the action is irregular or criminal, the observer will have to decide whether or not to blow the whistle. If the decision is made to blow the whistle, then ideally the organisation will have internal structures (or even a person) by which the disclosure can be made. If all attempts have failed to disclose successfully and internally, only then, external whistleblowing be considered.

In practical terms, if someone is concerned about corruption or serious wrongdoing in an organisation, he or she has the option to stay silent; to blow the whistle internally or with the responsible person; or to blow the whistle outside, either to the authorities or to the mediator or both. An internal channel refers to the disclosure of sensitive issues to coworkers or management within the same organisation. External channels refer to disclosures to those outside of the organisation such as the media or government organisation. The dilemma of the potential whistleblower may in part be due to economic dependence and in part to duty to keep the employer's business confidential. Besides the real fear of victimization resulting from such disclosures, a primary dilemma involves the conflicting loyalties between the desire to follow intrinsic moral beliefs and expose misconduct, and the organisational pressures to conform to a culture of loyalty and confidentiality, even though these may be misplaced.

In practical terms, if someone is concerned about corruption or serious wrongdoing in an organisation, he or she has the option to stay silent; to blow the whistle internally or with the responsible person; or to blow the whistle outside, either to the authorities or to the mediator or both.

An effective internal system of whistleblowing adopted by companies includes the following:

- Respect for the confidentiality of staff members raising concerns if they wish and an opportunity to raise their concerns outside the line of management structure.
- A clear statement that malpractice has taken seriously in the organisation and an indication of the kinds of conduct regarded as malpractice.
- Penalties for making false and malicious allegations.
- An explanation of the proper way in which concerns may be raised outside the organisation, if necessary.

Organisational Responses to Whistle Blowing

Internal or External Whistle Blowing

Internal whistleblowers are more likely to be dismissed immediately in order to silence or intimidate the employee, as internal reporting is viewed as a challenge to the authority structure in the organization. The external whistleblowers receive worse retaliation than the internal whistleblowers. Most of the whistleblowers experience some form of retaliation and this is not without consequence for the the whistleblower and the organisation.

Discussions with Colleagues

In determining whether or not to disclose organisational wrongdoing, employees might assess the severity of the wrongdoing, personal role and responsibility, and the perceived threat of retaliation, the organisational culture and group norms regarding the disclosure to peers. Some potential whistleblowers ask colleagues how they feel about the situation, to try and get more information about the wrongdoing, or to try to understand how the organisation might act in response. These talks may cause the employee who finds that there is a culture of silence, or that there is little organisational support for those who report wrongdoing, to keep quiet. This is especially true if there is a lack of trust. On the other hand, if the employee realizes that the culture of silence is not acceptable, the talks with colleagues will not change his or her mind. The talks with colleagues are a form of non-reporting, and so is silence, and both are dangerous. Non-reporting and especially employee silence, as an alternative to whistleblowing should therefore not be encouraged. Once the whistleblower has decided to blow the whistle, various steps can be followed. Whistleblowing is an obvious operation and concerns making public certain issues by an individual acting on his or her own, believing that both his or her motives and the accusation made will stand up to public examination. There are four components of whistleblowing

- An individual executes an action or a series of actions intended to make public information about an alleged act of wrongdoing.
- The information becomes a matter of public record. Successful whistleblowing requires that information becomes public and that it be accessible to others as part of a formal or open record.
- The information is about possible or actual wrongdoing in an organisation, such as dangerous, illegal or unethical activities in the organisation.
- The individual who makes the information public is not a journalist or an ordinary citizen, but a member or a former member of the organisation. Thus, whistleblowers sound an alarm from within the very organisation within which they work, aiming to spotlight the neglect or abuses that threaten the public interest.

Whistle Blowing in the Public Sector Undertaking

- As the government is entrusted with certain responsibilities, such as national security, confidentiality would be of the utmost importance and a breach of confidentiality through whistleblowing could have damaging effects on everyone.

- A public official may resort to the whistleblowing if the conduct of another official is gravely offensive to the standing and the fundamental interests of the public.
- The changing character of political heads could lead to a conflict of interests occurring between the public sector and the government. Whistleblowing occurs, therefore, whenever individuals take it upon themselves to point out what they believe to be an unethical or irregular behaviour. Such action is often met with a great deal of resistance from others in the organisation. Superiors often view such actions as being an insult to their authority or as a challenge to the organisational imperative, which they find useful to protect. Colleagues and subordinates are often unwilling to express their support either for fear of losing their own jobs or because of the fear for the future of the organisation. If public officials had accepted the correct ethical values and behaviour, then whistleblowing can be an effective measure that can be used by the government in its campaign against corruption.

Impact of Whistleblowing: Negative and Positive

The process of whistleblowing triggers a series of actions and reactions in organisation and the individuals that matters. The whistleblower is not only concerned about the loss of employment opportunities where he works but also affects his future employment. In some cases, it is a threatening for the life of self and family. It may lead to quarantining from the colleagues and in some cases, the best friend may turn hostile. Whistleblower might have to face legal actions leading to personal harassment coupled with high expenditure on legal action and loss of revenue due to the loss of employment. Some of the consequences are listed below.

- Abuse and anger from the people directly or indirectly involved in the wrongdoing.
- Whistleblowers may face hostility and resentments from his peers and superiors.
- He may face an awkward social surrounding and stilted relation with his employers.
- He may be compelled to leave the organisation.
- He may be demoted from the position.
- He may be transferred to a less desirable location.
- In an extreme situation, his family, health and or life might be in jeopardy.
- It may put him into isolation from the rest of the organisation.
- His credibility and future job opportunities may be at risk.
- Reputation of organisation against which whistle has been blown may be at stake.
- The whistleblower may feel restlessness, fatigue, headache, insomnia, anger, anxiety and disillusionment.

However, there are some positive outcomes as well. After the whistleblowing, at least in certain cases, he has the image of a hero. Rewards may follow. The positive outcomes are listed below.

- Promotion.
- Increased salary.
- High reputation.
- Getting a higher assignment where responsibility is expected.
- Financial rewards like perks, awards, bonus, etc.
- It changes the organisation culture that prevails.
- Motivate the transparency and the trust in organisation.
- It encourages the organisation to venture into risky areas.

Whistle Blowing Policy of Organisations

Organisations that intend to pursue its activities in high ethical order will frame policies for whistleblowing and thus frame a conducive ecosystem for whistleblowing. The main purpose of the whistleblowing policy is to bring a platform to the management and officials responsible for the governance without any fear or favour. Whistleblowing policy must provide confidentiality with respect to information and the identity of the informer. It should provide for the protection of whistleblowers and quick action against the wrongdoings. This could be achieved only when the designated authority dealing with whistleblowers are independent, senior and responsible. Whistleblowing policies are common in the developed countries of the world.

Elements of Whistleblowing Policy

Law protects the whistleblowers from a hostile attitude from superiors, peers and subordinates. Therefore, good whistleblowing policy should consist of the following:

- Manager should address disclosures of wrongdoing to avoid damage to individual or organisational reputations and other negative consequences.
- All parties in the problem involved must be adequately heard and proper recordings be made.
- Explain how the whistleblower is protected as per the policy of the company as well as the law prevailing in the country.
- State the good intention of the company in promoting the whistleblowing within the company.
- Specify the consequences if the guilt is proved and the seriousness and severity of the measures taken after the whistleblowing.
- Specify how the immunity is provided on staff who have positively contributed to the entire episode of whistleblowing.
- Obtain the feedback obtained from the parties involved in the whistleblowing.
- The time-frame must be specifically mentioned in finding solutions to issues involved in the whistleblowing.

Benefits of Good Whistleblowing Policy

- It fosters good governance based on strong foundations of corporate ethics.
- It fosters a good ecosystem in organisation conducive for whistleblowing.
- It prevents corruption and nepotism in organisation and promotes governance based on professionalism and competence.
- It promotes CSR in organisations.
- It promotes a good employer-employee and employee to employee relationship.
- It discourages management, administration and employees from committing mistakes and wrongdoings.

OECD Initiatives on Whistle Blowing Protection Law

Economic liberalization initiated all over the world has put severe challenges to business and industry. The opening up of economies to foreign competition, the removal of barriers to business and the free flow of capital across nations impose

a pressure on business to satisfy the shareholder's expectations. Companies started working with non-conventional business models to satisfy themselves and sometimes, shareholders. The Corporate frauds have also become part and parcel of the business. During the last thirty years, all over the world , we have seen a large number of corporate scams leading to corporate failures and a consequent loss of shareholder's wealth. These scams include illegal use of accounting loopholes, creation of special purpose entities, entering into highly risky ventures, price rigging, and other type of activities without the knowledge and permission of investors. Moreover the ethical behaviour on the part of management also increased to withstand in the market place. Among several checks and control measures initiated to discourage unethical behaviour and wrongdoing whistleblowing mechanism is an important one. Employees and other people in the organisation are stakeholders who firstly know the unethical and illegal activities of management. But most of them are reluctant to disclose these unfair behaviours on time so as to enable the regulators or authorities to take corrective action and save the company, fearing retaliation, such as intimidation, harassment, dismissal or violence by their fellow colleagues or superiors. They are even linked to treachery or spying.

Whistleblower protection is, therefore, essential to encourage the reporting of misconduct, fraud and corruption. Providing an effective protection for the whistleblowers supports an open organisational culture where employees are not only aware of how to report but also have confidence in the reporting procedures. It also helps the businesses prevent and detect bribery in commercial transactions. The protection of both public and private sector whistleblowers from the retaliation for reporting in good faith suspected acts of corruption and other wrongdoing is, therefore, integral to efforts to combat corruption, safeguard integrity, enhance accountability, and support a clean business environment. OECD has made several recommendations on improving ethical corporate behaviour during the last several years. This includes, the 1998 OECD Recommendation on Improving Ethical Conduct in the Public Service including the Principles for Managing Ethics in the Public Service, the 2003 OECD Recommendation on Guidelines for Managing Conflict of Interest in the Public Service. The 2009 Recommendation of the OECD Council for further combating bribery of foreign public officials in international business transactions also provides for the protection of whistleblowers in the public and the private sectors, the introduction of whistleblower protection requirements in the United Nations Convention against corruption, the preparation of guiding principles for whistleblowing protection law with the approval of G20 nations anti-corruption working group. The OECD also developed a Compendium of Best Practices to provide available options in various contexts for the decision-makers in designing and implementing whistleblower protection rules in line with the G20 Guiding Principles for Whistleblower Protection Legislation. A check list was prepared for this purpose and the check list includes the following:

Whistleblower protection is, therefore, essential to encourage the reporting of misconduct, fraud and corruption.

1. Is there a **comprehensive and clear legislation** in place to protect from retaliation, discriminatory or disciplinary action, employees who disclose in good faith and on reasonable grounds, the suspected acts of wrongdoing or corruption to competent authorities?
2. Are there effective **institutional frameworks** and **clear procedures and channels** in place for facilitating the reporting of wrongdoing and corruption?
3. Are **protected disclosures** and **persons afforded protection** clearly defined?
4. Are retaliatory actions clearly defined and is the **protection** afforded **robust and comprehensive**?
5. Are **remedies and sanctions** for retaliation clearly outlined?

6. Is **awareness-raising** regularly undertaken to encourage the reporting of wrongdoing and corruption and to disseminate existing information on the protection of whistleblowers?
7. Is the effectiveness in the practice of the whistleblower protection framework periodically evaluated and reviewed?[1]

Whistleblower Laws in India

The issue relating to the protection for whistleblowers in India caught attention of the entire public in November 2003 when Satyendra Dubey the project director of the National Highway Authority of India (NHAI) was killed. His tragic death came after he had written to the office of the Mr A. B. Vajpayee, the then Prime Minister, detailing corruption in the golden quadrilateral highway construction project. In his letter, he had requested for maintaining secrecy in relation to his identity. However, the letter was forwarded to various concerned departments without making Dubey's identity. Dubey's attempt to fight corruption which is largely prevalent in the country followed by his murder led to a public outcry at the failure to protect him. As a consequence, in April 2004, the Supreme Court of India pressed the government to issue an office order, the Public Interest Disclosures and Protection of Informers Resolution, 2004. This resolution designated the Central Vigilance Commission (CVC) as the nodal agency for handling complaints on corruption.

Another incidence of similar murder of Manjunath Shanmugham, an IIM graduate, and a sales manager of the Indian Oil Corporation on 19 November 2005 once again shocked India. He got killed for exposing the racket of adulteration of petrol and the mafia behind it. This incident brought renewed focus on the need for a law to protect whistleblowers. The killings of whistleblowers such as Dubey, Shanmugham and many more RTI activists by anti-social elements with vested interests have prompted the government to draft a bill on whistleblowers protection, known as Public Interest Disclosure (Protection of Informers) Bill 2010. Ultimately, the Whistleblowers Protection Bill, 2011 was approved by the cabinet as part of a drive to eliminate corruption in the country's bureaucracy, passed by the Lok Sabha on 27 December 2011, by the Rajya Sabha on 2 February 2014 and received the President's assent on 9 May 2014. The law was further amended in 2015.

Whistleblowers Protection Act 2014

The Act was envisaged to protect the stakeholders from corruption and stable performance of companies in India. The Central Vigilance Commissioner is the competent authority to deal with corporate corruption. False complaints or cooked up complaints are discouraged and the law imposes two years imprisonment and a fine of ₹30,000 for the persons who file false and frivolous complaints. The major highlights of the Act are as follows:

Disclosure

The Act provides that any public servant or any other person, including a non-governmental organisation may make a public interest disclosure to a competent authority, i.e., Central Vigilance Commissioner or State Vigilance Commissioner.

Procedure of Inquiry

The Vigilance Commissioner first ascertains the identity of complainant and has to protect such identity, unless the complainant has revealed it to any other authority. If the commissioner is convinced about the substance of the matter, inquiry is initiated and facts are collected and the steps to prosecute the guilty are taken. The appropriate court can take criminal proceedings against the guilty. But if any inquiry is already initiated by any court or tribunal based on any public interest litigation, the Vigilance Commission is exempted from further proceedings. The Section 11 of the Act also exempts the disclosure of proceedings of the cabinet if it is likely to affect the sovereignty of India, the security of the country, matters affecting the friendly relations with foreign states, public order, decency or morality which has to be certified by the Secretary to the State or Central Government.

Protection of the Persons Who Make Public Interest Disclosures

The Act protects the whistleblowers, who brings the wrongdoings of person or persons at the larger interest of the public, from harassment, the loss of employment, victimization, etc. The Vigilance Commission shall protect the identity of the complainant and related documents, unless it decides against doing so, or is required by a court to do so.

Penalty

The Act aims to balance the need to protect the honest officials from undue harassment and protecting persons making a public interest disclosure. It punishes any person making false complaints. The Act lays down that for not furnishing reports to the Vigilance Commission, a fine of up to ₹250 shall be imposed for each day till the report is submitted. However, total penalty shall not exceed ₹50,000. When a person knowingly makes false or misleading disclosures with mala fide intentions, the penalty is 2 years imprisonment and a fine of ₹30,000.

Whistleblowers Protection Under Clause 49 of the Listing Agreement

Clause 49II(F) of the Listing Agreement on the Whistleblower Policy effective from 1 October 2014 provides the following:

1. The company shall establish a vigil mechanism for directors and employees to report concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics policy.
2. This mechanism should also provide for adequate safeguards against victimization of director(s)/employee(s) who avail of the mechanism, and also provide for direct access to the Chairman of the Audit Committee in exceptional cases.
3. The details of the establishment of such mechanism shall be disclosed by the company on its website and in the Board's report.

Role of Whistle Blower in Corporate Governance: Selected Cases

The Tata Finance Case: A Successful Whistle Blowing Case

The Tata finance fraud case of 2001 was an important successful whistleblower (named as Shankar Sharma) intervention in exposing ₹2700 crore fraud committed by the Managing Director and his close associates during 2001. The Tata Finance was started as a Private Limited Company in 1984 with an equity capital of ₹2.5 crore, converted into Public limited company in 1985. It was an NBFC from the house of the TATAs mainly to provide vehicle finance. The company has, at present, a market capitalization ₹1062 crore, turnover ₹18,000 crore, and 8000 employees. Company had a borrowing of ₹2700 crore of which ₹875 crore were from millions of small depositors.

On 12 April 2001 the directors the Tata Finance, the SEBI the market regulator and several leading newspapers of Mumbai received a letter written by one Mr Shankar Sharma (the identity of the man is unknown) making some serious allegations against the Tata Finance and the Managing Director Mr Dilip Pendse. The allegations include serious frauds committed by the Managing Director and false information provided by the company in its prospects issued for the right issue preference shares. Initially, the members of the Tata sons and financial experts who know the value system of the Tata group did not believe it as they never expect the Managing Director of a Tata company himself would be involved in a fraud and provide false information in prospectus because tilldate the moral values and ethics of the company never allowed any senior executive to commit a fraud. Moreover the internal control system and audit system was so perfect that it was not possible to commit such a fraud in any of the Tata companies. Anyhow it was a shocking news of how things went terribly wrong in the Tata Finance. In an article published by the Tata Group Publication on this subject titled as 'Grime and Salvation' by Mr Ishaat Hussain, the Finance Director says, 'That letter altered us and further investigation revealed that there had indeed been some serious irregularities'. He goes on to add, 'We were all taken aback'.

After the initial denial of the incident by the Tata group, the top management realized that something went wrong in the Company and the smoke in the form of the letter is an indication of a big fire. After the initial anger and dismay the Company top management realized the fact and decided to act on the issue in the most transparent manner urgently. On 25 July 2001 through an extraordinary public statement the management admitted that some fraud has taken place in the Tata Finance and the company is in some financial trouble but the Tatas will ensure that no depositors will lose their money deposited. The management arranged ₹615 crores through its two holding companies the Tata Sons and the Tata Industries with cash and corporate guarantee for meeting the liabilities of all depositors. After the initial rush for withdrawal of deposits in front of the company offices, queues started disappearing in front of the Tata finance branches. A vast majority of depositors retained their deposits with the Tata Finance itself despite this fraud case. The way in which the situation was handled and a swift response in action had gained applause from everyone.

After the successful handling of the depositors issue, the company started addressing the second issue of finding out the culprit and punishing them appropriately. An efficient investigation team consisting of internal team and external financial experts, legal experts and independent chartered accountants was formed to investigate the issue. The investigation team evaluated the relevant

document and questioned the Managing Director and the senior executives of company and reported that Tata Finance led by Mr Dilip Pendse, had lent approximately ₹525 crore to two of its own subsidiaries companies called Nishkalp Inshallah Investments and Niskalp Investments to buy various stocks such as Himachal Futuristic Communications and Veerangana Software. A large part of this money had been invested in the scripts of poor quality in stock market. Many of these transactions were carried out to secure personal gain to the Managing Director and some directors. When these scripts crashed in the stock market original investment vanished and the people involved in it could not substitute with finance from their personal source. They were prosecuted as per law. The identity of Mr Shankar Sharma is yet to be known.[2]

Enron: A Failed Whistle Blowing Case

Enron was the biggest US Energy Company established in 1985 by Mr Kenneth Lay based at Huston. The company had a market capitalization of $60 billion and had a earning of 70 times of market capitalization and had 6 times its book value. The company had 20,000 employees and an annual revenue of $111 billions. The company was ranked as America's most innovative company by Fortune magazine for six consecutive times. M/S. Author Anderson one of the top five audit firms in the world was the auditor of the company. In August 2000 the stock price was $90.75. It had fallen to less than $1 by November 2001. On 2 December, 2002 Enron filed bankruptcy petition.

Kenneth Lay and his associates by following complex financial reporting practices and business models and unethical accounting practices relating to (1) Revenue recognition and (2) Market to market accounting and creation of special purpose entities, reduced Enron's tax payments; inflated Enron's income and profits, and stock price and credit rating and hid losses in off-balance-sheet subsidiaries, to engineer off-balance-sheet schemes and funnelled money to themselves, friends, and family and fraudulently misrepresent Enron's financial condition in public reports. This has finally resulted in the winding up of the company, punishing the directors with jail imprisonment and cancellation of license of Auditor Arthur Anderson. A new corporate governance law namely SARBANES–OXLEY ACT was introduced in the US.

On 15 August 2001 Sharron Watkins, the Vice President for corporate development, who was also the whistleblower of the company sent an anonymous letter to Kenneth Lay warning him about the company's accounting practices. One statement in the letter said: "I am incredibly nervous that we will implode in a wave of accounting scandals." Watkins contacted a friend who worked for Arthur Andersen and he drafted a memorandum to give to the audit partners about the points she raised. On August 22, Watkins met personally with Lay and gave him a six-page letter further explaining Enron's accounting issues. Lay questioned her as to whether she had told anyone outside of the company and then vowed to have the company's law firm. She argued that using the law firm would present a conflict of interest. Lay consulted with other executives, and although they wanted to dismiss Watkins, Lay decided against it to prevent a lawsuit. On October 15, Vinson and Elkins announced that Enron had done nothing wrong in its accounting practices as Andersen had approved each issue.[3]

The WorldCom Case

WorldCom—the telecommunications giant—collapsed and succumbed to $41 billion of debt and a corporate scandal that destroyed its access to capital. On 19 July, 2002 the Company was forced to file for Chapter 11 bankruptcy and seek protection from its creditors. Amidst the string of SEC investigation into

telecommunication companies, emerged a hero, Cynthia Cooper, whose careful detective work as an internal auditor at WorldCom exposed some of the accounting irregularities behind the greatest accounting fraud in the US history.

Cynthia Cooper, WorldCom's former Vice President of internal audit, and her team of middle managers took their commitment to financial reporting to extraordinary lengths and uncovered the largest corporate fraud in history. Cooper and her colleagues grew suspicious of a number of peculiar financial transactions and went outside their assigned responsibilities to investigate. What they found was a series of clever manipulations intended to bury almost $4 billion in misallocated expenses and phony accounting entries.

Her curiosity was first aroused in March 2002 when a senior-line manager, John Stupka, complained to her that her boss, CFO Scott Sullivan, had usurped a $400 million reserve account Stupka had set aside as a hedge against anticipated revenue losses. Under the accounting rules, if a company knows it is not going to collect on a debt, it has to set up a reserve to cover it in order to avoid reflecting on its books too high a value for that business, which is exactly what Stupka had done. However, Sullivan instead decided to take the $400 million away from Stupka's division and use it to boost WorldCom's income. She suspected a fraud and inquired of the Company's accounting firm, Arthur Andersen, who proceeded to brush her off. Cooper then decided to press the matter with the board's audit committee, which put her in direct conflict with her boss, Sullivan, who ultimately backed down but warned her to stay out of such matters.

Knowing that Andersen had been discredited by the Enron case and that the SEC was investigating WorldCom, Cooper continued her investigation, often working late at night to avoid detection by their bosses. Ultimately, she and her team uncovered a $2 billion accounting entry for capital expenditures that had never been authorized—it appeared that the company was attempting to represent operating costs as capital expenditures in order to make the company look more profitable (Pulliam and Solomon, 2002). When Sullivan heard of the on-going audit, he asked Cooper to delay her work until the third quarter, but she bravely declined. She went to the board's audit committee and in June, Scott Sullivan and two others were terminated. Cooper was later recognized as one of the three 'Persons of the Year' by the Time magazine for her whistleblowing efforts.

Her effective whistle blowing highlighted the Company's malpractices and led to the eventual resignation of WorldCom CFO, Scott Sullivan and other senior executives. After that whistleblowing has emerged as a valuable tool for internal corporate monitoring, although the social repercussions often deter employees from reporting such frauds. While legislation has attempted to address the issue and encourage whistleblowers, It will be argued that the motive behind whistleblowing reflects Kant's idea of good will and thus cannot be enforced by government regulation.[4]

San Diego City's Pension Fund Scam

Diann Shipione, the former trustee of the San Diego City Retirement Board and former Vice President of UBS financial services who exposed an unlawful under funding of city's pension fund and omission of multiple billion dollar pension and retiree health care debt in the city of San Diego municipal bond offering and sales documents. City officials and pension board trustees created a multi-year smear campaign, including filing ethics charges against her and plotting to have her arrested by the San Diego City Police.

The scandal caused a widespread fallout in the city's political and financial sectors. Several city officials resigned, including the City Auditor, City Manager, City Treasurer and the Mayor. The City became the target of two federal investigations and in November 2006, the U.S. Securities and Exchange Commission entered an

order sanctioning the City of San Diego for committing securities fraud. Shipione was eventually proven right about her concerns and received public recognition for her pension system related services from many civic organisations in San Diego.[5]

General Motors Car Safety Case

Courtland Kelley was the head of the General Motors inspection and quality assurance program for many years. He found faults in the Chevrolet Cavalier and the Chevrolet Cobalt, and repeatedly reported them, with little response. He thought his supervisors were more interested in maintaining sales and their own positions than with expensive recalls. In 2003, Kelley sued the GM alleging that the company had been slow to address the dangers in its cars and trucks. Even though he lost the court case, Kelley thought that by blowing the whistle he had done the right and proper thing. Faulty ignition switches in the Cobalts, which cut power to the car while in motion, were eventually linked to many crashes resulting in fatalities, starting with a teenager in 2005 who drove her new Cobalt into a tree. In May 2014, the NHTSA fined the company $35 million for failing to recall cars with faulty ignition switches for a decade, despite knowing there was a problem with the switches. Thirteen deaths were attributed to the faulty switches during the time the company failed to recall the cars.[6]

Pharmaceuticals Companies Inadequate Care

Stefan P. Kruszewski was a whistleblower, who brought law suits against South wood Psychiatric Hospital, Pfizer, Inc., and AstraZeneca. Kruszewski while working for the Department of Public Welfare, the Bureau of Program Integrity for the Commonwealth of Pennsylvania, became aware of inadequate care and the exploiting of state-committed mentally ill children through overmedication. When he refused to keep silent about his discoveries, he was fired from his position at the State. However, he did not stop his work and started legal battle. Kruszewski filed a case against the State of Pennsylvania and the companies and won settlements for both a First Amendment case against the state of Pennsylvania as well as his first Qui tam lawsuit against the hospital. In the cases against pharmaceutical giants, Pfizer and AstraZeneca, Kruszewski highlighted the clinical science that was misrepresented by the defendants in their marketing and promotion of certain drugs. He also demonstrated problems with off-label marketing (marketing that promotes uses, patients or doses that are not approved by the US FDA) which resulted in heightened, but often non-transparent, risk to the health of patients and exceptional costs to taxpayers and state and federal governments.[7]

Pfizer Case 2004

Peter Rost, who was the former Vice President at Wyeth Pharmaceuticals and a whistle blower, reported about some accounting irregularities and other irregularities to the his management. But the management instead of taking it in a positive sense transferred him from Sweden to a position in New Jersey, a change that he characterized as a retaliatory demotion. He sued Wyeth, and the case was settled out of court on undisclosed terms. Then he moved to Pharmacia, where he became concerned about off-market labelling of Geotropic. He reported this activity to his managers at Pfizer, after Pfizer's purchase of Pharmacia, and later filed a False Claims suit against the company. The Department of Justice declined to join the suit as Pfizer had already disclosed the violations.

Another whistle blowing exercise carried out by Rost, while working as a highly paid executive at Pfizer, when he took positions opposed to those of Pfizer

such as advocating drug reimportation and writing a glowing review of a book highly critical of the industry. He was exiled internally by Pfizer and removed him from all responsibilities and decision making, a move which Rost felt was due to his whistle blowing. In 2004, he testified in the Congress as a private individual in favour of drug reimportation, a position strongly at odds with the official policy of the pharmaceutical industry. In December 2005, Rost was fired from Pfizer In September 2006 he published his experiences in the book, '*The Whistleblower: Confessions of a Healthcare Hitman*'.

Another whistle blower for Pfizer was its former sales representative and West Point graduate who filed a law suit which led to a massive government investigation into Pfizer's illegal and dangerous marketing of Bextra, a prescription painkiller. Pfizer paid $1.8 billion to the government to settle the case, including a $1.3 billion criminal fine, which was the largest criminal fine ever imposed on any matter. The Bextra settlement was part of a $2.3 billion global settlement – the largest healthcare fraud settlement in the US history.[8]

The Citygroup Case

Richard M. Bowen III was the senior Vice President and the chief underwriter of Citygroup's Consumer lending division and the whistle blower of the company. When the company started taking extreme risks in the mortgage operations he started warning the board of directors about the extreme risks that could potentially result in massive losses. When Bowen first blew the whistle in 2006, 60 per cent of the mortgages were defective. The amount of bad mortgages began increasing throughout 2007 and, eventually exceeded 80 per cent of the volume. Many of the mortgages were not only defective, but were fraudulent. Bowen attempted to rouse the board via weekly reports and other communications. On 3 November 2007, Bowen emailed the Citigroup chairman Robert Rubin and the bank's chief financial officer, chief auditor and the chief risk management officer to again expose the risk and potential losses, and claiming that the group's internal controls had broken down. He requested an outside investigation of his business unit that eventually confirmed his charges. In retaliation, Citigroup stripped Bowen of most of his responsibilities and informing him that his physical presence was no longer required at the bank.[9]

The Astra Zeneca Case

Jim (James) Wetta, who was the whistleblower for AstraZeneca (AZ), filed a false claims qui-tam case that triggered the United States Department of Justice investigation into AstraZeneca violating the Federal Anti-Kickback Statute and promoting the unapproved use of the (anti-psychotic) drug Seroquel. In September 2000, the drug Seroquel received the FDA approval for the short-term treatment of schizophrenia and in 2004, for bipolar depression. James Wetta exposed the company's alleged fraud, where sales reps were promoting the drug for a wide range of less serious disorders which included aggression, Alzheimer's disease, anger management, anxiety, attention deficit hyperactivity disorder, bipolar maintenance, dementia, depression, mood disorder, sleeplessness and post-traumatic stress disorder. Promoting drugs off-label amounts to fraud under the False Claims Act, as the unapproved uses were not medically accepted indications for which the federal and state Medicaid programs provided coverage. Under the Food, Drug

and Cosmetics Act, a company must specify the intended use of a product in its new drug application to the FDA. Once the drug is approved by the FDA, the drug may not be marketed or promoted for off-label uses. The civil settlement agreement required AstraZeneca to pay $520 million to the federal government to resolve civil settlements. Jim Wetta provided the information which proved the drug was promoted for conditions other than the FDA medical indication.[10]

CONCLUSION

Whistleblowers can bring about a sea change in the functioning of corporations/government or any organisation that matter on sound principles of ethics and transparency. An effective mechanism of whistleblowing is essential for mature entrepreneurial society. In almost all developed and industrialised countries there exits whistleblower policy and an appropriate legislation. India is also now showing the maturity of a sound and mature nation and has a sincere effort to bring transparency in the organisational functioning, and a fight against corruption is taking place.

KEYWORDS

- Article 33 of UN Convention against corruption
- Clause 49 of Listing agreement and whistle blowing
- Meaning and Definition
- Whistleblowing
- Whistleblower
- Whistleblower Protection Act 2014

DISCUSSION QUESTIONS

1. What do you mean by whistleblowing? Explain the benefits of good whistleblowing policy.
2. Explain the major provisions of Whistleblowing Protection Act 2014.
3. Explain the different types of whistleblowers. State the importance of each whistleblower.
4. Explain different elements of whistleblowing.
5. What do you mean by wrongdoing? Explain.
6. Explain the role played by Vigilance Commissioner in whistleblowing.
7. Explain the need and the importance of whistleblowing policy.
8. Are whistleblowers protected in India? State the legal provisions to protect whistleblowers in India.
9. Do whistleblowers have legal protection? Distinguish between whistleblowers and informants.
10. Why should an employee blow the whistle? Explain the various types of whistleblowers in an organisation.

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12



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Role of Government in Corporate Governance

CHAPTER OUTLINE

- Introduction
- Different Roles of Government in Economy
- State Intervention in a Developing Economy
- Public Governance and Corporate Governance Government
- Regulatory Framework
- Rule-based vs Principle-based Regulations
- Self vs Government Regulation
- Regulatory Enforcement
- Political Governance Requires Restraints of Power
- Public vs Corporate Governance—A Study of Comparison

Introduction

Taking the cue from the classical economists, die-hard admirers of capitalism often aver that 'the government should get out of the way and let the market function'. Of course, that idea is a myth. Government is absolutely essential in setting up of a market economy. Without rules and structures of a binding nature, anarchy will be the outcome. 'Under such conditions business becomes nothing but 'casino capitalism' where investments are simply bets: bets that people will keep their word, bets that the firms are telling the truth, bets that employees will be paid, and bets that debts will be honoured. What corporate governance is all about in larger terms is how a structure can be set up that allows for a considerable amount of freedom within the rule of law. Ultimately these arrangements provide for the establishment of trust, one of the most important ingredients in business.'[1]

State participation in the orderly functioning of the economy is no more a matter of disagreement among social scientists. The free play of economic forces has often resulted in an anarchy of production, unemployment, and economic instability.

State participation in the orderly functioning of the economy is no more a matter of disagreement among the social scientists. The free play of economic forces has often resulted in an anarchy of production, unemployment, and economic instability. *Laissez-faire* has now been considerably diluted. State intervention is now considered necessary to ensure economic stability and full employment of the productive resources. The transformation of 'free enterprise' economies from ones with a non-interfering state to one that intervenes too often and sometimes far too much in economic affairs has been due to the following historical developments: (i) The facile assumption of the classical economists that capitalism does not require any state intervention and has enough self-correcting mechanism within itself, has been proved wrong by the regular occurrence of trade cycles, causing untold miseries to people in times of recession and depression due to unemployment and falling incomes. State intervention becomes absolutely necessary to restore the economy back to its recovery—prosperity path. (ii) The necessity of the state to concentrate on defence production and the co-ordination it has to bring about in transporting men and materials to the theatres of war so as to execute its war efforts successfully call for and justify a state interference. (iii) The emergence of socialism as an alternative economic system to capitalism and its vehicle of delivery, namely, central planning, has provided another justification. (iv) The emergence of labour power and the imperative of the state to protect its interests calls for state intervention. (v) The concept of a welfare state and the need to direct development efforts to have a human face and be covered by a social safety net could not be achieved without the active role of the state. (vi) In recent times successive corporate frauds and scams have necessitated a state intervention to protect the unwary investors and regulate corporates so as to make them accountable to their internal and external stakeholders that include the society at large.

Government Interference in Market Economies

The modern capitalist or market economies are characterised by the government interference in varying degrees. A variety of reasons explain why this is the case, but the following are the most important ones:

1. The contractual arrangements and exchanges needed for free market operations cannot exist without the protection and the enforcement of a governmentally provided legal structure.
2. The claim that the market mechanism leads to an efficient use of resources (i.e., produces what consumers want most and does so in the cheapest possible way) is based on the assumption of movement product markets. This means that there are no obstacles to free entry and free exit and that consumers and

producers have full knowledge of market conditions. However, government regulations or other administrative measures are needed to secure these conditions.

3. Even if all barriers to competition are removed, production or consumption characteristics of certain goods are such that these goods cannot be provided through markets.
4. The market system, especially in a highly development oriented economy, does not necessarily bring high employment, price stability and the socially desired rate of economic growth. Public policy is needed to secure these objectives.
5. Social values may require adjustments in the distribution of income and wealth which result from the market system and from the transmission of property rights through inheritance.
6. Today, government participation is considered an essential ingredient of high and rising levels of economic activities for both the developing and the developed countries.
7. In the developed market economies, budgets of governments exercise a very significant influence over the economy. In a number of these countries, government revenue as well as expenditure exceed one-third of the Gross Domestic Product (GDP).
8. In many countries, there has been a growing participation by the State in the national production and a vast expansion of its laws, regulations and executive fiats governing economic affairs.
9. Even in free market economies, the state ownership of enterprises and even of the whole of certain industries is quite common. There has also been a tendency in some of these countries to nationalise certain critical industries as well as to own enterprises in important industries.

In short, there is hardly any country in the world, the economy of which is not in one way or the other influenced by its government.

Different Roles of Government in the Economy

There are four important roles played by the government in an economy, namely:

(i) The regulatory role
(ii) The promotional role
(iii) The entrepreneurial role
(iv) The planning role

There are four important roles played by the government in an economy, namely, the regulatory role, the promotional role, the entrepreneurial role and the planning role.

The first three roles of the state are elucidated in the following pages.

Regulatory Role

A large part of the economy of even most of non-centrally planned countries is regulated by the government, as discussed below:

(i) Government may determine the conditions under which persons or corporations may enter certain lines of business as in the granting of a charter, a franchise, a licence, or permitting any 'person' to use public facilities or resources.
(ii) Government may regulate or assist the conduct of economic ventures of various types once they are under way.

(iii) Public control may extend to the results of business operations as in the limitation of public utility profits, ceiling on dividends and imposition of excess-profit taxes on business, etc.

(iv) Government may control the relationship between various segments of the economy, the purpose being to settle conflicts of interests or of legal rights and to prevent concentration of economic power in the hands of few monopolies or in a few localities that may cause regional imbalances.

(v) Government may put in place legally constituted regulatory bodies to protect investors, consumers and the general public by ensuring best corporate practices.

Government regulation of an economy may be broadly divided into

1. Direct controls 2. Indirect controls

Direct controls: Direct administrative or physical controls are more drastic in their over-all effect and impact. For instance, many developing countries have instituted a variety of direct controls over their economies including industrial licensing and price and distribution controls. The use of industrial licensing is, therefore, justified as the mechanism by which the State can control industrial investment and allocate resources to conform to pre-determined priorities and plan targets.

Indirect controls: Indirect controls are usually exercised through various fiscal and monetary incentives and disincentives or penalties. For instance, a high import duty may discourage imports and fiscal and monetary incentives may encourage development of export-oriented industries.

Promotional Role

Considering the whole of its activities, a government does more to assist and to help develop industrial, labour, agricultural and consumer interests than it does to regulate them. The promotional role of the state also encompasses the provision of various fiscal, monetary and other incentives, including measures to cover various risks for the development of certain priority sectors and activities.

The promotional role played by government is very important in the developed as well as the developing countries. Thus, considering the whole of its activities, a government does more to assist and to help develop industrial, labour, agricultural and consumer interests than it does to regulate them.

In the developing countries, where the infrastructural facilities for development are inadequate and entrepreneurial activities scarce, the promotional role of the government assumes special significance. The State will have to assume direct responsibility to build up and strengthen the necessary development of infrastructure such as power, transport, finance, marketing, institutions—for training and guidance and other promotional activities.

The promotional role of the State also encompasses the provision of various fiscal, monetary and other incentives, including measures to cover certain risks for the development of certain priority sectors and activities.

Entrepreneurial Role

The growing importance of the entrepreneurial or participative role of the State has been evident from the fast expansion of the public sector in the most developing countries. However, in post-1990s, there has been a significant reversal in this policy as governments, having experienced inefficient functioning of public sector industries and the huge losses incurred by them which are made good by budgetary allocations affecting the tax-payers, have given up their policy of promoting them.

Public ownership in free societies and their growth in recent times are justified for the following reasons:

(i) In a democracy, the national emergency of war inevitably causes an expansion of State activities, including public ownership, because modern requirements of total war cause people to forsake their convictions concerning private responsibilities and to concentrate on mass power in the State apparatus.

(ii) Major economic dislocations, such as the great depression of the 1930s, also tend to stimulate State activities, again leaving a residue of public ownership that takes time and efforts to dissipate, if it is ever finally accomplished.

(iii) In economic dislocations, as in the early history of the United States and in the economic development of the developing nations today, government is called on to act as banker, helper or owner of infant industries and generally to expand its central concern for the economy, thus creating considerable degree of public ownership at the outset.

(iv) When the private undertakings become unprofitable but the need for their services continues, government may be prevailed upon to acquire and manage such non-profitable business concerns even at a loss.

(v) Governments are also required to extend the owner-manager relationship when there is a pronounced wastage of national resources, or when the threat to them is great, thus diminishing the nation's ability to defend itself or to preserve the bases of a sound economy.

(vi) Government ownership may also be extended by the failure of private management to consider itself a trustee of the public good and abuse its power, especially in cases where monopoly or semi-monopoly, is the condition.

For these reasons, and also due to compulsions of development, there had been a tendency in many developing countries to assign a dominant place to the government-owned public sector, as is evident in India.

State Intervention in a Developing Economy

State intervention is inevitable in the developing countries to break the (1) vicious circle of poverty—a circular constellation of forces that keep the poor country in a stationary state of underdevelopment, and (2) to usher in economic growth through comprehensive government planning. The economic rationale for State intervention in the process of economic development of poor countries is briefly discussed further:

(i) Simple market forces cannot ensure a high rate of investment and growth in output. Economic rigidities and structural disequilibrium hinder free operation or even the normal process of growth. Since economic development is not an automatic or spontaneous process, government should interfere with the market forces to break the vicious circle of poverty.

(ii) In the initial phase, development is hindered for want of basic social and economic overheads. These create external economies, but require huge investments. For development of industry and agriculture, these are essential but private enterprise will not enter these areas.

(iii) Poor countries also suffer from deficiency of resources and skills. This calls for wise and efficient allocation of limited resources. Only the State is best equipped to do this through centralised planning. Besides, a government can mobilise large resources through taxation, borrowing and deficit financing. Large enterprises that require huge investment can be started only by the State.

(iv) Besides, monopolies should be curbed, investments in schemes of collective values made, long-term problems of economy tackled, immediate prospects of profit not being the sole criterion, economic decisions properly co-ordinated, integration of various sectors of economy ensured only by a decisive role of the State.

(v) The latest addition to these functions of the State is that it should help promotion of investments in industries by safeguarding investors' interest

State intervention is inevitable in developing countries to break the circular constellation of forces that keep the poor country in a stationary state of underdevelopment, and to usher in economic growth through comprehensive government planning. The rationale for State intervention in the process of economic development of poor countries is several fold. In the initial phase, development is hindered for want of basic social and economic overheads. In poor countries resources should be wisely allocated, skills developed, monopolies should be curbed, investments in schemes of collective values made, long-term problems of economy tackled, immediate prospects of profit not being the sole criterion, economic decisions properly coordinated, integration of various sectors of economy ensured only by a decisive role of the state.

and instilling confidence in them. The state has a moral responsibility to ensure that corporates are run ethically and do not in any manner offend the interests of its stakeholders, both internal and external. To achieve this objective, they have to put in place laws, legal and institutional structures, regulatory bodies and help trade associations develop codes of best practices to be observed by their members.

Public Governance and Corporate Governance

Governance is the exercise of authority, to direct, to lead and to control an organisation. Commercial activity conducted by corporations and by other forms of business is fundamentally different from the types of activity conducted by coercive government. Good governance is supposed to exist if three objectives are achieved. The first is equality of law and effective implementation of laws. Secondly, opportunity for every individual to realise his full human potential and thirdly, there should be effective productivity and no waste in every sector.

Governance is the exercise of authority, which involves not solely the right to direct but also to lead and to control within an organisation. Two problems exist regardless of whether the organisation operates within a political society or within a civil society:

1. How to accumulate the power and authority required to achieve the purposes of the association?
2. How to limit the power and authority to specified areas rather than to allow it to overflow into areas that are not its concern?

Although the same problems need to be addressed, governance within enterprise associations such as corporations is not at all like governance within a governmental body. Commercial activity conducted by corporations and by other forms of business is fundamentally different from the types of activity conducted by coercive government.

Good governance is supposed to exist if the following three objectives are achieved:

- The first is there should be equality of law and effective implementation of laws.
- Second there should be opportunity for every individual to realise his full human potential.
- Third, there should be effective productivity and no waste in any sector.

Political Governance Requires Restraints of Power

Constitutional governments are characterised by specific restraints established by law and imposed on power-holders to ensure that citizens' rights are not being transgressed. Constitutionalism embodies the principles that the government is organised by, and operated on behalf of the people, but subject to a series of restraints, a system of checks and balances and to keep power from being abused. By dividing power, constitutionalism provides a system of restraints upon coercive state action.

The basic idea underpinning restraints rests on the notion of a law higher than positive man-made law, and thus limiting the operation of the State. Natural law provides a criterion by which positive laws are judged. Another basic principle underlying the idea of limited government is that legitimate governments always rest on the consent of the governed. The working democracies that have developed from these ideas are given below.

1. A political system with a central-local distribution of power.
2. Subordinate distributions of power among agencies with functionally-defined realms of authority.
3. A chronological distribution of power through periodic and regular elections.
4. A written constitution enforceable by the courts limiting the exercise of political power.

Forms of Government Regulation

The object of government regulation, as has been pointed out earlier, is to steer the wheel of the economy in the direction of maximum social good without replacing it. This can be achieved through a regulatory action at all-important points in the economic system. However, the regulatory system and the context of regulation may vary from country to country, the degree of maturity of political governance and the degree of economic growth. The more important forms of regulation of private enterprises by the government especially in developing countries like India are as follows:

The object of government regulation, is to steer the wheel of the economy in the direction of maximum social good without replacing it. The more important forms of regulation of private enterprises by the government are general direction and regulation of investment activity in private enterprise regulation of investment, location, size and expansion of individual enterprises through a well-defined policy of industralisation and regulation of prices of commodities and industrial products through legislative authority.

- General direction and regulation of investment activity in private enterprise. This is achieved through economic planning and industrial licensing policy.
- Regulation of investment, location, size and expansion of individual enterprises and specific industries through a well-defined policy of industralisation.
- Regulation of prices of commodities and industrial products through legislative authority and systematic investigations into cost structures and mark-ups.
- Regulation of monopolies and unfair trade practices or restrictive practices through legislation.
- Regulation of wages and bonus for employees in private sector to minimise exploitation, ensure reasonable standards of living and maintain peace and harmony in industry.
- Regulation of corporate management.
- Regulation of specific norms of business activity such as speculation in shares and commodities or imports/exports, etc.

In this connection, the following issues require special attention.

Self-regulation Vs. Government Regulation

One important aspect of the development of a regulatory system for corporate governance is that whether it should be designed as a self-regulatory mode or a government regulated mode. Matured markets generally prefer self-regulatory system because they have greater proximity to the industry being regulated; flexibility and more focused towards the real issues of the sector and address the collective interest of the sector. It will be less bureaucratic in nature, ensuring equity to all the stakeholders, will be more transparent and principle-oriented rather than rule-oriented and will be easy for compliance. The mechanism involved in the formulation and implementation of such system will be aware of all the theoretical and practical issues involved in it and able to design the system to solve the problems. At the same time, it may lead to a conflict of interest, a lesser compliance and scarcity of resources for the design and implementation, etc.

Government regulation, on the other hand, takes into account the wider socio economic and political canvas of the nation at the macro level and addresses all issues for long term development and sustainability the system must address the issues of the society and business in which the government has a greater role. Suppose an industry design its regulatory system, mostly intra-industry issues are addressed but many inter-industry issues inter-societal issues will be unattended. Also socio political issues involved in it are not addressed many at a time. On the other hand, all these issues are addressed by a government designed and administered regulatory system because the government is responsible not only to the particular segment but also to the larger society. Market maturity is an important factor in its decision. In a less matured market, government-designed regulatory system are preferred because it will be less biased, takes all issues at macro level, and easy for enforcement. Inter-stakeholder disputes can also be addressed easily.

In the area of corporate governance, most of the expert committees on corporate governance of advanced countries focused towards developing a good corporate citizenship rather that compliance of some regulations formulated and implements by an external agency like government. The Cadbury Committee, Hampel Committee and even the OECD code emphasise this aspect. For achieving this aim, a self-regulatory system is more appropriate. The King committee has highlighted the need of creating an environment of developing a good corporate citizenship within the sector for ensuring good governance which is possible only under a self-regulatory system. In India, though the two prominent committees on corporate governance viz. The Birla Committee and The Narayana Murthy Committee have not specifically recommended for a government sponsored regulatory system, the spirit of the recommendations were focused towards government controlled regulatory mechanism for a higher compliance and less conflict of interest for the time being till the county reaches maturity in this regards.

In this respect a seminar, on the role of government in corporate governance conducted at John F. Kennedy School of government, Harvard University, suggests the following advantages and disadvantages of a self-regulatory system.

1. **Proximity:** Self-regulatory organisations are, by definition, closer to the industry being regulated. This close proximity means that self-regulatory organisations will generally have more detailed and current information about the industry, something that is especially helpful in rapidly changing sectors. By comparison, government regulators are often playing 'catch up'. Being closer to the action, self-regulators are better situated to identify potential problems more quickly.
2. **Flexibility:** Self-regulatory organisations can act with greater flexibility than government regulators. They are not subject to the same kinds of procedural and due process hurdles that government is, nor do they face the same political constraints. Governmental regulators do not relish dealing in politically unpopular or extremely complex issues, so these issues can be delegated to self-regulatory bodies.
3. **Compliance:** Self-regulation may generate a higher level of compliance. The greater the involvement of industry in setting the rules, the more those rules may appear reasonable to the individual firms. Self-regulation may also generate rules that solve the regulatory problem in ways more sensitive to industry practices and constraints, and hence it may be easier for firms to comply with them.
4. **Collective interests of industry:** Self-regulation can harness the collective interests of the industry. This may be another way that self-regulation promotes compliance, as competitors can effectively 'police' each other.
5. **Resources:** Self-regulatory bodies may have a better ability to secure needed resources. In addition, when regulatory funding is self-directed, the legislature cannot cut it off or use it as a leverage point over the self-regulatory body.

Although self-regulation has these important advantages, it also has some noteworthy drawbacks. Self-regulation possesses at least five potential disadvantages:

1. **Conflicts of interest:** The very proximity that can help the self-regulator acquire useful information can be a disadvantage because of conflicts of interest. Knowing an industry better does not mean that a regulator will have the proper incentives to regulate it more effectively. There is also the possibility that self-regulation will be used by older, more established entities simply to keep out the newer market entrants.
2. **Inadequate sanctions:** The greater flexibility afforded self-regulatory organisations also means they may have the discretion to meet out only modest sanctions against even serious violators. Conference participants noted

several instances of self-regulatory organisations imposing small sanctions for egregious malfeasance.

3. **Under enforcement:** Self-regulators' conflicts of interest and flexibility may also make it more likely that compliance with rules will be insufficiently monitored. If industry's interests are different from society's interests, then enforcement with self-regulation might be less than optimal for the overall good of society.
4. **Global competition:** In a global marketplace, an industry's collective interest can be defined by competition with foreign markets. If foreign markets are not equally burdened with regulation, then aggressive self-regulation could put domestic firms at a serious disadvantage, providing yet another reason to question whether self-regulators will make socially optimal decisions.
5. **Insufficient resources:** Although the funding of self-regulatory bodies may not be susceptible to the whims of legislatures, underlying conflicts of interest could leave self-regulatory bodies with less than sufficient funding. Clearly, self-regulation has both advantages and disadvantages. It is neither an inherently good nor inherently bad way to regulate corporate conduct. The challenge, then, is to find the situations in which self-regulation is the most appropriate model. After that, the challenge becomes finding optimal ways of designing self-regulatory institutions.

   The seminar concludes that even if there is some shortcoming to the existing self-regulatory system of US corporate governance which led to some scams, it does not mean that the existing self-regulatory system should be abandoned entirely. Instead, the internal governance structure of the system must be modified by granting more powers and resources. It should also subject to changes with the change in the environment.[2]

Discretionary Vs. Non-discretionary Regulation

Another issue with regards to the regulatory role of government is whether it is discretionary or non-discretionary. Discretionary regulations are those at the choice of the regulations administrative agency and not as an obligation on the part of the regulatory agency. Discretionary regulations are formulated by the regulatory agency based on its principles, policies and approach. They are mostly implemented at micro level. These include fixing the price of various commodities, distribution of scarce resources, optimum utilization of resources, imposing quantitative restrictions an imports, etc. The purpose is to ensure fairness to all stakeholders. On the other hand non-discretionary regulations are those regulations formulate and implemented by the agency as per rule/law and the administering agency has no choice with regards to whether formulate and implement or not. These measures are generally exercised at macro level through legislative form. For example, amendment in Income Tax law while increasing or decreasing the rate of tax, concessions granted to any sections of tax payers, etc., amendment in the Companies Act, the Foreign Exchange Management Act, the SEBI Act, etc.

Mandatory Vs. Voluntary Regulations

Lot of debates is going on as to whether corporate governance regulations are to be made mandatory or voluntary at the implementation stage. If it is mandatory, compliance rate will be higher because non-compliance will invite penalty. But at the same time full or adequate disclosure cannot be ensured some times because people will try to satisfy the rules. On the other hand, if it is voluntary codes, those who are very much ethical will make full compliance but at the same time others will not observe all the codes as no penalty will be there for non-compliance. In this

regards, the view of Cadbury Committee was that compliance with a voluntary code coupled with disclosure will be more efficient than a statutory code of corporate governance. Hence the Committee emphasises on 'Comply or explain' principle. All the listed companies in the London Stock exchange are bound to comply and give reason for non-compliance of any aspects. At the same time the Blue Ribbon Committee emphasises on making the code of governance as mandatory and hence all the recommendations of the Blue Ribbon Committee were adopted and declared to be mandatory by the NYSE, the American Stock Exchange (Amex), the Nasdaq and the American Institute of Certified Public Accountants (AICPA). However, the recommendations are not mandatory for foreign issuers.

King (the South African Corporate Governance Committee) Committee recommended the implementation on voluntary, non-legislative but principle-based. The philosophy of the King Code consists of the three key elements such as (1) leadership, (2) sustainability and (3) good corporate citizenship. It views that to ensure good and efficient governance ethical leadership is necessary. This cannot be achieved by forcing people by citing rules. King believes that the leaders should direct the company to achieve sustainable economic, social and environmental performance. It views sustainability as the primary moral and economic imperative of the century and the Code's view on corporate citizenship flows from a company's standing as a juristic person under the South African Constitution and should operate in a sustainable manner.

In India, both the Birla Committee and the Narayana Murthy Committee followed a mixed approach, in some aspects these two committees believe that some sort of compulsion is necessary to follow, otherwise, compliance rate will be less whereas some less important aspects, it is not necessary to force the companies to follow. Hence, some of the recommendations of both these committees are mandatory in nature and some are non-mandatory recommendations. But at the same time the Naresh Chandra Committee was against forcing companies to comply with the code. Hence, his report enumerates a set of voluntary recommendations with an objective to establish a higher standards of probity and corporate governance in the country.

In India, Clause 49 of the Listing Agreement contains the corporate governance code to be complied with by the listed companies in India. The code is divided into mandatory requirements and the non-mandatory (voluntary) ones. Non-compliance of any mandatory requirement with reasons thereof and the extent to which the non-mandatory requirements have been adopted/not adopted needs to be specifically highlighted in the annual corporate governance report. It will be reasonable to assume that companies will necessarily comply with the mandatory requirements in view of the penal provisions for non-compliance like fine and delisting among others. However, in respect of voluntary requirements, they have a choice. With this background, the paper sought to examine the extent of compliance/non-compliance of these norms by the listed companies to ascertain whether the corporate sector is complying with the regulatory norms in letters or in spirit. The study found a not too encouraging response.

Rule-based Vs. Principle-based Regulation

Another issue regarding the regulatory system, both self and government, is whether it should be rule-based or principle-based. Many of the regulatory system in our country or elsewhere in the world is rule-based because of its easiness in the formulation and implementation. Adherence rate will also be higher if the regulatory system is rule-based than principle-based which demark a clear line between the acceptable and unacceptable behaviour. Rules also reduce the discretion of the individual management to follow it. But it is easy to manipulate

also. Moreover, rules are more complex and hence easy to overcome. Rule-based system seldom cultivate a culture and value system of adherence to the regulation, but at the same time it will satisfy the 'Box ticking' purpose. Its success depends on the vigilance of the implementation agency. Principle-based regulatory system on the other hand, is philosophical in nature and inculcate the culture and value system in the organisation and will be adhered to, even if the enforcement system is not very much vigilant. In many occasions, we see that companies satisfy the rule without achieving the purpose for which it is introduced. Most of our corporate governance regulations are rule-based. It fails to prevent the occurrence of scams and frauds because the spirit of the issue is not reflected in the rule. We have introduced several cods based on law/rules, the purpose of most are not achieved. Implementers have easily manipulated, according to their requirements.

For example, with regards to the composition of the board of directors, the rule states that half of the board members must be independent directors. The purpose of such rule is that decision making must be fair, unbiased, transparent and the pecuniary interest of the decision makers should not affect the decisions. Most of the companies have implemented this also. In many cases the real independence of such directors are questioned and the purpose is defeated. Similarly, the rule says that there must be at least one woman director on the board. The purpose is to ensure some gender justice and address gender issues in the company. But in most cases, the spirit behind this rule is not achieved and it is criticized that the rule has only added some colour to the board and created a cosmetic appeal. Rules cannot ensure that the person appointed is able to do what she is expected to do except, and hence only 'Box Ticking' purpose is achieved. This type of approach will not promote good corporate governance. Another example is, with regards to Mutual Fund regulations. In mutual fund regulations there are several inter industry and intercompany restrictions regarding the deployment of funds raised through mutual fund schemes with the aim of risk management and reduction. All the mutual funds companies are adhering to the rules, but how many are able to achieve the aim of risk reduction. Similar is the case of statutory warnings given along with mutual funds investment advertisements. The aim of the rule is to caution the investors about the risk involved in the investment in mutual funds. But the aim is often defeated by the way the statutory obligations are complied.

The principle-based system is more scientific in nature and ensure long term sustainable development of the sector. It aims to achieve what it is aimed and create a corporate culture based on certain principles. For example, how many companies have identified the issues relating to independence of the decision making and appointed half of the total numbers of independent directors before the introduction of the clause. Similarly how many companies have identified the gender justice issues and appointed women directors before the introduction of the clause.

In this respect, the Hampel Committee on corporate governance emphasises that the governance system must be principle-based rather rule-based to ensure the growth and development of a good corporate citizenship and all recommendations are proactive in nature (anticipate wrong thing before it happens and introduce checks) and heavily relies more on broad principles and common-sense to apply in different situations. In the words of Narayan Murthy Committee on corporate governance, 'the corporate governance should not be in a strict legal point of view but from the point of view of mindset and culture of the management'. The King Committee while developing the South African corporate governance system said that, 'the code must be non-legislative and should be based on certain principles'. The OECD has the opinion that the corporate governance system must be rules-based, transparent and enforceable. However it fixes certain principles for forming rules. Similarly, the SEC also put forward some principles and made some recommendations for achieving it.

In between the argument and counter arguments for rule-based and principle-based governance system, a third view is that a good regulatory system should take into account the good aspects of both and suggested a hybrid system integrating both. For example, the international standard governing the computation of risk adjusted capital adequacy code popularly known as Basel norms is based on the hybrid system. The underlying principle behind it is, the risk management and reduction relies heavily on parties with access to best information. Individual banks are to calculate the risk weighted asset and determine the capital adequacy and the regulatory agencies only supervise it.

Regulation Enforcement

The credibility of a regulatory system, whether self or government regulatory system, depends on its enforcement. Regulatory enforcement covers all activities aimed at promoting compliance and reaching regulatory outcome. The quality of enforcement includes the accuracy, speed and satisfaction. This, in turn, depends on the quality of the regulation and the size and composition of regulatory agencies. In the words of OECD, 'a well formulated enforcement strategy is one that provides correct incentives for the regulated subject as well as appropriate guidelines for enforcement staff minimize both monetary effects and the cost for the regulated subject. Enforcement action sends a message to the broader public. They deter bad actors and level the competitive playing field'.

An increasing number of countries are coming to realize the importance of the enforcement phase in ensuring the quality and effectiveness of the regulatory policy and delivery, reducing the overall level of regulatory burden. In this aspect the OECD gives ten principles:

1. Regulatory enforcement and inspections should be evidence-based and measurement-based: deciding what to inspect and how should be grounded on data and evidence, and results should be evaluated regularly.
2. The potential of market forces, private sector and civil society actions to support compliance and enforcement should be explored wherever possible, inspections and enforcement cannot be everywhere and address everything, and there are many other ways to achieve regulations' objectives.
3. Enforcement needs to be risk-based and proportionate, the frequency of inspections and the resources employed should be proportional to the level of risk and enforcement actions should be aiming at reducing the actual risk posed by infractions.
4. Enforcement should be based on 'responsive regulation' principles, inspection enforcement actions should be modulated depending on the profile and behaviour of specific businesses.
5. Governments should adopt policies on regulatory enforcement and inspections, clear objectives should be set and institutional mechanisms set up with clear objectives and a long-term road-map.
6. Inspection functions should be coordinated and where needed, consolidated, less duplication and overlaps will ensure a better use of public resources, minimize burden on regulated subjects and maximize effectiveness.
7. Governance structures and human resources policies for regulatory enforcement should support transparency, professionalism and focus on outcomes. Execution of regulatory enforcement should be independent of political influence and compliance promotion efforts should be rewarded.
8. Information and communication technologies should be used to maximize risk-focus, coordination and information sharing and as well as optimal use of resources.

9. Governments should ensure the clarity of rules and process for enforcement and inspections, coherent legislation to organize inspections and enforcement needs to be adopted and published, and clearly articulate rights and obligations of officials and of businesses.
10. Transparency and compliance should be promoted through the use of appropriate instruments such as guidance, toolkits and checklists.[3]

Effective enforcement is likely to depend on the continued use of civil penalties combined with criminal sanctions. Several issues are involved in it as to whom civil penalties are levied and criminal sanctions as part of enforcement action. The enforcement people must be able to pursue action simply against the lower level people who are directly responsible for such actions or the top level people who masterminded the scam or even the company itself. In this respect the enforcement people and general public are mostly driven by 'Lynch-Mob mentality' to prosecute the people at the top regardless of whether they have done something warranting punishments. Proper judgment about fairness and reasonableness is essential for deciding who is to be punished. Charging the company as a whole may earn applause from the public, but what impact it creates in the economy is to be looked in to. In such aspects, the enforcement officials should consider the nature of misconduct and decide whether the company or the people driving the company or the people who simply executing the decision are punished. For example, the organisation should be punished for any illegal action that benefited the organisation. On the other hand, if some wrong actions led to some gain to individuals, then the individuals must be punished.

Role of Governments in Limiting Corporate Power

Modern corporations have grown so huge in size and so powerful in influence that these mega corporations, if unrestrained by political authority, might overreach all the segments of the society with their mercenary and baneful influence. Unrestricted and unregulated corporations could overwhelm governments if proper checks and balances are not worked out and put in place, as Enron and WorldCom tried to do. Ralph Nader, the consumer advocate, and Mark Green, Director of Public Citizens' Congress Watch were almost prophetic, as early as in 1979 when they articulated this view as follows: 'We must redesign the law to keep up with economic and political evolution of giant corporations, which are tantamount to private governments.' One definition of 'government' would be 'an entity that can tax, coerce or even take life….. They (giant corporations) can spend decisive amounts in elections, determine which town thrives and which gathers cobwebs, corrupt or help overthrow foreign governments, develop technology that takes lives or saves lives….'.

The economic government (giant corporations) is largely unaccountable to its constituencies—shareholders, workers, consumers, local communities, tax payers, small businesses, future generations, etc.[4]

This view, which would have sounded extreme, strident and partisan when it was expressed with the major scams of mega corporations still to emerge from the womb of time, did reflect the most fundamental public concerns with large corporations. 'However expressed, there appears to be a widespread fear that corporate managers have significant *unrestrained* discretion to make critical choices regarding a myriad of economic, social and political issues touching the lives of every citizen—including to name a few: what products and services to offer; what prices to charge; whether to invest in existing lines of business, to build new lines or buy out existing companies; where to locate corporate headquarters and new

facilities; what plants to open and close; whether to adopt measures to protect the environment and conserve energy; whether to adopt worker benefit, safety and health programmes; which philanthropic endeavours to favour; and so on.'[5]

Public versus Corporate Governance—A Study of Comparison

Link Between the Two Systems

The Corporate governance depends upon two factors, namely, the attitude and the values cherished by the management of the business enterprise and the external environment in which the business operates. The external environment in which the business operates would include the legislation relating to the functioning of business enterprises, covering the entire spectrum from the registration of companies, their structure, and the settlement of disputes, to the laws relating to the capital market and the punishment for unethical practices such as insider-trading.

The Public governance, on the other hand, is broadly connected with the running of the government of a country, and ensuring that the rule of law prevails. There has to be a fairness and transparency in the system of justice. If the public governance is not conducted on healthy lines and there is corruption, then there is no fairness. Corruption, as the World Bank defines, 'is the use of public office for the private gain'. If the public servants are going to exploit their position for a private gain, then the quality of public governance suffers. If the quality of public governance suffers, the corporate governance then is more difficult to practise. It can definitely be said that the management of an enterprise can still be ethical, and try to maintain its internal corporate governance. If the environment in which it operates is not clean, then it may not be successful or even if successful, it will find it very difficult to operate.

Corporate Governance can be an End by Itself

The issue of corporate governance has its own dynamism and justification. This will be obvious from the fact that, thanks to the globalisation, there are many multinational companies that have their own internal sense of values. In India, there are excellent business leaders like Narayana Murthy of Infosys and Azim Premji of Wipro who have built world-class enterprises. Both these business leaders are also placing a very high value on the principles of business ethics. What Narayana Murthy said in a talk to the students at the Wharton School of Business is worth recalling: 'The Infosys value system can be captured in one line—the softest pillow is a clear conscience. A company's value system is the guiding light in its hours of darkness. It builds confidence, peace of mind, and enhances enthusiasm during tough times. The importance you attach to your value system is reflected in the cost you are willing to incur for your beliefs and convictions. At Infosys, we have stood firm whenever our value system was tested. We know that taking short cuts that compromise our values would be detrimental. One of my strongest beliefs is that the corporations have an important duty to contribute to the society. No corporation can sustain its progress unless it makes a difference to its context.'

It is, therefore, obvious that even if public governance is not up to the mark in a country, managements of business enterprises can try to maintain the best corporate governance and stick to certain values in their own system. Companies that observe good corporate governance or maintain values seem to be doing better in the business areas also.

Better Public Governance Can Accelerate Corporate Governance

Public governance can also brings in greater discipline for a better corporate governance by nurturing the appropriate external environment in which an enterprise operates. Presently in India, we have the Securities and Exchange Board of India (SEBI), to regulate the stock exchanges. We also have the Companies Act for governing the operations of business enterprises. Based on the experience gained, the rules and regulations relating to business are being constantly revised.

Based on the past experience, corrections have to be made in the public governance and the regulation of business. In the stock exchanges of the United States in the 1980s and 1990s, there were a series of scams such as insider-trading, junkbond schemes and savings and loan scandals. Corrective measures were taken to build systems to ensure that malpractices do not flourish in the capital market and the business world. The role of public governance, therefore, as the watchdog of corporate governance and as the agency primarily responsible for laying down the rules of the game is therefore important and obvious.

Role of Globalisation and Information Technology

The increasing globalisation and removal of trade barriers, thanks to institutions such as the WTO, is also adding one more dimension to better corporate governance through introduction of uniform standards. For instance, India has been examining the issue of adopting GAAP—Globally Accepted Accounting Practices. Perhaps acceptance of such standards will bring in, in due course of time, a uniform set of practices for corporate governance. The thrust for greater uniform standards has got a boost thanks to the increasing use of information technology. The Internet and the increasing use of information technology are opening new horizons for business. Simultaneously, the potential for cyber crimes which can be committed internationally is also being realised and the corrective measures are contemplated along with the research to arrest such crimes. To tackle the cyber crimes, it becomes necessary to have international standards and international cooperation. This is also going to contribute significantly to the evolution of systems and procedures, principles and regulation to ensure healthy corporate governance practices prevail. One can hope that this, in turn, will have an impact on the public governance in different countries and this may bring out a healthy impact on the society.

The Development of organisations like the WTO is also another step that would introduce in good time a set of uniform standards and approaches so far as the treatment of the behaviour of business enterprises is concerned. To the extent common standards evolve, either due to the operational needs dictating adoption of uniform standards or the necessity for fighting common evils such as cyber crime promoting cooperation or the legal commitment entered into internationally by the members of the WTO, all point to a state where the public governance and the corporate governance become increasingly inter-related. To the extent a country is more and closely linked with the global economy, this inter-connection also becomes stronger.

Role of the Judiciary

The judicial system has an important role to play in ensuring better public governance and corporate governance. There may be so many regulations, rules and procedures; but ultimately when disputes arise, they have to be settled in a court of law. There could be, of course, alternative dispute resolution mechanism such as conciliation or arbitration, but in countries like India, it is the judiciary that has to step in and ensure that healthy practices prevail.

The basic framework of the Constitution in India depends on the three main pillars, namely, the judiciary, the executive and the legislature. It is axiomatic that the basic structure of the Constitution is not to be tampered with. One of the areas

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in which the judiciary has been very active is in pointing out whether in terms of any legislation that is passed or practised, principles and laws are enacted to test whether they are in tune with the basic structure of the Constitution. This is an important provision and to that extent the judiciary is found to be clean and effective. It can be a guarantee not only for a better public governance but also for the better corporate governance.

Governance is a Matter of Continuous Learning

Ultimately, both better the public governance and the corporate governance are an exercise in continuous learning. We learn from experience and try to avoid the mistakes committed in the past. But when it comes to new types of crimes or new types of frauds, it is better to remember what Oscar Wilde said: 'The thief is an artist and the policeman is only a critic.' It does not mean that we should stop devising systems, which will be as effective as possible in ensuring that better governance prevails. Ultimately, there are two elements for better governance. First is the individual values of the people who are running the enterprise and the second is the external framework of rules, regulations, organisations and systems. Perhaps a continuous effort at sensitising the people about the need for good corporate governance is required because, however good are the operational systems and procedures, we will not succeed if the people, who are operating the systems, do not have the right values.

Of Governance and Government

The present concerns of governance present a point of view that seems to suggest a singular concern for the shareholder, whether minority or otherwise. A change in this narrow perspective is essential. The discussions on the practices of corporate governance have to include a stakeholder perspective. Governance has to be understood as a construct, which includes the accountability of the entity to all its stakeholders. Managing the interests of all the stakeholders is the essence of governance. Governance is as much a political process as it is economic, unlike management, which is only economic. Governance is about managing interests.

Corporate governance is as much about the organisation and goals of companies as it is about the institutional environment and markets in which companies operate. Hence, it deals with the constitutions, competence and character of the board as much as it deals with the internal government of the company and its rule-making processes. Corporate governance is concerned with the rule of law in the company and the respect the company has for the rule of the law. And for good corporate governance, the leadership of the entity has to manifest statesmen-like behaviour. Therefore, invoking the tenets of governance in every context may dilute the concept beyond recognition.

While the need to move towards desirable governance practices by the Indian companies is essential, it may be useful to define these practices in wider terms within a broader perspective. Measuring such a rich and broad concept in terms of simple instrumentalities such as the audit committees or the accounting compliance may lead to trivialising the concept. As a consequence, companies may just present their accounts better and continue to ignore the more critical and substantial governance practices. The entities at the level of the state and corporate have to recognise that governance is not merely about being compliant but about understanding the importance of compliance and accountability to stakeholders. Corporate India and the Government of India have to work hard towards this understanding.

The Scope of Government's Relations with Business

The scope of government relations with the business in the context of developing countries is indeed wide and deep. The role of government in few areas are mentioned below:

- It prescribes the rules of the game.
- It is the major purchaser of the output of the business.
- It uses its contracting power to get the business do things it wants.
- It promotes and subsidises business.
- It is an architect of economic growth.
- It protects interests of the society against the business exploitation.
- It directly manages large areas of private business.
- It is a national security protector.

The scope of government relations with business in the context of developing countries is indeed wide and deep. The government prescribes the rules of the game, is the major purchaser of the output of business, uses its contracting power to get business do things it wants, promotes and subsidises business; is an architect of economic growth and directly manages large areas of private business.

Governments Have to be Proactive in the Following Areas

- The Government should ensure that stakeholders' interests are protected by continuous monitoring of companies, to see that they do not cheat their the stakeholders.
- The Government should make laws to govern companies, to undertake all the activities within the rules of the game. It should also make sure that all companies adhere to rules, as for example—MRTP (Monopolies and Restrictive Trade Practices) Act. This Act enables the government to regulate industries wherein none of the private companies becomes a monopoly by indulging in practices that would adversely affect consumer interests.
- If companies do not adhere to rules and regulations, the government should penalise such companies and make sure that they do not repeat it again.
- Government has appointed regulators to regulate several sectors, to monitor the activities of companies, to allow them to a have fair competition in the market and also to save them from disputes when problems arise. For example, we have the Reserve Bank of India (RBI), the Securities and Exchange Board of India (SEBI), the Telecom Regulatory Authority of India (TRAI), and the Insurance Regulatory and Development Authority (IRDA). These regulatory authorities have some important functions to perform to ensure a better governance practices in their respective areas. They should ensure accountability, which follows from transparency. Responsibilities could be fixed easily for actions taken or not taken. Each activity in the company should be made known to all the stakeholders. A company has to be very fair to its stakeholders and inform them as to how the funds are being utilised. Regulators can also avoid insider-trading through preventive measures. Regulators allow fair competion in the market. They also prevent the emergence of monopolies in their sector.

Enactment of Laws

Different laws have been enacted by the government to fulfil the needs of different people in society like employees, employers, customers and the society at large. To protect the employees, government has brought in legislations such as Factory Acts, Minimum Wages Act, Labour Laws and Trade Union Act to make sure that they are well protected and their problems are solved. Through these Acts, employees are able to negotiate or bargain with their employers. Employees' grievances are addressed by these Acts so that employees' welfare can be taken care of by the government.

Different laws have been enacted by governments to fulfill the needs of different people in society like employees, employers, customers and the society at large. To protect employees, government has brought in legislations such as Labour Laws and Trade Union Act. Human rights are protected by ensuring good quality products at reasonable prices. Pollution standards are maintained by making all companies adhere to some ecological standards. Governments make investments in capital goods industries in which most private companies cannot invest because of some constraints like huge investments and long gestation period as in the power sector, oil sector, telecom, airlines and so on.

There are laws for the employer protection, also to save them from illegal strikes and lock-outs that cause production losses and the like.

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As a Role Model

Government should portray itself corrupt-free so that companies can follow its worthy example. Removal of the license system for several industries, greater transparency in administration, granting of autonomy to the public sector enterprises, reducing the role of the Inspector Raj in the economy, allowing a greater degree of competition in industries which were hitherto protected, will all go a long way to reduce corruption.

The Areas That Need Special Attention

The government should ensure that the quality of audit, which is required for effective corporate governance, should be considerably improved. Government should ensure with assistance from industry, the accountability of the CEOs and the CFOs. It should try to maintain the quality and effectiveness of the legal regulatory framework as well as the administrative framework.

CONCLUSION

In the ultimate analysis, government should set an example by a transparently blameless conduct of its own affairs. It should legislate, regulate, and ensure proper conduct of organisations, and enable them to adopt the effective voluntary codes of conduct without the heavy hand of legislation, and, wherever possible, stimulate national debate on moral aspects of governance and help create awareness among all the sections of the society on the importance of ensuring better governance practices both among corporates and in the civil society. In this context, it will be worthwhile to quote the view the of the Indian government in the matter of corporate governance. The government has indicated that while it believes in regulation of corporate governance standards in the country, it would not transgress to policing. Speaking at a CII conference on corporate governance trends, the Minister of Company Affairs, Mr Prem Chand Gupta, said that the government was committed to transparency and simplification, and was opposed to any kind of policing of the corporate sector. On the long-standing debate on whether corporate governance should be regulated or flexibility should be accorded to companies *vis-à-vis*, their corporate governance practices, the minister counted two reasons in support of the stand for regulation. 'One corporate failure or scandal can potentially erode shareholders, trust in the whole of the corporate sector and thus negatively affect the business of honest firms as well,' he said, citing the examples of the Enron and the WorldCom, which had dented the faith of investors in the corporate sector and hurt the larger interest of the economy. 'It is thus the responsibility of the government to prevent such occurrences.'[6] Mr Gupta further argued that the employment of a large number of public and substantial public money rides on the corporate sector.

KEYWORDS

- Comparative study
- Corporate constitutionalism
- Developing economy
- Different roles of government
- Enactment of laws
- Entrepreneurial role
- Globalisation
- Government regulation
- Government relations with business
- Information Technology
- Limiting corporate power
- Political governance
- Power of coercion
- Principle Based Regulation
- Promotional role
- Public governance
- Regulatory role
- Restraints of power
- Role model
- Role of Judiciary
- Rule Based Regulation
- State intervention
- Self Regulation
- Voluntary associations.

DISCUSSION QUESTIONS

1. Discuss the rationale for government intervention in free market economies. What are its limitations in its exercise of power in regulating business?
2. Explain with suitable examples the different roles of governments in free market economies.
3. Why is it necessary for the State to intervene in the development process of a developing economy? Explain this in the context of Indian's economic growth.
4. What are the limits of corporate power? In this context, discuss the role of the State in limiting corporate power.
5. Do you think better public governance can play a decisive role in improving corporate governance? Discuss it in the context of the developing countries like India.
6. Discuss the scope of governments' relation with business. When do you think this relationship will lead to a win–win situation?

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13



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The Role of the Media in Ensuring Corporate Governance

CHAPTER OUTLINE

- Introduction
- The Board of Directors
- Corporate Governance and the Press
- Ethics in Advertising
- Adverse Effects of Advertising
- Some of the Leading Media Intervention in Corporate Governance
- Shareholder Activists and Press

Introduction

Media is a powerful tool in making and unmaking entities in a democratic system. It is the fourth powerful pillar of democracy and therefore, it is often referred as fourth estate. Media has often played the role of a friend, a philosopher, a guide and a critic of corporate entities. Its role is very pervasive in every corporate functioning. Media's role as an external whistleblower has been proved in many corporate failures in India. In the recent past, the Sahara episode came into the light with the active intervention of media. It protects the interest of every stakeholder right from the principal stakeholder to the society at large. Media pressures the corporate to implement laws effectively, it demands the politicians to frame laws and reform the existing law. Media is often seen as a caretaker of the shareholder's money. It plays a crucial role in adhering to the need and necessity of upholding the societal norms.

Media not only barks on wrongdoers but also bites mercilessly. It now assumes different forms with the emergence of social media and the corporates are now struggling hard to keep the images of the company at the highest level.

Media not only barks on wrongdoers but also bites mercilessly. It now assumes different forms with the emergence of social media and the corporates are now struggling hard to keep the images of the company at the highest level. Corporate does not encourage negative publicity and therefore, they manage them efficiently. Even though media is picturized as a powerful tool in society, the media is often taken with precaution while dealing with corporate wrongdoings. The business model pursued by the media and the corporate world is almost similar. Media is more dependent on corporate when dealing with its business particularly on matters related to generating income for the media. Therefore, it strikes a balance when dealing with its reader's interest and corporate interest. It may be noted that still some of the big corporate scandals are brought to the public with the media intervention.

What Role Can the Media Play in Corporate Governance?

The role of the media is to collect, select, certify and repackage information. This helps the investor to collect the necessary information about the investment at his fingertips. Media as an information disseminator reaches all the stakeholders at one go without any cost, and therefore, media act as the cheapest and powerful communicator on corporate issues. The second way in which the media can affect the decision is by increasing the reputational cost. Reputation of the company, is the systematic effort on the part of company administration through a steady and constant effort of good governance. This is a fragile image, and therefore, media should be dealt with utmost care. Third, the media can have an impact by changing the expected enforcement costs. Media as an enforcer of good decisions, is a trade off force in reputation and good governance. Finally, it can change the size of the penalty of bad governance. The cost of bad governance will increase manifold with the intervention of media.

Media and Reputation of Companies

Media plays a vital role in bringing the reputation of the company. The total value of the company as reflected in the market capitalisation is the outcome of corporate reputation. This in turn reflects the cognitive and emotional behaviour of investors of the company. Reputation plays in disciplining corporate managers.

This reputation reflects in the employee attrition and employee re-entry in organisations. The CEO of the organisation continues to change their mind on account of the image the company has built over a period of time. More important, instead, is the role played by a manager's (or a company's) reputation with regard to financial markets. To the extent a company needs to access financial market repeatedly, its reputation will affect the terms of future financing. Since these terms affect the profitability of a company and its ability to exploit future investment opportunities, they will be important even for self-interested managers. Managers, however, seem to care not only about their reputation with regard to the future financial market, but also with respect to the society at large.

The role played by the media in the battle between public interest and vested interests is very high. A major reason why vested interests have so much power in political decisions is because of the 'rational apathy' of voters however; this rational apathy can be overturned by the media.

Effect on the Reputation of the Enforcers

The reputational cost of not acting is affected by the media reporting. The role played by the media in the battle between public interest and vested interests is very high. A major reason why vested interests have so much power in political decisions is because of the 'rational apathy' of voters however; this rational apathy can be overturned by the media. By making political news entertaining, the media can overcome voters' cost to become informed and, in so doing, reduce the power of vested interests. Finally, politicians do not care only about reputation with regard to voters, but also their reputation (and their country's reputation) with respect to foreign countries.

When are the Media Most Effective?

If we look at the impact of media it is greater when the media reach a larger number of relevant groups (i.e., groups with whom managers care to maintain a good reputation) and when the news reporting generates a greater increase in public interest. In the language of the media these two characteristics are diffusion and credibility. *Ceteris paribus*, the more people a medium reaches, the broader will be the reputational impact of its reports. Similarly, to increase the public interest, the news must come from a credible source, otherwise it is not believed. Finally, the effectiveness of the media depends upon the magnitude of the reputational punishment. If the punishment occurs in the labour/product market, its magnitude depends upon the frequency of repeated buyers in that market and the ratio between the future and the current benefits. In a market where repeated buyers are rare, then the reputational penalties are limited. Similarly, if the future benefits from having a reputation are small (for example, a company that has cash flow positive and does not expect to raise additional funds in the future) relative to the current benefit of deviating, then the media cannot have much of an effect. If the punishment occurs through social pressure, then its magnitude depends upon the strength of the social norm. For example, when a former CEO of Fiat was convicted for false financial reporting, the major Italian newspaper published a letter of solidarity of the most important business leaders. Thus, in this case, the social sanction associated with the news appears to have been minimal, because in Italy there is not a strong social norm that this law should be obeyed. By contrast, in the United States there is a well-developed set of business publications that share the view that managers should maximize shareholder's value. Hence, executives fear being exposed as villains in these publications. Hence, the media can only be as effective as the moral norms shared by a certain community and its media.

Stages of News Media Influence on Governance Practices of Corporate

1. Occurrence of a corporate governance violation by a listed public company in the country.
2. News media communication of the violation to company stakeholders.
3. The actions of company stakeholders in response to news media coverage of the violation.
4. The effects of stakeholder actions on the violating company.
5. The response of the company or corporate governance outcome.

Stakeholder Actions in Response to News Media Coverage of Corporate Governance Violations

Shareholders

The theory of the market for corporate control vindicates that shareholders of inefficiently managed companies may dispose of their shares whereby, the threat of takeover is a means of disciplining management. If the shareholders learn that management have failed to safeguard their interests in pursuit of their own objectives, they may choose to exit the firm and sell their shares. Empirical evidence indicates that the news media is one means through which the shareholders may receive such information and note the downward movements in share price following media pessimism regarding firm performance. Investor behaviour may not be so predictable, however; recent findings indicate that individual investors tend to 'overreact' to media scrutiny of the corporate governance practices of companies, quickly disposing of shares, while more sophisticated institutional investors, who account for a greater proportion of firm ownership, tend to buy shares in violating firms anticipating the dismissal of underperforming management or a reform in governance practices. Share price movements in either direction may potentially impact upon the company management leading to corporate governance reform.

There are alternative options available to shareholders who receive news of management negligence. Active owners as opposed to active traders, namely indexed institutional investors may become more effective monitors and able to reduce their information costs. As has been proposed herein, the news media is one means of achieving such efficiency and there is a range of strategies which informed, activist shareholders might take to target underperforming or opportunistic management. Collectively, investors may seek to change corporate policy and campaign for improved governance through the use of 'more sophisticated communication strategies'. Specifically, coordinated groups of shareholders may improve the standard of monitoring, using proxy contests to make changes to the board. By making use of their right to vote in an organised manner, institutional investors may initiate debate over policies, replacing existing policies with the ones endorsed by the shareholders and address the concerns relating to more specific facets of the company's governance such as the independence of the board or the structure of committees.

Policy Makers

Shareholders may require court or governmental protection in case, of corporate governance failure. As in the case of the failure of Satyam Computers the political system in India quickly acted and to a certain extent rescued the stakeholders from further damage. As a debating forum for the political affairs, the policymakers

Shareholders may require court or governmental protection in case, of corporate governance failure

evaluate the efficacy of corporate policy in parliament or in the respective party forums as a part of their professional duties. Having identified a problem in a given environment, which for the purposes of this discussion is assumed to be the corporate environment, the members of the government formulate a policy through a parliamentary debate, following this, laws and regulations are passed, implemented and evaluated. The media may not necessarily initially alert the policymaker to a violation of corporate governance, however, the level of media coverage of the issue allows legislators to gauge the extent of its effects, that is the number of shareholders or general stakeholders whose interests have been neglected. The degree of effort and attention with which the policymaker intervenes depends on a number of factors including political objectives, political reputation with the voting public and international political reputation. The governments may use agency problems to further their political agendas. In the wake of corporate governance scandals, political parties opposing the governing party may use the issue as an opportunity to criticise the performance of the principle legislators, thereby coercing them to increase the stringency of corporate legislation or approve regulatory intervention. The stakeholder model further points toward how the media potentially influences corporate governance practices by way of corporate policymaking activity. The media has traditionally been referred to as the fourth branch or 'fourth estate' of the government. That is to say, that by informing the voting public, the media facilitates the functioning of a democracy.

The Board of Directors

The board of directors, in its capacity as a monitor of shareholders' interests, has a responsibility to take appropriate action so as to discipline the underperforming or opportunistic management.

From the perspective of the stakeholder model of corporate governance, it may be argued that while the shareholders may express their concerns against the management through voting or by exercising some of the other rights afforded to them; other company stakeholders, namely claimants such as customers, suppliers or partners must find alternative means of action in the wake of media scrutiny of the company's governance. These responses would be expected to involve the withdrawal of finance, custom or a service necessary for the company to operate profitably, thereby causing some degree of financial concern and hindering wealth maximization. The board of directors, in its capacity as a monitor of shareholders' interests, has a responsibility to take appropriate action so as to discipline the underperforming or the opportunistic management. Directors would also be expected to ensure that future performance of the company will not be jeopardised by an inappropriate managerial behaviour. Alternatively, in accordance with the stewardship approach to corporate governance, media criticism of management may alert directors, be they executive or non-executive, to a need to encourage management to work towards organisational goals. Working collaboratively and realizing the long-term utility of the company's reputation, directors and management may work to remedy a situation caused by the management misconduct. It may then be argued that sufficient press coverage on a corporate governance violation by a firm may pressurize and lead directors and management to institute reform within the business. This effect is related to the power of the press to control corporate reputation, a valuable firm resource (From Brun and Shanley, 1990; Deephouse, 2000). Hall (1992) notes that 'reputation, which is usually the product of years of demonstrated superior competence, is a fragile resource; it takes time to create, it cannot be bought, and it can be damaged easily'. The management and directors of companies which receive negative media coverage due to the occurrence of a corporate governance violation would therefore be expected to repair any damage done to the company reputation by compensating the shareholders and implementing reforms.

The Influence of the News Media on Corporate Governance via the Shareholders

The theories of both the finance model and the political model of corporate governance suggest that the shareholders who actively consume news media information may eventually minimise agency costs and ensure managerial accountability. As predicted by the theory of the market for corporate control, by disposing of company shares upon learning of the violations of corporate governance through the news media, dissatisfied shareholders may impose the threat of takeover, which may compel management to act within the interests of shareholders in future or face a situation where more diligent management would be instituted by new owners. It would be expected that under the new management, better standards of corporate governance would be practiced in the firm. Using this rationale, one might argue that through the market, the news media influence the corporate governance practices of the violating firms.

The theories of both the finance model and the political model of corporate governance suggest that the shareholders who actively consume news media information may eventually minimise agency costs and ensure managerial accountability.

The Influence of the News Media on Corporate Governance via Corporate

Policy Makers

Consideration of corporate governance through both the political and the stakeholder theoretical lenses indicates that as an information intermediary between the company, corporate policymakers, their political counterparts and the voting public, the news media influences corporate policymaking and regulatory activity. News media criticism of companies' governance practices leads various groups to question the ability of the policymakers to preserve an effective corporate legal and regulatory environment. It follows that the policymakers intervene by increasing the stringency of corporate legal instruments and regulatory provisions. Consequently the violating companies must follow guidelines which curtail their behaviour more extensively or potentially face imposition of penalties by regulators or the judicial system. The threat of increased corporate legislative and regulatory control and the potential financial and reputational consequences associated with non-compliance would be expected to encourage improved corporate governance practices in companies vulnerable to opportunistic managerial behaviour or director complacency.

The Influence of the News Media on Corporate Governance via The Board of Directors

As many commentators on Stewardship Theory indicate, the balance directors strike between monitoring and stewardship is a matter of contingency. Nevertheless, should a company receive a negative coverage in the news media regarding the way its standards of corporate governance, the directors and management would be expected to take actions to repair the reputation of the company. Measures may include parties affected by misconduct within the company through an alignment of goals or financial reimbursement. Management accountability, financial transparency and active board oversight and/or stewardship would also be expected from the board of directors in future, that is to say, that if reputation is considered an important company resource, one would envisage that the board of directors would take steps to implement corporate governance reform.

Corporate Governance and the Press

The press also intercept with various corporate governance mechanisms.

Shareholder Activists and the Press

While activists such as Robert Monks and Nell Minnow have found the press useful in their fights with managements in the United States, does the press have a similar effect in the emerging markets? Recent events in the Republic of Korea indicate that it does.

Korea has long been known as a place where the controlling shareholders in the largest Korean firms (Chaebol) take advantage of their position at the expense of small investors. National corporate laws convey few rights to outside investors—they score only 2 out of 5 in La Porta and others' (1998) index that measures the strength of protection for minority shareholders—and expectations in relation to law enforcement are low. According to an index designed to assess countries' law and order tradition, Korea has a level half of the average in the industrial countries.

The beginning of efforts to force change in Korea dates back to 1996 and the formation of the People's Solidarity for Participatory Democracy (PSPD) driven by Jang Ha-Sung of Korea University. As in the United States, this investor activist has focussed his attention on changing corporate policies in the largest Korean firms, and has relied both on legal pressures, including proxy battles, criminal suits, and derivative suits, and on the use of the press to shame corporate leaders into changing their policies. Perhaps to an even greater extent than in the United States, the success stories have resulted more from the creation of public opinion pressure than from legal sanctions.

The most successful challenge to date has been the battle to stop insider dealings in SK Telecom. SK Telecom was an extremely profitable company, but its financial results did not show this because the company used 'transfer pricing' to benefit two companies almost 100% owned by the chairman of SK Telecom and his relatives. The PSPD drew attention to these policies. After the London-based the Financial Times picked up the story, a media campaign ensued to attract proxy votes. This campaign involved publishing advertisements in newspapers and using television and radio. In March 1998, SK Telecom's directors capitulated and agreed to the PSPD's requests.

This success stands in a sharp contrast with the failure of legal actions. For example, shareholders' proposals are severely restricted and cannot involve the removal of directors or auditors. Perhaps the only successful legal challenge has been the one to ensure investors' rights to speak at meetings, though the right to speak can only be used to affect the reputation of the parties involved, not to trigger any legal remedy. For example, the press gave extensive coverage to the fact that the Samsung shareholders' meeting that lasted 13 hours. The effect of shareholder and public opinion pressure was an increase in the transparency of Samsung's financial statements.

Institutional Investors

While institutional investors have many legal mechanisms to encourage change in corporate policies, the presence of an active press increases their influence. It provides a relatively cheap way to impose penalties on companies and to coordinate the response of other investors in availing themselves of potential legal protection.

Private and Government Regulators

Public opinion pressure generated by an active press plays an important role in the efforts by private sector organisations to use self-regulation to improve

corporate governance. Consider the approach in the United Kingdom to the range of financial scandals of the 1980s, including the collapse of the Bank of Credit and Commerce International and the Maxwell Group. Instead of legislation that proscribed certain activities matched by the court sanctions and fines, the United Kingdom pursued self-regulation, enforced through disclosure. The Cadbury Committee, dominated by the private sector, defined corporate governance standards and developed mechanisms to compel the disclosure of performance relative to standards, allowing the force of public pressure generated by disclosure and news stories to change practices. This publicity route had the advantage that the self-regulatory organisation had the power to impose it and the penalty could be introduced quickly. Alternative sanctions, such as fines and court-enforced penalties, were either unavailable or could be delayed through court proceedings, thereby limiting their effectiveness.

The Cadbury Committee, which submitted its report in December 1992, was the first effort at reform by means of disclosure and public pressure. The key element of the report was a code of best practices with 19 recommendations, including an enhanced role for the independent directors, a minimum number of independent directors, and the separation of the roles of the Chairman and the CEO. Since 1993, the London Stock Exchange has made a requirement for listing a company to include a statement of performance relating to the code and a written explanation for any variation in its annual reports. It has since become a common practice for company statements issued to the press and for independent press reports to identify performance relative to code standards, with a lack of compliance described largely as a failure of corporate governance by the company and its directors. A similar approach regarding company practices toward executive compensation was adopted in the Greenbury Report, issued in July 1995, and in the Hampel Report, released in January 1998. All these best practices have been consolidated into a 'supercode' published by the London Stock Exchange in June 1998, again, with the requirements for disclosure rather than compliance.

The Cadbury Committee, which issued its report in December 1992, was the first effort at reform by means of disclosure and public pressure. The key element of the report was a code of best practices with 19 recommendations, including an enhanced role for independent directors, a minimum number of independent directors, and the separation of the roles of the chair and the CEO.

The extent success of a disclosure and publicity approach is widespread. In Hong Kong (China) the stock exchange has historically not had the legal authority to impose penalties on companies that misbehave. Instead, it uses the media as a sanction, taking out advertising space to notify the public about a firm's security violations. The threat is usually enough. Shaming is both a personal penalty for the executives involved and may introduce a financial penalty if others now update their beliefs about the reliability of the executives and company and increase their terms for financing projects suggested by the executives.

The Press Versus Other Mechanisms for Addressing Governance Problems

In some markets the penalties that can be imposed by the press are at least as important as other mechanisms for fighting misgovemance that the literature more commonly focusses on. Consistent with this contention is a recent survey in Malaysia that asked institutional investors and equity analysts to identify the factors that were most important in assessing corporate governance and deciding to invest in publicly listed corporations. The analysts thought that the frequency and the nature of public and press comments about the company were more important than a host of other factors that receive more attention in academic debate, such as the company's relationship with the regulatory authorities, the number of independent non-executive directors and their qualifications, the existence of remuneration and audit committees, and the identity of company auditors.

Selective Coverage and Media Credibility

A critical issue is the credibility of the information the media communicates to the public, This is extremely important. It opens up the question of newspapers' incentive to conduct further investigations to establish the validity of the information reported to them and to report the information they receive accurately. If it is difficult for a newspaper to build a reputation of integrity in a market where all the other newspapers are colluding, the possibility for multiple equilibria arises.

So far we have treated the media as a single entity that aggregates and then communicates information. A critical issue we have ignored is the credibility of the information the media communicates to the public, which is, of course, extremely important. The fact that the Financial Times reported on the SK Telecom and Gazprom insider deals brought credibility to the stories, because even in Korea and Russia, the Financial Times is more credible than local newspapers. Similarly, the Business Week ranking of business schools had a much greater impact than the US News and World Report ranking because the former is not only more diffused, but also more authoritative than the latter.

The issue of credibility is particularly delicate because it opens up the question of newspapers' incentives to conduct further investigations to establish the validity of the information reported to them and their incentives to report the information they receive accurately. It is precisely when newspapers do have an impact that they have an incentive to enter into side deals with the parties involved and be paid for not to reveal damaging information. Threats to increase (or withhold) future advertising revenues in exchange for stories that reflect well (or badly) on company management and directors are one example of side deals. Of course, such side deals might hurt the reputation of a newspaper in the long run and hence its credibility.

If it is more difficult for an individual newspaper to build a reputation of integrity in a market where all the other newspapers are colluding, the possibility for multiple equilibria arises. One equilibrium is where the newspapers have credibility and thus avoid side deals for fear of losing it. Another is where the newspapers do not have credibility and happily accept bribes not to publish damaging information or to publish a false damaging information. Important factors that determine which equilibrium prevails are the competitive environment in which the newspapers operate, the ownership structure of the media, and libel laws. In a competitive market, a newspaper agreeing not to publish bad news is likely to be scooped by another newspaper and to lose credibility. Thus the more competitive the environment is, the less likely is the collusive equilibrium.

Similarly, an independent newspaper whose survival rests solely on its own success is less likely to collude with established business interests. By contrast, a newspaper owned by a business group is naturally less likely to publish bad news about the group itself. This, in turn, affects its credibility in correctly reporting other news, thereby reducing its incentives to build a reputation (and increasing its incentives to collude). More stringent libel laws reduce the likelihood of a newspaper publishing information that suggests that managers are 'bad', again reducing the information content of the media.

Consumer Demand and Selective Coverage

Demand considerations also lead to a selective focus on stories with a wider interest, such as executive compensation levels, (rather than on other elements of good corporate governance) the composition of boards and the role of auditors, even after scandals such as Enron and WorldCom. Readers may not be able to appreciate the nuances of corporate situations, leading to news stories that simplify firm performance relating to environmental or corporate governance standards in too stark a way. In the United Kingdom, for example, while the recommendations developed in the Cadbury, the Greenbury, and the Hampel reports are often qualified, they are rarely reported that way. The 'public' version is a gross oversimplification around bright line rules, producing 'box checking' and intense pressure to conform to standards different from those intended.

Finally, the demand for corporate governance news might depend on the structure of corporate ownership. Thus the extent of coverage and the consequent sanctioning role of the press are likely to be more important when a broad group of citizens have a personal interest in the outcomes, because of their direct or indirect (through pension funds) shareholdings. The important corporate governance role played by the media in Korea and Malaysia described earlier is probably attributable to the widespread dispersion of ownership in the publicly traded firms in these two countries.

The media play an equally important role in shaping corporate policy in addition to governments and regulatory bodies. The media selectively reduce the cost of acquiring and verifying information. This information is crucial in shaping the reputation of the key players who determine corporate policy. The reputation that the decision makers seem to care about is not just the reputation in the eyes of current and future employers, but more broadly, their reputation in the eyes of the public at large, that is, their public image. Only concerns about their public image would explain the responsiveness of corporate directors to environmental issues, which have a zero or negative impact on the wealth of their ultimate employers, that is, the shareholders.

These effects of the media are not only anecdotal. The more diffuse the press in a country is, the more companies are responsive both to environmental issues and to minority shareholders' concerns, even after controlling for the presence of specific laws and regulations and the level of law enforcement. The media can help shareholders or can hurt them. It is to be noted that the media is important in shaping corporate policy and should not be ignored in any analysis of a country's corporate governance system.

Ethics in Advertising

Advertising is one of the major tools corporates use to direct persuasive communications to target the buyers and the public. They advertise to inform potential buyers of the existence of a product and to establish a positive attitude towards it. According to Aristotle, one of the basic concepts in effective persuasion is to be ethical. Every advertiser needs to be ethical. Raymond Baumhart has quoted this in his book *An Honest Profit: What Businessmen Say About Ethics in Business*, 'Ethical is what my feelings tell me is right. Ethical means accepted standard norms in terms of your personal and social welfare: What you believe is right.'

Advertising is one of the four major tools corporations use to direct persuasive communication to target buyers and the public. They advertise to inform potential buyers of the existence of a product and to establish a positive attitude about it. This is an era of a vigilant and well-informed consumer who wants to know what is in a product, who produced it and under what working conditions it was produced.

For decades, broad social and economic issues have been raised concerning the role of advertising in society. This is an era of a vigilant and well informed consumer who wants to know what is there in a product, who produced it and under what working conditions. This is an era in which corporates will have more lasting relationships with the consumers than just marketing products.

Social accusations have been directed at advertising in such pungent, and imaginative terms that they appear to emanate from talents as creative as those within the advertising community. Advertising is said to destroy the finer things of life. If has been described by some as vulgar, idiotic, degrading, shrill, noisy, blatant and aggressive. It is said to exalt lower values and glorify mediocrity.

A number of humanities and social science scholars view advertising as intrusive and environmental and its effects as inescapable and profound. They see it as reinforcing materialism, cynicism, irrationality, selfishness, anxiety, social competitiveness, sexual preoccupation, powerlessness and a loss of self respect. These are strong indictments which imply that advertising is a powerful force, that could cause a lot of harm, if unregulated.

Beneficial Effects of Advertising

Advertising aids in the education of the general public. It facilitates the exercise of free choice and free will and subsidises mass communication providing essential services to the public.

- **Information:** Advertising aids in the education of general public; facilitates the exercise of free choice and free will; and subsidises mass communication providing essential services to the public.
- **Values and life-styles:** Advertising contributes to the improvement in the standard of living; contribution to the sharing of opulence (comforts) among the masses; and represents as essential factor in the economies of abundance.
- **Creative experience:** Advertising adds new and interesting experience to life.

Discussion on the ethical aspects of advertising can be organised around the various features identified in the statement mentioned above: its social effects, its creation of consumer desires and its effects on consumer beliefs.

Adverse Effects of Advertising

Deception

A deceptive advertisement is one in which a material untruth is told or hinted at. The use of a secondary meaning of a word is also considered as deceptive. For example, a soft drink may be described as an orange drink, though it is artificially flavoured.

Fear Appeals

Fear appeals have been criticised. The intent of fear appeals is to create anxiety in the minds of the consumer and provoke him/her to make use of a particular product to allievate the fear in him/her.

Advertising to Children

Many advertisements cater to children. Most of the advertisements such as those for chocolates and ice creams are directed at children. Children between ages of 2 and 11 spend at least 3 hours a day watching television. Second, pre-school children cannot differentiate between commercials and programmes. They do not understand the selling intent of commercials and cannot distinguish between fantasy and reality. Third, children between ages 7 to 12 have difficulty in balancing appeals of highly sugared products—the long term health risks of diseased gums and tooth decay are high. Fourth, there are hardly any counter ads for fruits and vegetables. Fifth, most of these advertisements are deceptive as they omit significant information such as the complexity and safety of operating toys. However, defenders of advertising to children offer the following positive effects:

1. Advertising gives product information to the child that assists him/her in making decisions.
2. Children are developing skills through advertising and will be more independent and make better selections among products targeted towards them.
3. Advertising is an influence on the process of socialisation—it is a means whereby children learn the value system and norms of the society they are entering.

Materialism

Materialism is defined as a tendency to give undue importance to material interests and objects. It leads to a sort of 'Mammon-worship'. Consequently, there is a corresponding lessening of importance to non-material interests such as love,

freedom, and intellectual pursuits. The message of a television communication is essentially materialistic. The message of television advertising is that the acquisition of a few things will gratify basic needs and aspirations. It is the message of the communication that the major problems confronting an individual can be immediately solved by the use of some products. Thus externally derived products are made a prescription for life's difficulties. The commercials do not give importance to the individual to deal with his/her life's problems.

Promoting Stereotypes

There is an accusation that advertising has contributed to the role of stereotyping of women. Nearly 90% of the advertisements show the woman as a housewife. Most of the advertisements portrary only beautiful girls thereby creating an inferiority complex in the minds of plain-Janes. This also increases expectations of the viewers.

Advertising Alcoholic Beverages

There is a national concern with the problem of alchoholism. That is the reason why advertising of alcohol is banned in several states in the country. However, there is a possibility that the states that have resource constraint may revert to it. However, when exposed to it, children see the advertisements for beer, wine, etc., long before they are old enough to drink.

Competitive Advertising

Competitive advertising is a form of advertising in which two or more brands of the same product are compared and the comparison is made in terms of one or more specific product attributes. It is considered legal and is used quite widely. Comparitative advertising can lead to consumer confusion and is ethically questionable.

Increasing Costs

Advertisements that provide information to the consumers about the existence of certain products indirectly increase the final cost of a product. The ultimate burden of the cost is passed on to the consumer.

Exploiting Visual Appeals

Men succumb to visual appeals, the use of bathing beauties to attract men's attention is ubiquitous. Television advertisements strongly influence both the sexes.

"I'm the Best"

Nearly all the advertisement contain some measure of exaggeration. Many a time the audiences are carried away by the exaggerated language of the commercials where each manufacturer claims his product to be the best, the finest and the greatest. The buyers get carried away by these tall claims and make purchases.

Absence of Full Disclosure

Often the information relating to deficiencies and limitations of the product of service relating to matters of health or society is not disclosed. For example, most of the advertisements catering to cooking oil do not disclose the harmful effects such as increasing in obesity of an individual by using the product.

Use of Celebrities

Most of the advertisements use celebrities from the world of cinema or sports. The celebrity for the sake of money does such advertisements and influence the common man's choice of a product. These celebrities would not have even used the product once.

Fantasy and Reality

Nowadays, most of the advertisements make use of fantasies. The audiences in the fit of excitement may try out some dangerous pranks. For example, the advertisement of a popular soft-drink shows a boy going in search of the drink in question and later on lifts a bottle from a moving truck. Such incidents provoke the audiences to try out these stunts with dangerous consequences.

Advertising Standards

When it comes to the advertising and marketing, ethical issues become quite blurred. The advertising business in India has, therefore, tried to regulate itself with clear statements on what is proper and what is not. The code of the Advertising Standards Council of India expects, inter alia, that there will be:

(a) No offence to generally accepted norms of public decency.
(b) Truthfulness and honesty in claims and respresentations.
(c) No indiscriminate use of advertising for products which are hazardous to society or to individuals.
(d) No references to eminent personalities/political figures and the use of national emblems there will be permitted.
(e) Respect for the principles of fair competition generally accepted in business during comparative ads.

Unfair Trade Practices Through Advertisements Under the MRTP Act

Provisions bearing on unfair trade practices were incorporated in the Monopolies and Restrictive Trade Practices (MRTP) Act by an amendment in 1984. As defined under Section 36A of the Act, an unfair trade practice means any trade practice which for the purpose of promoting the sale, use or supply of goods or services adopts one or more specified unfair practices and causes loss or injury to the consumer, whether by eliminating or restricting competition or otherwise.

The following trade practices are considered to be unfair practices.

Provisions bearing on unfair trade practices were incorporated in the Monopolies and Restrictive Trade Practices (MRTP) Act by an amendment in 1984. As defined under Sec. 36A of the Act, an unfair trade practice refers to any trade practice, which for the purpose of promoting the sale, use or supply of goods or services adopts one or more specified unfair practices and causes loss or injury to the consumer, whether by eliminating or restricting competition or otherwise.

Misleading Advertisement and False Representation

These include the following:

(a) Falsely representing that the goods are of a particular standard, quality, grade, composition, style or mode.
(b) Falsely representing that the services are of a particular standard quality or grade.
(c) Falsely representing that the re-built, second-hand, renovated, reconditioned or old goods are new goods.

(d) Representing that goods or services have sponsorship, approval, performance, characteristics, accessories, uses or benefits they do not have.

(e) Representing that the seller or the supplier has a sponsorship, approval or affiliation which he does not have.

(f) Making a false or misleading representation concerning the need for or the usefulness of any goods or services.

(g) Making a representation to the public in the form of a warrantee or guarantee of the performance, efficiency or length of life of a product or of goods that is not based on an adequate and proper test thereof, the proof of which lies upon the person making the representation.

(h) Making a representation to the public in a form that purports to be:
   (i) A warranty or guarantee of a product or of goods or services.
   (ii) A promise to replace, maintain or repair an article or any part thereof or to repel or continue a service until it has achieved a specified result. Such form of purported warranty or guarantee or purpose is materially misleading or there is no reasonable prospects that it will be carried out

(i) Making a materially misleading representation to the public concerning the price at which a product or like – products or goods have been, or are ordinarily sold.

(j) Making false or misleading representation of facts disparaging the goods, services or trade of another person.

Bargain Sale, Bait and Switch Selling

This includes advertising for supply, at a bargain price, goods or services that are not intended to be offered for supply at the price, for a period that is, and in quantities that are, reasonable.[1] In India, apart from voluntary codes of the advertisers' bodies, the government also has enacted laws to protect consumers and others in society.

Under the MRTP Act, there are also provisions for safety standards, against offering gifts or prizes with the intention of not providing them and conducting promotional contests and also against hoarding or destruction of goods.

Section 36B empoweres the MRTP Commission to enquire into unfair trade practice, while Section 36D provides that on enquiry if the Commission comes to the conclusion that the practice is prejudicial to the public interest, or the interest of any consumer or consumers generally, it may order discontinuance of the practice. Besides, under Section 12B, the Commission has been empowered to award compensation, in appropriate cases, for the loss or damage caused to government, trader or consumer on an application made by him in respect of an unfair trade practice. Recently, the Commission has been vested with powers to initiate *suo moto* proceedings against any one offending the above cited sections of the MRTP Act. Such an order for payments of compensation may be enforced in the same manner as if it were a decree or order made by a high court in any suit.

Recent Trends in Advertising

The increase in competition in the market place with several new entrants has resulted in more aggressive advertising, giving rise to more intra-industry complaints, plagiarism of advertisements published outside India, and advertisements on satellite television channels in utter disregard of the Advertising Standards Council of India's (ASCI) code. What is more disturbing is the recent increase in vulgarity/obscenity in advertisements in various media, including

The increase in competitiveness in the market place with several new entrants has resulted in more aggressive advertising, giving rise to more intra-industry complaints, plagiarism of advertisements published outside India, and advertisements on satellite television channels in utter disregard of the ASCI code.

outdoor. This violation of public decency has been linked with cinema (feature films) and television (serial programmes) in the perception of the general public, which has raised a hue and cry in the sensitive and discerning segments of the viewing/reading public.

The British Codes of Advertising Sales Promotion

The Committee of Advertising Practice is the self-regulatory body that devises and enforces the British Codes of Advertising and Sales Promotion. The Advertising Standards Authority is the independent body responsible for ensuring that the system works in the public interest.

Advertising Code Principles

(i) All advertisements should be legal, decent, honest and truthful.
(ii) All advertisements should be prepared with a sense of responsibility to the consumers and to the society.
(iii) All advertisements should respect the principles of fair competition generally accepted in business.
(iv) No advertisement should bring advertising into disrepute.
(v) Advertisements must conform to the codes. Primary responsibility for observing the codes falls on advertisers. Others involved in preparing and publishing advertisements such as agencies, publishers and other suppliers also accept an obligation to abide by the codes.
(vi) Any unreasonable delay in responding to the ASA's enquiries may be considered a breach of the codes.
(vii) The ASA will, on request, treat in confidence any private or secret materials supplied unless the courts of officials acting within their statutory powers compel their disclosure.
(viii) The codes are adhered to in the letter as well as in the spirit.

Substantiation

1. Before submitting an advertisement for publication, advertisers must hold documentary evidence to prove all claims, whether direct or implied, that are capable of objective substantiation.
2. If there is a significant division of the informed opinion about any claims made in an advertisement, they should not be portrayed.
3. If the contents of non-fiction books, tapes, videos and the like have not been independently substantiated, advertisements should not exaggerate the value of practical usefulness of their contents.

Advertisers have the primary responsibility for ensuring that their advertisements are legal, decent, honest and safe. Advertisers should obtain written permission for portrayal of individuals/testimonials. Advertisements should be clear in terms of the price of the product, free offers, guarantee and availability of products.

No advertisement should cause fear or distress without good reason or provoke violence and anti-social behaviour. Unfair comparisons and exploitation of goodwill of competitors are unethical practices.

Cigarette Code

The cigarette code applies to advertisements for cigarettes and their components such as tobacco and tobacco substitutes. According to the rules of the code:

(a) No advertisement should incite people to start smoking.
(b) Advertisements should not encourage smokers to increase their consumption or smoke in excess.
(c) Advertisements should never suggest that smoking is safe, healthy, natural, necessary for relaxation and concentration, popular or appropriate in all circumstances.
(d) Smoking should not be associated with social, sexual, romantic or business success and advertisements should not be sexually titillating, though the choice of a particular brand may be linked to taste and discernment.
(e) No advertisement should play on the susceptibilities of those who are physically or emotionally vulnerable, particularly the young or immature. (For example, If you are an adult, smoke…… cigarettes)
(f) Anyone shown smoking should always and clearly be seen to be over the age of 25.

Other Restraints

There are restraints on some advertising. Certain services like legal and medical services are restricted in the way they can be advertised. For example, doctors cannot advertise boldly, individually in view of the medical ethics. Similarly, prescription drugs cannot be advertised for. There are restraints which respect to certain media—liquor or cigarettes cannot be advertised on the state channels.

Advertising has a large social responsibility as it is highly visible. The role of the government is very important in regulating advertising. It might be possible for the government to restrict advertising levels in certain industries. This restriction could take the form of mandatory controls on the rates at which firms could increase their advertising budgets. It could even include a provision for firms to decrease their level of advertising. The control should be on large organisations who have a monopoly in the market and not on small firms who would be wiped out by such controls.

Remedies for the Evils of Advertising

The following are some of the remedies for the evils of advertising.

Substantiation

A document procedure wherein the advertiser is required to submit proof that advertising is truthful. In other words, to substantiate their advertising claims, advertisers from selected industries should submit evidence that claims made with respect to safety, performance, quality of comparative price are true.

Fullest Possible Disclosure

The consumer expects an affirmative disclosure from the manufacturer of the product including the price, the contents, the usage, etc.

Corrective Advertising

These measures allow the advertisers to rectify the past deception in making suitable statements in future commercials. This will have a good effect.

Self-regulation

Setting up of a Board to investigate the matters relating to complaints against the advertiser.

Some of the Leading Media Intervention in Corporate Governance

Media both Indian and foreign have played a significant role in exposing corporate scams and improving the corporate governance in recent years. Some of the unique examples are given below.

1. Harshad Mehta Stock Scam, one of the biggest stock scams of 1992 involving ₹4000 crore bankers money lost in the deal was first brought to notice by Sucheta Dalal, a columnist for Times of India. In her words 'The crucial mechanism through which Mehta masterminded the scam was the ready forward (RF) deal. The RF is in essence a secured short-term (typically 15-day) loan from one bank to another. It is just like the bank lends against government securities as the local money lender lends against jewellery. The borrowing bank actually sells the securities to the lending bank and buys them back at the end of the period of the loan, typically at a slightly higher price.' In a ready-forward deal, a broker usually brings together two banks for which he is paid a commission. Normally the broker does not handle the cash or the securities, but in this case Mehta has done otherwise. Mehta and his associates used this RF deal with a great success to channel money through banks. Further by taking advantage of the many other loopholes in the banking system, Mehta and his associates drained off funds from the inter-bank transactions. Subsequently, they bought huge amounts of shares at a premium across many industry verticals causing the Sensex to rise dramatically. However, this was not continued as the banks who lent to Mehta identified the modus operandi started demanding their money back, causing the Sensex to plunge almost dramatically as it had risen. Mehta was later charged with 72 criminal offences and over 600 civil action suits.[2]
2. Mossack Fonseca Scam popularly known as the Panama Papers scam, was another scam involving money laundering, dodge sanctions, tax avoidance, formation of shell companies etc. at a global level in the recent history brought to the public notice by media in 2015. This happened with the leakage of confidential files maintained by one of the world's most secretive companies namely Mossack Fonseca, a Panama law firm. This was the biggest leak in the history since the release by Wikileaks Organisation in 2010. Over 11.5 million documents having the details of financial and client information of more than 2.14 lakhs off shore entities were leaked to a German journalist called Bastian Obermayer of Suddeutche Zeitung (SZ) by the so called whistle blower of the firm.

   The leaked document contains illegal investments of 12 current or former heads of states including dictators accused of looting their own countries and 60 relatives of the heads of states including the Pakistan Prime Minister Nawaz Sharif. It also contains the details of more than 500 banks including their subsidiaries and 15600 shell companies registered with Mossack Fonseca.

According to the BBC News, it also revealed suspected billion dollar money laundering involving the close associates of Russian President Vladmir Putin.

The files show how Mossack Fonseca clients were able to launder money, dodge sanctions and avoid tax. In one case, the company offered an US millionaire fake ownership records to hide money from the authorities. This is a direct breach of international regulations designed to stop money laundering and tax evasion.

Based on the release of the name of Pakistan Prime Minister Nawaz Sharif who had some accounts in the names of his three children with Mossack Fonseca, a case was filed in the Pakistan Supreme Court and the court in a 5–0 verdict disqualified Sharif from the Prime Ministership and membership in National Assembly. The Supreme Court found that Sharif and his family members possess assets in excess of known source of income. The leak revealed that the three children of Pakistan Prime Minister owned offshore companies and assets, not shown in his family wealth statement. The companies identified are three British Virgin Islands based companies Nescoll Limited, Nielsen Enterprises Limited and Hangon Property Holdings Limited incorporated in 1993, 1994 and 2007 respectively. Huge investments were made in these three shell companies and some apartments in Park lane in Mayfair area in London.[3]

3. **Adarsh housing society scam:** Adarsh Housing Society is a society established for constructing eight storey flats in the prime location of Colaba, Mumbai for housing 31 war widows and the heroes of 1999 Kargil war. When construction was completed it was allotted to 103 persons including the Union Minister Suresh Prabhu, Former army chief Deepak Kapoor, Diplomat Devgani Khobragade, Sanjay Sankaran, son of former chief secretary D. K. Sankaran, Congress leader Kanhaiyalal Gidwin and his two sons and some relatives of then Chief minister Ashok Chavan. The society did not get environment clearance to construct high rise building in the coastal zone. Many other regulatory violations also took place in this case. This case was brought to notice by two RTI activists Simpreel Singh and Yogacharya Anandji by making use of the Right to Information Act in its early days of implementation in India. Indian media also took an active role in exposing the scam once it was brought to public notice by the RTI activists. Finally the scam led to the resignation of then Chief Minister Ashok Chavan.[4]
4. Much publicized Ketan Parekh Stock Scam of 2001–02 involving ₹ 1500 crore of public money was also brought to public and regulatory attention by Sucheta Dalal, a columnist for the Times of India as in the case of Harshad Mehta case. In the words of the columnist, 'it is yet another black day for capital market'. Parekh attracted the attention of market players and they kept track of every move of Parekh, as everything he was laying his hands on was virtually turning into gold. As the technology industry began embracing the entire world, India's stock markets started showing signs of hyper-activity Almost everyone, from the investment firms which were mostly controlled by the promoters of listed companies to foreign corporate bodies and cooperative banks were eager to entrust their money with Parekh, which, he in turn used to inflate stock prices by making his interest obvious. Stocks of many technology companies increased ten times and twenty times within a few months by price rigging. When the prices of select shares started constantly rising, innocent investors who had bought such shares believing that the market was genuine were about to suffer at huge losses. These rigged stocks have been dumped in the portfolio of financial institutions like the UTI with his influence. He was charged for speculation, operating dubious companies, etc., by the CBI which ended his two year dominance in the stock market. The CBI has arrested him on the complaint of the Bank of India.[5]

5. C. R. Bhansali accounting fraud case of 1996 was also exposed by the Indian media. In 1996 as a part of the surveillance activities regulatory agencies started suspecting his company on the basis of a media report saying that the company's wealth which was ₹2 crore in 1992 has grown to ₹430 crore in 1996. After that, a series of reports appeared in the Indian media about the unfair business practices of the company which played a significant role in unearthing the fraud. CR Bhansali was soon charged under various grounds like fraud, cheating, siphoning off funds from the SBI, etc. under various sections of the CRPC.[6]
6. **2G spectrum scandal:** Another land mark corporate scam which shocked the whole political spectrum of India and caused the consequent fall of the UPA government headed by Mr Manmohan Singh was exposed by the India media. Gopi krishnan, a young and dynamic Journalist of 'The Pioneer' newspaper first brought to notice of the scam to the political parties, the administrators and the investigation agencies. The Pioneer had published almost 200 reports in this exercise. The scam allegedly began in 2008 when nine telecom companies were issued scarce spectrum and licenses for Second Generation (2G) mobile phone services arbitrarily. The case is related to illegally undercharging mobile telephony companies for frequency allocation licenses, which they would then use to create 2G subscriptions for cell phones. The shortfall between the money collected and the money which the law mandated to be collected was estimated to be ₹1,76,645 crore, as valued by the Comptroller and Auditor General of India based on 3G and BWA spectrum auction prices in 2010. India is divided into 22 telecom zones, with 281 zonal licenses in the market. According to the telecom policy of India, when a license is allotted to an operator, some start-up spectrum is bundled along with it. In 2008, 122 new second-generation (2G) Unified Access Service (UAS) licenses were given to telecom companies at a price arrived at in 2001 and on a first-come-first-serve basis. On 20 February 2012, the Supreme Court of India delivered a judgment on a PIL directly related to the 2G spectrum scam. Declaring the allotment of spectrum as 'unconstitutional and arbitrary', the court quashed all 122 licenses issued in 2008 by the then Minister for Communications and IT, A. Raja. The Court also imposed a fine of ₹5 crore each on Unitech Wireless, Swan telecom and Tata Teleservices and ₹50 lakh fine on Loop Telecom, S Tel, Allianz Infratech and Sistema Shyam Teleservices Limited. The court also said A. Raja 'wanted to favour some companies at the cost of the public exchequer' and 'virtually gifted away an important national asset'. Apart from A. Raja and Kanimozhi, Member of Parliament and the daughter of DMK leader M. Karunanidhi then Telecom Secretary Siddharth Behura, Shahid Balwa, the promoter of DB Realty and Swan Telecom and several other corporate heads were involved in the case and charged.[7]
7. **Radia tapes controversy**: This case is related to the way Nira Radia an influential head of Vaishnavi Communication, a PR firm whose client list includes the Tata Teleservices and Mukesh Ambani's the Reliance Industries, etc., lobbied Indian politician, senior journalist and top people in the corporate houses to get appointed A. Raja as IT and Telecom Minister in place of Dayanidhi Maran in the UPA Government. In November 2010, Open Magazine carried a story which reported transcripts of some of the telephone conversations of Nira Radia with senior journalists, politicians, and corporate houses. The tape was the recordings of Indian Income Tax department in 2008–09 which after taking permission from the Home Ministry as part of surveillance and investigation of money laundering and tax evasion cases. The tape had almost

5851 recordings of phone conversations by A. Raja, with some people having close link with 2G Spectrum scandal. Many of those recordings in the tape are denied by the parties. According to the transcripts of the tapes, Radia lobbied against the reappointment of Dayanidhi Maran to the post of Union IT and Communications Minister. When major India media blacked out this issue initially, the social media Twitter and Facebook brought it to the notice of public attention. Only a handful of the mainstream newspapers in India, like The Deccan Herald, the Indian express had openly written about the tapes while many major newspapers and TV Channels said 'the authenticity of these transcripts cannot be ascertained'. According to the Washington Post 'Twitter has played an important role in launching what has become an international conversation on the issue, with the Indian Diaspora weighing in'. The Deccan Chronicle commented, 'The 'Radia tapes' may have torn the veil off the nexus between information hungry journalists, lobbyists and industrialists, and opened everyone's eyes to what has long been suspected — the ability of a small but powerful group to use their connections to influence policy'.[8]

CONCLUSION

To conclude, it could be said that ethics in management should be of concern for all practising managers, in all organisations, private, public, profit-making, non-profit, manufacturing, service—in fact the society as a whole. Ethics in advertising is essential for the betterment of the business and the society at large. The codes put forth by the Advertising Standard Council of India and the Advertising Standards Authority, guide the various organisations to follow ethical practices in advertising, thereby enabling the society to distinguish between issues that are right and wrong. Canada and Mexico are among those countries that have pre-clearance requirements for advertisements on health-related products. In effect, an advertiser must provide the burden of proof that his/her advertisement is truthful. The extent to which advertising to children should be controlled is a subject of continuing controversy. Advertisements must be handled carefully and tastefully, if and when, they are aimed at a vulnerable group (e.g., children, elderly people and uneducated people).

KEYWORDS

- Adverse effects
- Advertising Code Principles
- Advertising standards
- Cigarette code
- Consumer demand
- Corporate governance practices and media
- Corporate advertising
- Corrective advertising
- Ethics in advertising
- Fullest possible disclosure
- Governance problems
- Government regulators
- Impact of media
- Institutional investors
- Media
- Media and whistleblowing
- Media conflicting interest
- Media credibility
- Media role
- Recent trends
- Sales promotion
- Selective coverage
- Self-regulation
- Substantiation
- The Fourth Estate
- Unfair trade practices

DISCUSSION QUESTIONS

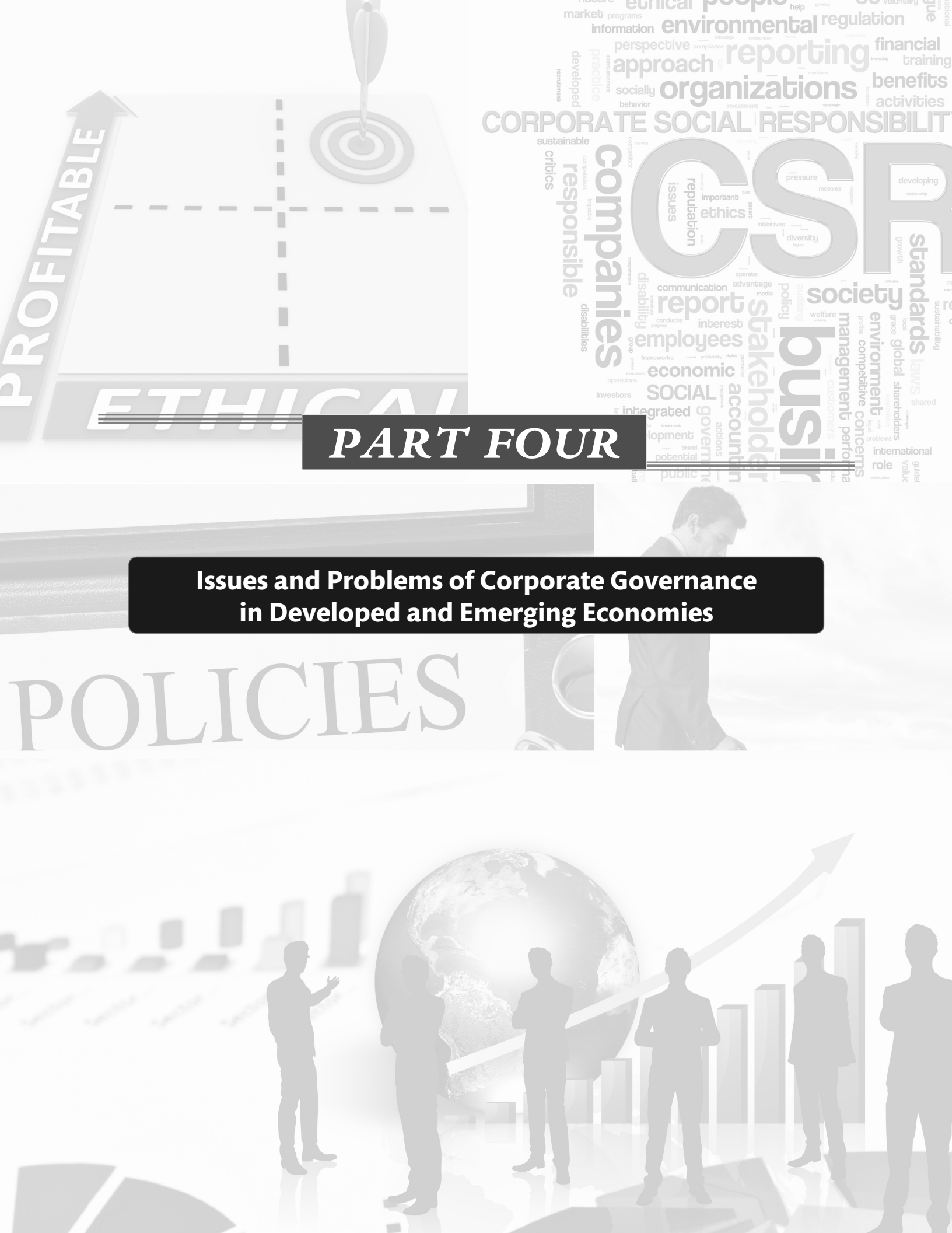
1. What is the role of media in effecting corporate governance?
2. How does selective coverage impact media credibility? How can the media build its reputation with regard to corporate reporting?
3. Discuss the importance and the need for ethics in advertising.
4. Advertising is a powerful tool in marketing. What are its demerits when it is handled inappropriately?
5. Discuss the recent trends in advertising.
6. How does advertising serve the society? How can the baneful effects of unethical advertising be countered?
7. Explain in detail the role played by the media in corporate governance.
8. State how the media can positively and negatively influence corporate governance.

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   (a) a price that is stated in any advertisement to be a bargain price, by reference to an ordinary price or otherwise
   (b) a price that a person who reads, hears or sees the advertisement would reasonably understand to be a bargain price having regard to the price at which the product advertised or like-products are ordinary sold.
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PART FOUR

Issues and Problems of Corporate Governance in Developed and Emerging Economies

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14



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Corporate Governance and Buisness Ethics

CHAPTER OUTLINE

- Introduction
- Importance and Need for Business Ethics
- The Indian Context
- Corporate Ethical Framework
- Promoter's Ethics
- External Stakeholder's Ethics
- Societal Ethics
- Roots of Unethical Behaviour
- Some Unethical Issues
- Corporate Governance Ethics
- How can Ethics Make Corporate Governance More Meaningful?

Introduction

The word "ethics" is derived from the Greek word "ethikos" meaning custom or character. It is the science of morals describing a set of rules of behaviour. Business ethics itself is an offshoot of applied ethics. The study of business ethics essentially deals with understanding what is right and morally good in business.

Ethics is a branch of philosophy and is considered a normative science because it is concerned with the norms of human conduct, as distinguished from formal sciences such as mathematics and logic, physical sciences such as chemistry and physics, and empirical sciences such as economics and psychology. As a science, ethics must follow the same rigours of logical reasoning as other sciences.

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The principles of ethical reasoning are useful tools for sorting out the good and bad components within complex human interactions. For this reason, the study of ethics has been at the heart of intellectual thought since the time of early Greek philosophers, and its ongoing contribution to the advancement of knowledge and science makes ethics a relevant, if not vital, aspect of management theory.

What is Business Ethics?

The principles of ethical reasoning are useful tools for sorting out the good and bad components within complex human interactions. Business ethics is the application of general ethical ideas to business behaviour.

Ethics is a conception of right and wrong behaviour, defining for us when our actions are moral and when immoral. Business ethics is the application of general ethical ideas to business behaviour. Ethical business behaviour is expected by public, prevents harm to society, improves profitability, fosters business relations and employee productivity, reduces criminal penalties, protects business against unscrupulous employees and competitors, protects employees from harmful actions by their employer, and allows people in business to act consistently with their personal ethical beliefs. Ethical problems occur in business for many reasons, including the selfishness of a few, competitive pressures on profits, the clash of personal values and business goals, and cross-cultural contradictions in global business operations. Similar ethical issues, such as bribery and corruption, are evident throughout the world, and many national governments and international agencies are actively attempting to minimise such actions through economic sanctions and international codes. Although laws and ethics are closely related, they are not the same; ethical principles tend to be broader than legal principles. Illegal behaviour by business and its employees imposes great costs on business itself and the society at large.

To be precise, "business ethics is the art and discipline of applying ethical principles to examine and solve complex moral dilemmas".[1] Business ethics proves that business can be and have been ethical and still make profits. Till the last decade, business ethics was thought of as being a contradiction in terms. But things have changed, today more and more interest is being shown to the application of ethical practices in business dealings and the ethical implications of business. "Business ethics is that set of principles or reasons which should govern the conduct of business whether at the individual or collective level."[2]

Ethical solutions to business problems may have more than one right answer or sometimes no right answer at all. Thus logical and ethical reasoning are tested in that particular business situation. "A business or company is considered to be ethical only if it tries to reach a trade-off between pursuing its economic objectives and its social obligations, i.e. between its obligations to the society where it exists and operates; its obligations to its people due to whom it can even think of pursuing economic goals; to its environment, from whom it takes so much without it demanding anything back in return; and the like."[3]

Business ethics is based on the principle of integrity and fairness and concentrates on the benefits to the stakeholders, both internal and external. Stakeholder includes those individuals and groups without which the organisation does not have an existence. It includes the shareholders, the employees, the customers, the dealers, the vendors, the government and the society.

Evolution of Ethics Over the Years

If we trace the history of ethics in business, we would realise that ethics has emerged as a part of theological discussions prior to 1960. Catholic teachings through Papal Encyclicals emphasised the need for morality in business, such as the workers' rights and the living wages as in Rerum Novarum of Pope Leo XIII. Some of the Protestant seminaries developed ethics as a part of their curriculum. During the 1960s, we see the rise of social issues in business. During this period many business practices came under social scrutiny. President John F. Kennedy's Consumer Bill of Rights reflected a new era of consumerism. Only during the 1970s we see business ethics as an emerging field. During this period professors, teaching business, began to write about business ethics and philosophers began to involve themselves in the business ethics. Businessmen became more concerned with their public image and addressed ethics more directly. When we think from this background, we will be able to attach more importance to ethics in business today.

Ethics is More Than Just Collection of Values

Values are almost always over-simplified, which can rarely be applied uniformly. Values tend to be under-defined, situational by nature and subject to flawed human reasoning such that by themselves they cannot assure true ethical conduct. Consider the sought-after value of employee loyalty: should employees be loyal to co-workers, supervisors, customers, or investors? Since it may be impossible to be absolutely loyal to all the four simultaneously, in what order should these loyalties occur? Employers that demand employee loyalty rarely can answer this question completely.

Importance and Need for Business Ethics

Ethics is closely related to trust. Most of the people would agree on the fact that to develop trust, behaviour must be ethical. Ethical behaviour is a necessity to gain trust. Trust will be used as an indicator variable of ethics. Basically, trust is three-dimensional, that is, the trust in supplier relationships, the trust in employee relationships and the trust in customer relationships. In such a situation, the entire stakeholders of the company are taken care of. If the company is able to maintain this trust-relationship with the internal as well as the external stakeholders, then we can call that company as an ethical company.

Ethical behaviour is a necessity to gain trust. Trust will be used as an indicator variable of ethics. Basically, trust is three-dimensional, that is, trust in supplier relationships, trust in employee relationships and trust in customer relationships. If the company is able to maintain this trust-relationship with the internal as well as external stakeholders, then we can call that company an ethical company.

Trust leads to predictability and efficiency of business. Ethics is all about developing trust and maintaining it fruitfully so that the firm flourishes profitably and maintains good reputation. Lack of ethics would lead to unethical practices in organisations as well as in personal life. One wonders, sometimes why even educated, well-positioned managers or employees of some reputed companies act unethically. This is because of a lack of ethics in their lives. We can point out to a number of examples of companies whose top managements are involved in unethical practices, to name a few, Enron, WorldCom. Earlier it was said that—

"business of business is business"— now there is a sudden change in the slogan. In the contemporary scenario where ethics has got a due importance, the slogan has taken the form—"business of business is ethical business".

There are a number of companies which have succeeded in profit-making and public esteem by following ethical practices in their realm of business. Some of such companies are: Boeing, Johnson and Johnson, Larson & Tubro, Wipro, Infosys, Tata Steel, and Ford. They have gained the trust of the public through ethical practices. In India, the House of Tatas, for instance, adheres to, and communicates key ethical standards in several ways. The Tata Code of Conduct affirms: "The Tata name represents more than a century of ethical conduct of business in a wide array of markets and commercial activities in India and abroad. As the owner of the Tata Mark, the Tata Sons Ltd., wishes to strengthen the Tata brand by formulating the Tata Code of Conduct, enunciating the values which have governed and shall govern the conduct and the activities of companies associating with or using the Tata name and of their employees."[4] Applying ethics in business makes good sense because it induces others to follow ethics in their behaviour. Ethics are important not only in business but, in all the walks and aspects of life. The business of the society which lacks ethics is likely to fall sooner or later.

The Indian Context

With the onset of globalisation and the huge foreign institutional investment in India, the Indian corporates can no longer turn a blind eye to the needs of the hour. The writing on the wall for the erstwhile unethical corporates is clear—"clean up your acts or perish for want of investment". It is inherently in the corporates' own interest that they shape up to be better corporate citizens. The time has come for them to be more prudent in incorporating ethics into their systems. An ethical corporate can go a long way in serving the community around it directly and indirectly in a myriad ways. Furthermore, a corporate expects others in the line of business to be ethical in their dealings, or else the entire trust upon which business is conducted will be lost. Business cannot be conducted in an environment of mutual distrust and suspicion and hence it is in its own interest that a corporate conducts itself ethically.

Ethical business must be adhered to by the entire business community. Mere lip service to the cause would undermine the trust which is the very foundation on which the business stands. Agreeing to be ethical and then reneging on the commitment would lead to inconsistency in the business environment. A trustworthy company, that has over the years earned a good reputation and the goodwill of the people through its ethical conduct, stands a much greater chance of attracting more business than the others. An ethical corporate not only attracts more business but also gains the respect of its employees, the shareholders, the creditors and the society at large.

Ethical business has only helped organisations to improve their brand equity and image. A good example would be Johnson and Johnson. The way it conducted itself in the wake of the Tylenol drug controversy was laudable. It had to withdraw massive stocks of drugs from various pharmacies and druggists and suffered huge loses running upto $100 million. The effort that went into recalling all the stocks from the retail outlets was mind-boggling. Ultimately, Johnson and Johnson came out triumphantly with its image enhanced even further when the public realised that it was not its fault. Johnson and Johnson was lavished with praises and the grateful public gave it an overwhelming support. The company regained its standing and also made up for its losses in a very short time. Nearer home, when it was pointed out to the late J. R. D. Tata that competitor companies were growing much faster than the House of Tatas, he answered that the Tatas

believed only in growth that is based on ethics, equity and socially responsible behaviour. J. R. D. Tata once observed in an interview: "The prime influence in my career in Tatas was certainly that which was inspired by Jamsetji Tata. Jamsetji was a towering personality in every sense, and above all, he was a man of vision. At a time when the British were skeptical about Indians setting up a steel plant, Jamsetji never had any doubts whatsoever. Even though there were several vicissitudes, TISCO emerged as the largest entity in the country. The same could be said about its entry into the power generation business and also hoteliering. I don't think anyone was on par with Jamsetji as an industrial visionary. But that is not the sole reason why I have been an admirer of Jamsetji. The major reason was *his sense of values, sterling values*, which he imparted to the group. If someone were to ask me, what holds the Tata companies together, I would say it is *our shared ideals and values as a corporate citizen* which we have inherited from Jamsetji Tata."[5]

Another Dimension: "Corporates in India Cannot Afford To Be Ethical"[6]

When questioned about unethical practices, many companies claim that the conditions in India are not conducive to allow them the luxury of being completely ethical. Thousands of underhand deals are struck everyday and go unreported. There is hardly a company which has not at sometime or the other been either involved or suspected of some foul play. Even companies that started off with intentions to do business in an ethical manner have had to compromise their principles due to the highly politicised and bureaucratic business environment in the country. Growing corruption, increasing disparity between people and rapidly reducing profit margins add to the woes of organisations that want to be ethical.

Indian companies face two types of corrupt practices: political corruption in which money is paid for favours done, and administrative corruption. A study on the ethical attitudes of Indian managers conducted by Arun Monappa (1977) reported that business executives listed three major obstacles to ethical behaviour, namely, company policies, unethical industry climate and corruption in government.

Indian companies face two types of corrupt practices: (i) political corruption in which money is paid for favours done, and (ii) administrative corruption. In the early days of Independence, companies had to grease the palms of bureaucrats to make them do things they were not supposed to do, but now corruption has graduated to such an extent that companies have to bribe bureaucrats to make them do things they are supposed to do. Examples of this sort of corruption include "gifts" to the Factory Inspector, Boiler Inspector, Pollution Control Board Inspectors, and assessors for customs, excise, income tax, sales tax and Octroi. It is the administrative corruption, which most companies find unavoidable most of the time.

A study on the ethical attitudes of Indian managers conducted by Arun Monappa (1977) reported that business executives listed three major obstacles to ethical behaviour, namely: (i) company policies, (ii) unethical industry climate and (iii) corruption in government. Company policies tend to be unethical due to socio-cultural environment, and get reinforced because of the sense of frustration and helplessness that comes from the prevalent and all pervading unethical environment.

With regard to the socio-cultural reasons underlying the tendency of Indian corporates to be unethical are, the low priority accorded to business ethics in newly formed democracies as it seems there are more urgent demands that have to be dealt with first (Rossouw, 1998): The imperatives of the day-to-day survival for businessmen and the law-makers to be unduly concerned about the ethical and moral implications of their actions. This situation has been sharpened by the opening up of the economy wherein Indian corporates find it increasingly difficult to compete in a dog-eats-dog kind of global markets. Another factor that has contributed to the lack of ethical ethos and behaviour is the country's aspiration to build a strong and economically powerful nation in a short time.

The other factors affecting ethical dilemmas of corporates are: (i) socio-cultural factors such as the sense of hospitality (not inviting a business associate could be

construed as impolite, and once invited, showering him with gifts is an accepted custom) and reciprocity (You gave me a license with which I make money, and there is nothing wrong in sharing a part of it with you); (ii) the psychological fear of losing jobs; (iii) the lax government structures and regulations; (iv) sanctions and discriminations in the society that can be offset with accumulation of wealth by fair or foul means; (v) the uncertainties and fears about the future; (vi) the strong family traditions and the laws of inheritance in which parents want to leave substantial assets to their progeny; (vii) an overall scarcity of resources and the difficulty of amassing wealth through normal and legitimate means; (viii) an inequitable and scorching tax system (almost an unbelievable 97.75 per cent in terms of both direct and indirect taxes at the highest bracket in the 60s and the 70s of last century) which discourage the hardworking and honest tax-payers and lead them to bribe tax-collectors; (ix) a belief that business and ethics are irreconcilable; and (x) a tendency to adopt an easy option, when confronted with difficult ethical choices—"Well, if I can't beat them, I may as well join them", becomes a natural choice.

Lea (1999) gives another explanation to the deviant ethical behaviour found among the corproates in the developing societies. Transition from subsistence culture to the commercial enterprise of capitalistic culture can result in a moral chaos in which behaviour falls short of ethical expectations. In the traditional sub-cultures, rituals govern life, these rituals are insufficient behavioural guides in capitalism, which increases individual autonomy and responsibility and generates surpluses and wealth. Rapid economic growth leads to the development of a distorted understanding of capitalism and growth, in which money power, survival and profitability at any cost are considered as the primary goals of any business. The manifestation of this idea is very apparent in India and, especially in the case of some famous "rags to riches" stories.

The need to adapt to the unethical environment is so strong that even large multinationals setting up facilities in India have been unable to avoid cutting corners. In their eagerness to capture the Indian market and beat the competition, many companies have grossly broken their stringent codes of conduct, which in the West would be unthinkable. This was apparent when a major portion of the top management of a leading FMCG multinational in India were removed on the grounds of violation of the ethical code of conduct. However, there was no visible effort on the part of the company to own up or reverse some of the unethical actions performed by its erstwhile employees.

Roots of Unethical Behaviour

People often wonder why the employees indulge in unethical practices as lying, accepting bribery, coercion, conflicting interest, etc. There are certain factors that make the employees to think and act in unethical ways. Some of such influencing factors are: "pressure to balance work and family, poor communications, poor leadership, long working hours, heavy work load, a lack of management support, pressure to meet sales or profit goals, little or no recognition of achievements, company politics, personal financial worries, and insufficient resources."[7] The statistical data given by Ethical Officers Association in 1997 shows how certain practices or factors contribute to unethical behaviour.[8]

Some of such influencing factors that make the employees think and act in unethical ways are: "pressure to balance work and family, poor communications, poor leadership, long work hours, heavy work load, lack of management support, pressure to meet sales or profit goals, little or no recognition of achievements, company politics, personal financial worries, and insufficient resources."[7] It is evident that conflicting interests lead to most of the unethical practices.

Balancing work and family	*52 per cent*	*Lack of management support*	*48 per cent*
Poor leadership	*51 per cent*	*Need to meet goals*	*46 per cent*
Poor internal communication	*51 per cent*		

From the above statistics it is very much evident that conflicting interests lead to most of the unethical practices.

Why Does Business Have Such a Negative Image?

Competitive pressures, individual greed, and differing cultural contexts generate ethical issues for organisational managers. Further, in almost every organisation some people will have the inclination to behave unethically (the ethical egoist)—necessitating systems to ensure that such behaviour is either stopped or detected (after the unethical behaviour occurs), and remedied. Ethics (also called moral philosophy) involves systematising, defending, and recommending concepts of right and wrong behaviour.

Why Should Businesses Act Ethically?

There are a number of reasons given below as to why businesses should act ethically:

- Protect its own interest (prudence).
- Protect the interests of the business community.
- Keep its commitment to society to act ethically.
- Meet stakeholder expectations.
- Prevent harm to the general public.
- Build trust with key stakeholder groups.
- Protect themselves from abuse from unethical employees and competitors.
- Protect their own reputations.
- Protect their own employees.
- Create an environment in which workers can act in ways consistent with their values.

Businesses should act ethically to protect their own interest (prudence) and the interests of the business community, keep their commitment to society to act ethically, meet stakeholder expectations, prevent harm to the general public, build trust with key stakeholder groups, protect themselves from abuse from unethical employees and competitors, protect their own reputations, protect their own employees, and create an environment in which workers can act in ways consistent with their values.

Moreover, if a corporation reneges on its agreement and expects others to keep theirs, it will be unfair. It will also be inconsistent on its part, if business agrees to a set of rules to govern behaviour and then to unilaterally violate those rules. Moreover, to agree to a condition, where business and businessmen tend to break the rules and also they can get away with it, is to undermine the environment necessary for running the business.

Additionally, an organisation has to be ethical in its behaviour because it has to exist in the competitive world. We can find a number of reasons for being ethical in behaviour, a few of them are given below:
Most people want to be ethical in their issues for:

- Values give management credibility with its employees. Only perceived moral uprighteousness and social concern brings employee respect.
- Values help better decision-making.
- Hard decisions which have been studied from both an ethical and an economic angle are more difficult to make, but they will stand up against all odds, because the good of the employees, the public interest, and the company's own long term interest and those of all stakeholders have all been taken into account.

Ethics within organisations is a must, as only then, that can be conveyed through the activities they perform. Ethics should be initiated from the top management to the bottom of the hierarchy. "Ethical behaviour starts at the top. Before a company can expect to be viewed as ethical in the business community, ethical behaviour within its own walls to and by employees is a must, and top management dictates the mood. Ethical behaviour by the leaders of an organisation will inevitably set the tone for the rest of the company-values will remain consistent. Further, a

well-communicated commitment to ethics sends a powerful message that ethical behaviour is considered to be a business imperative.[9] If the company needs to make profit and to have a good reputation, it must act within the confines of ethics. The ethical communication within the organisation would be a healthy sign that the company is marching on the right path. Internalisation of ethics by the employees is of very much importance. If an employee has properly internalised ethics, then the activities that he or his organisation caries out will have ethics in it.

Corporate Ethical Framework

The companies also must take into account the effect of their actions on their employees, customers, investors and other stakeholders.

'Strong ethics and corporate citizenship are the foundations of our business philosophy, which demonstrates to our customers what we stand for as a company', this is the comment of, Executive Chairman of General Motors, Mr. Bill Ford which is named for the 8th consecutive time in the list of 124 companies ranked by the US think-tank Ethisphere Institute, USA as World's most ethical companies in 2017.

Starting from 2007, Ethisphere Institute has been honoring those companies which are able to acknowledge their part in the society in order to influence and bring about positive changes in the business arena as well as the society. The companies also must take into account the effect of their actions on their employees, customers, investors and other stakeholders. To be included in the List, a company has to submit a questionnaire answering 200 questions about how the company addresses ethics in their business and other related details. The responses are then independently verified by Ethisphere Institute by taking help from the SEC filings, the supporting documents provided by the companies, company's history of litigation, etc. The application fees for small firms (<$500 million revenue) is $1000 while larger firms (>$500 million revenue) has to pay $1500.

The companies are honored based on their excellence in:

- Ethical business and practices promotion within the company.
- Permitting employees and managers to choose better alternatives.
- Instituting the best practices so as to shape the industry standards for future years.

The assessment for the World's Most Ethical Company is based on the Ethics Quotient (EQ) designed by the Ethisphere Institute whereby the method is weighted into 5 major categories:

- Ethics and compliance – 35%
- Corporate citizenship and responsibility – 20%
- Culture of ethics – 20%
- Governance – 15%
- Leadership, innovation and reputation – 10%

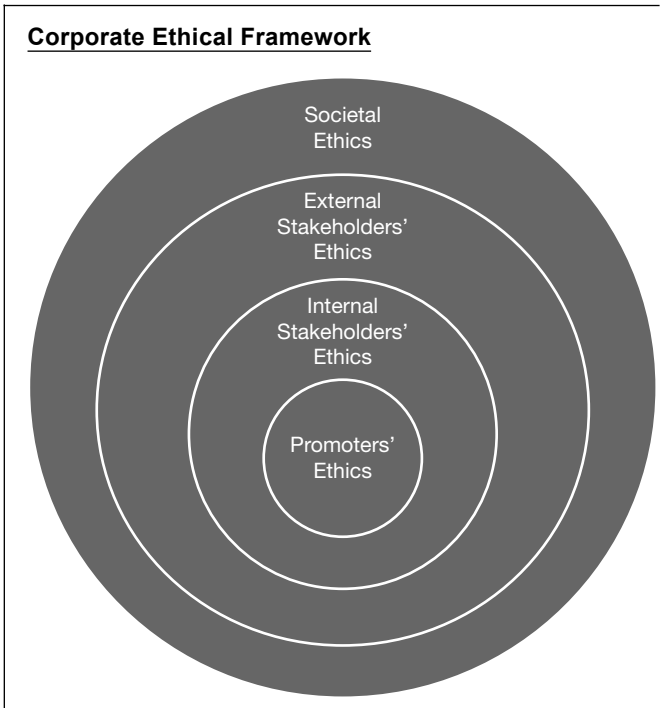
Indian Companies in the List

Along with 98 US companies such as GE, Aflac, Deere & Company, Ecolab, Fluor, Xerox, PepsiCo, Starbucks, Texas Instruments, Ford Motors two Indian companies namely the Tata Steel and the Wipro are in the list. The list is prepared after selecting 124 companies from 5 continents, 19 countries and 52 industries. The former is named in the metals, minerals and mining space along with the US-based Schnitzer Steel Industries Inc., and the latter is named under the Information Technology sector along with the Xerox Corporation. Ethisphere honours those companies who recognise their role in society to influence and drive positive change in the business community and societies

around the world. These two Indian companies were ranked by The Times of India ranking and the Business Line ranking of Indian companies 2015 and 2016 as the top ranked companies in India.

What made these two companies to get a seat in the list? According to the institute, 'These companies have taken the righteous path to shift in terms of societal expectations, the changing scenarios of geo-political climate across the world and also the continuous revamping of laws and regulations. Companies have also been able to exhibit strong ethical and corporate social responsibilities (CSRs) which mark the basic foundation of business ideology and also establish in front of the customers what they are as the organisation itself'.

In this context we examine the broad ethical framework of a corporate organisation.



Promoter's Ethics

The above diagram shows the ethical framework of business corporations. It has four layers. At the centre of the frame work is the promoters of the company. They are the people who conceive the business idea, organise money, men and materials and initially lead the organization to achieve the goals. Their personal and family views about the business and its role in the society are the most important factors affecting the ethical behaviour of a corporation. They are the first people who develop and internalize ethics and values in the organization and ready to win or sometimes lose, by doing business in a particular way, by upholding the core values and ethics. Maintaining ethics and values and doing business accordingly involve some cost in the form cost overrun or time overrun. But in a competitive market place, the customer may not be willing to pay extra for the product or service. In such a situation the company must be able to sacrifice that part of profit for maintaining the ethics and value at least in a short run.

The House of Tata's is considered as the one of the most ethical business groups in the country because the ethics and value system developed by the founders like JRD Tata and Ratan Tata that have been internalised in all their companies. A perusal of the web site of Tata Sons reveals the following.

Purpose: "At the Tata group we are committed to improving the quality of life of the communities we serve. We do this by striving for leadership and global competitiveness in the business sectors in which we operate".

Core Values

The Tata Group has always been value-driven. These values continue to direct the growth and business of the Tata companies. The five core Tata values underpinning while doing the business are:

- **Integrity:** We will be fair, honest, transparent and ethical in our conduct; everything we do must stand the test of public scrutiny.
- **Excellence:** We will be passionate about achieving the highest standards of quality, always promoting meritocracy.
- **Unity:** We will invest in our people and partners, enable continuous learning and build caring and collaborative relationships based on trust and mutual respect.
- **Responsibility:** We will integrate environmental and social principles in our businesses, ensuring that what comes from the people goes back to the people many times over.
- **Pioneering:** We will be bold and agile, courageously taking on challenges, using deep customer insight to develop innovative solutions.

In all the Tata companies these core values are internalized over the years and all managers, directors and employees have become part of the ethical behavior. For example, when a fraud was committed by the managing director and a few top officials in Tata Finance resulted in the loss of money of the poor depositors, the Tata Sons was ready to provide help to repay the obligations of the depositors. Because of the ethical behavior, the Group enjoys the patronage of all other stakeholders in the market like government, customers, regulators, supply chain, etc.

Similarly, the website of the Wipro Limited says the core values as "Wipro's policy is to comply with all **applicable** laws and regulations, being **committed** to conducting business in an ethical manner and **acting** with **integrity** in dealing with our customers, suppliers, partners, competitors, employees and its other **stakeholders**". These are the core values developed by its promoter Mr. Azim Premji and his family and tried to internalise in the Wipro all the years.

Most organisations have a statement of values or ethical principles usually found on the wall, or on the company website or beautifully printed in the Annual Reports. But the question is, can they be found in people's hearts? Are they found in people's actions? And what do these principles mean in the day-to-day complexity of decision making? Here arises the task of internalising the ethical values and behaviour. This is more important, more strenuous than developing the value. Some times for a short run a lot of sacrifices have to be made to internalise the ethical behaviour. Willingness of the promoters to sacrifice is more important. When it starts from the promoters or the main stakeholders, it can easily internalise with others in the organisation. The cost involved is no matter in such cases. It is no wonder that the Tata Steel and the Wipro Limited have been included in the list of the most ethical companies of the world by the US think-tank Ethisphere Institute, USA.

Internal stakeholder's ethics: At the second level as seen in the diagram, the immediate stakeholder's ethical behaviour and value system influence the overall ethical behaviour of the company. The immediate stakeholders are the directors, the top management, the auditors, the legal advisors and the employees of the organisation. They are the people who actually carry out the activities of the company on behalf of the investors. As their agents, they are expected to

discharge the fiduciary functions. Their activities have a significant bearing on the day to day working of the organisation because they represent the company in front of the external stakeholders. Normally, the promoters have a major say in the appointment of directors, top executives and employees, at least in the initial period. They used to select only those people who can function within the promoter's core value system as directors or management. Moreover, even if at the individual level their value system is slightly different, they can be moulded to the value system of the organisation by mentoring, training and group functioning. Training plays an important role in it. A study by KPMG on ethics-training in the Canadian organisations found the following:

- 86.4% of respondents have a document that outlines their values and principles, and 72.7% have some kind of program or initiatives focused on promoting ethical values and practices.
- 41.6% of respondents have a senior level manager whose role specifically, includes implementation, monitoring, or assurance of ethics initiatives.

Of the organizations surveyed that provide ethics training to managers and senior managers, less than 10% provide more than eight hours per year, and almost one-third provide one hour or less of ethics training per year.

Moreover, strict reward and punishment system can also be introduced for internalising the promoter's core values among the immediate stakeholders. Some of the important ethical issues emerging at this level are trust, honesty and conformity with law, conflict of interest, service orientation and procedural fairness, public policy determination, ethics of compromise and social integration, transparency, etc.

The External stakeholder's ethics: At the third level the external stakeholder's value system and ethical behaviour influence the overall value system of the organisation. The external stakeholders are the people not directly involved in the decision making process, rather they are the beneficiaries of the decision making by the internal stakeholders. People like investors, consumers, financiers, marketing intermediaries, supply chain people etc. come under this category. The value system of these people contributes greatly to the corporate ethics. If they maintain good values and positively respond to the corporate values and ethical behaviour, that will strength the overall corporate values. Also how much they are willing to sacrifice for maintaining good values, at least in the short term point of view, also influences the overall corporate value. Again most of the value based companies design their long term relationship with the external stakeholders in such a way to create a trust and mutual understanding for achieving common benefits. For example, consumers see the dealers of the company and interact at the time of purchasing any product or service. They see the company through the dealer. Any unethical behaviour on the part of the dealer is considered as the unethical behaviour of the company by the customer. Same is the case of supply chain. Different segments of the supply chain see the immediate higher or lower segment as the representative of the company to which ultimately the materials are supplied. Any unethical behaviour on the part of any one in that affects the reputation of the company and the reputation of other members of the channel. Normally, ethical companies formulate a policy in this respect and try to involve only those external stakeholders who maintain synergy with the organizational value system.

The Societal ethics: At the macro level, the culture and value system of the society influences the ethical behaviour of the companies operating in each country. The wider society includes religion, culture, political system, governance system, regulatory environment, norms and sanctions, reward and punishment system, the level of transparency, legal environment, etc. For example, in a society where

the politics is highly corrupted, it is very difficult for ethical companies which are against corruption to successfull operate. In such a case, some companies follow the policy of 'if the system is corrupt we will go with it'. Similarly bribery, nepotism, absence of transparency, etc., all influence the ethical behaviour of corporations. For example, since the introduction of the RTI Act, the transparency level has increased in all walks of life to a good extent and hence, the administrators at least have started showing some reluctance to decide issues unethically. The 2G spectrum and the Coalgate scams are best the examples for this. In this aspect the American companies are mostly affected as their societal ethical framework is much tougher than many other countries like China, Russia, India, etc.

For example: The Foreign Corrupt Practices Act (FCPA), introduced after the Water Gate scandal in the USA is to make it illegal for companies and their supervisors to influence foreign officials with any personal payments or rewards. The FCPA applies to any person who has a certain degree of connection to the United States and engages in foreign corrupt practices. The Act also applies to any act by the US businesses, foreign corporations trading securities in the US, American nationals, citizens, and residents acting in furtherance of a foreign corrupt practice whether or not they are physically present in the US. Any individuals that are involved in those activities may face imprisonment. This Act was passed to make it unlawful for certain classes of persons and entities to make payments to foreign government officials to assist in obtaining or retaining business. Under this Act several US companies such as ABB Limited, the Airbrake Technology Corporation, the Walmart, the Dow Chemical Company, have been fined with huge penalty for bribery and corrupt practices. Similarly in the so called ''Panama Papers Case" many US companies are under the scanner of the Federal administration and facing punishment. Huge penalty has been levied against the Lockheed Martin Corporation for bribing other country defense people for getting orders for the supply of fighter aircrafts. Many people have criticized this by saying that it is a display of moral imperialism and related to extra territorial sovereignty of the US.

Similarly, Piracy is a big issue in the US. There are several laws dealing with piracy like the Net act, the Digital millennium Copy Right Act, the Computer fraud and Abuse Act, dealing with such issues. These are not big issues in China. Another aspect is the environment protection and pollution issues have got highest priority in some countries like the UK, the US, where strict laws are there for preventing environment degradation by companies. Environment orientation is a part of the basic culture of the US. Consumer protection is also another area which is given high priority by the developed countries. The US culture gives highest priority to transparency also.

In India the values and ethics are greatly influenced by the Hindu culture and value system as it is the major religion in the country. It is also influenced by the Bhagavad Gita (Krishna's advise to Arjuna in the battle fields), life and teachings of the Buddha and the Mahaveera, and that of Mahatma Gandhi. Jainism advises their community "to follow truthful and peaceful means of earning wealth". Panchasheela, namely Ahimsa, Satya, Asteya, Brahmacharya and Aparigraha are the five principles of Jainism. Buddhism focuses on eight principles such as Right view, Right thought, Right speech, Right action, Right livelihood, Right effort, Right mindfulness and Right concentration. Gandhism focuses on five management principles such as Customer is the most important visitor, Manager is a trusty, Harmony is the basis for relationship between the employees and the employer, Leadership of the self and Means-ends relationship.

Another aspect is the regulatory environment prevailing in the country where the company is operating. In India during the last several years the regulatory environment was not conducive for maintaining good ethical behaviour. Most of the regulations were focused on preventing wrong doing rather than promoting

ethical behaviour. The MRTP Act, the FERA Act, etc. are examples for this, but during the last two decades, sea changes have taken place in the regulatory environment. Instead of the reactive involvement, we have started proactive involvement Also we have shifted emphasis from the rule-based regulatory system to principle-based regulatory system. Shift has also taken place from forced compliance to voluntary compliance as is existing in some developed countries. All these macro environmental changes in the societal environment are contributory to a higher level of ethical behaviour from companies.

Some Unethical Issues

As we discuss business ethics, it is necessary to address the unethical issues that are involved in business. Right from the Harshad Metha scam till the recent insider-trading of L & T versus Reliance, and even more recently Satyam Computers, we see unethical practices taking place even in reputed organisations. Researches and studies show that several ethical issues are faced by an organisation, they are: bribery, coercion, deception, theft, unfair discrimination, insider-trading, conflicts of interest. Some of these are dealt in detail below.

Bribery

Bribery is a manipulative method where one buys the power or the influence of other person in order to satisfy his selfish need. Bribes create a conflict of interest between the person receiving bribe and his/her organisation. This conflict would result in unethical practices. When somebody is bribed for something his thinking and actions are oriented towards his personal goals. This direction towards personal goals always results in a mismatch between the interest of the organisation and of the individual. When there is a mismatch between the goals, naturally, he cannot be loyal to the organisation, and in turn, he will indulge in unethical practices. Bribery undermines market efficiency and predictability, thus ultimately denying people their right to the minimal standard of living. "Bribery does more than destroy predictability; it undermines essential social and economic system."[10]

Bribes create a conflict of interest between the person receiving bribe and his/her organisation, which result in unethical practices. When somebody is bribed for something, his thinking and actions are oriented towards his personal goals. This always results in a mismatch between the interest of the organisation and of the individual.

For example, companies like the Boeing and the GE (General Electric) have well formed policies to deal with this issue. These policies of the company protect the employees from indulging in such practices. The statement of the GE is worth mentioning, "No matter how high the stakes are, no matter how great the 'stretch is', the GE will do business only by lawful and ethical means. When working with customers and suppliers in every aspect of our business, we will not compromise our commitment to integrity".[11]

Likewise, the Boeing is categorical with regard to this issue: "It is the policy of The Boeing Company to deal with its suppliers and customers in a fair and impartial manner, business should be won or lost on the merits of the Boeing products and services. A business courtesy may never be offered under circumstances that might create the appearance of impropriety or cause embarrassment to the Boeing or the recipient. An employee may never use personal funds or resources to do something that cannot be done with the Boeing resources. Accounting for business courtesies must be in accordance with the approved company procedures and practices."[12] Nearer home, the Indian engineering giant, L & T makes its business policy clear thus: "All marketing personnel will adhere to the highest standards of personal and corporate integrity, and thereby maintain and promote our reputation as an outstanding company with which to do business."

Coercion

"Coercion is forcing a person to act in a manner that is against the person's personal beliefs."[13] It is an external force or a man-made constraint created in circumstances asking the other to act against his free will. Authority of the person who demands certain activity plays an important role, that is, blackmailing or arm-twisting an individual in an organisation. This may be in the form of threat of blocking a promotion or the loss of a job. This sort of unethical practices in the organisation will lead to further unethical behaviour of an individual. For example, the Tylenol tampering case of Johnson and Johnson was done with an intention of damaging the image of the company and forcing it to incur heavy financial expenses in correcting the problem.

Deception

Deception is another unethical practice commonly seen in the corporate governance. Financial reports and annual accounts are the main media through which a company connect with its stakeholders. Mostly new investors and shareholders depend on this document for their investment decisions. Even though strict regulatory framework are there for the preparation of financial statements and annual reports, many companies which are not very much ethical use a number of deceptive practices in reporting. They also use accounting and a regulatory loophole to create a different impression about the company among the users from what it actually exists. People who are to oppose such unethical practices, sometimes show cold shoulders to such events. For example, when the Enron Corporation and the World Com magnified their profit by converting revenue expenditure to capital expenditure and capital receipt to revenue receipt the director board and audit committee shut their eyes. Similarly, the wrong market to market accounting, creation of special purpose entity to pump money intended to deceive the shareholders and market who are the main users of financial statements was unnoticed by the auditors. The same was the case when the Sathyam Computers management magnifie its staff strength by 10000 employees and diverted ₹20 crore per month for several years was not noticed by the auditor or even the independent directors.

What constitute deception? This is an important question while addressing this issue. There is no uniformity among management professionals regarding such questionable practices. However, all are agreed on one aspect that while considering the question of such unethical practices the focus must be to safeguard the interest of the company and its stakeholders who invest money in it at the micro level and the society at large at the macro level. Some of the deceptive practices followed by unethical companies while preparing the financial statements, prospectus for new issues and other documents aimed to communicate to outsiders are as follows:

- False and misleading presentations
- Deliberate omission of needed information
- Implying a benefit that do not exist
- Use of complex business models
- Trade-puffing and exaggerations
- Use of unnecessary technical jargons
- Creating ambiguity in the minds of the stakeholders, and
- Creating fear in the minds of the users

Insider Trading

This is one form of misuse of the official position by an individual in the organisation. Here, the employee leaks out certain confidential data to outsiders or to other insiders, which in turn ruins the reputation of the company. Insider-trading may lead to the bad performance of the company.

This is how it is done: If the employees trade the confidential matters, the competitor may intervene and make use of the opportunity. Inside-traders often defend their actions by claiming that they don't injure anyone. It may be true with nonpublic information but certain moral concerns arise because of this act. For example, the report of L & T versus Reliance (*The Hindu*, 23 November 2003) issue which was reported in the media shows that such practices are taking place in reputed companies and at the top management level.

Tax Evasion

There are major unethical practices towards tax evasion. Many large corporations hire the services of professional tax consultants to take advantage of loopholes in the law and evade taxes to the extent possible. The reason, they attribute for such behaviour, is the prevalent rate of corporate taxation, which is very high. In fact, this has generated a parallel economy in spite of government's continuous endeavours to channelise this money towards legitimate purposes.

The well-known tax consultant, Dinesh Vyas, says that J. R. D. Tata never entered into a debate over tax avoidance, which was permissible, and "tax evasion," which was illegal; his sole motto was "tax compliance." On one occasion, a senior executive of a Tata company tried to save on taxes. Before putting up the case, the Chairman of the company took him to JRD and Vyas explained to JRD: "But sir, it is not illegal." JRD asked, softly: "Not illegal, yes. But is it right?" Vyas says that during his decades of professional work, no one had ever asked him that question. Vyas later wrote in an article: JRD would have been the most ardent supporter of the view expressed by Lord Denning. "The avoidance of tax may be lawful, but it is not yet a virtue."[14]

Conflicts of Interest

Even the most loyal employees can find that their interests collide with that of the organisation. Sometimes, this clash of goals and desires can take the serious form of conflicts of interest. In an organisation, conflict of interest arises when employees at any level behave with the private interests that are substantial enough to interfere with their job or duties. This conflicting interests in the individual and the decisions taken may act against the desire of the employer. Conflicts of interests are morally worrisome, not only when an employee acts to the detriment of the organisation but also when the employee's private interests are significant enough, that they could easily tempt the employee to do so. Great men like J. R. D. Tata had been trying all their lives to reduce such conflicts of interest in the work place. JRD's strong point was his intense interest in people and his desire to make them happy. Towards the end of his life, he often said: "We don't smile enough". Once, he told a friend about his dealings with his colleagues: "With each man I have my own way. I am one who will make full allowance for a man's character and idiosyncrasies. You have to adapt yourself to their ways and deal accordingly to draw out the best in each man. At times it involves suppressing

The CEO and the senior leadership of the finance department bear a special responsibility for prompting integrity throughout the organisation, with responsibilities to stakeholders both inside and outside of companies. They have to act with honesty and integrity, avoiding actual or apparent conflict of interest in personal and professional relationships.

yourself. It is painful, but necessary. To be a leader, you have got to lead human beings with affection." It is a measure of his affection that even after some of them retired, he would write to them. He was always grateful and loyal. To him, ethics included gratitude, loyalty and affection. It came about because he thought not only of business, but also of people.[15]

In dealing with his workers, he was particularly influenced by Jamshetji Tata, who at the height of capitalist exploitation in the 1980s and the 1990s gave his workers accident insurance and a pension fund, adequate ventilation at the workplace and other benefits. He wanted workers to have a say in their own welfare and safety, and he wanted their suggestions on the running of the company. A note, that he wrote on personnel policy, resulted in the founding of a personnel department. As a further consequence of that note, came about two pioneering strokes by the Tata Steel: a profit-sharing bonus and a joint consultative council. The Tata Steel has enjoyed peace between management and labour for 70 years.[16]

Pollution

The unethical practice towards pollution affects society and population to a major extent. The high levels of pollution due to the indiscriminate and improper disposal of effluents by industries has rendered the world a highly unsafe place for progeny. In his last years, J. R. D. Tata was very conscious of the environment and industry's part in spoiling it. He wrote in his Foreword to *The Creation of Wealth* in 1992: "I believe that the social responsibilities of our industrial enterprises should now extend even beyond serving people to the environment." The J. R. D. Tata Centre for Ecotechonology at the M. S. Swaminathan Research Foundation was created in furtherance of his desire.[17]

Corporate Governance Ethics

Ancient Indian texts are the true originators of good business governance as one sloka from the Rigveda says "A businessman should benefit from business like a honey-bee which suckles honey from the flower without affecting its charm and beauty."

Though the concept of corporate governance may sound a novelty in the Indian business context and may be linked to the era of liberalisation, it should not be ignored that the ancient Indian texts are the true originators of good business governance as one important sloka from the Rigveda says: "A businessman should benefit from business like a honey-bee which suckles honey from the flower without affecting its charm and beauty."

As a public company, it is of critical importance that companies' information reporting to the regulators be accurate and timely. The chief executive officer and the senior leadership of the finance department bear a special responsibility for prompting integrity throughout the organisation, with responsibilities to the stakeholders both inside and outside of companies. In this context, it is appropriate to keep in mind the following seven cardinal principles of business, applicable at all levels, both national and international.

1. Act with honesty and integrity, avoiding actual or apparent conflict of interest in personal and professional relationships.
2. Provide information that is accurate, complete, objective, relevant, timely and understandable to ensure full, fair, accurate, timely, understandable disclosure in reports and documents that companies file with, or submit to, the regulators.
3. Comply with applicable laws, rules and regulations of federal, state, and local governments, and other appropriate public and private regulatory agencies in all material respects.

4. Act in good faith, with responsibility, with due care, competence and diligence, without misrepresenting material facts or allowing one's independent judgement to be subordinated.
5. Respect the confidentiality of information acquired in the place of one's work except when authorised or otherwise legally obligated to disclose. Confidential information required in the course of one's work will not be used for personal advantage.
6. Share knowledge and maintain skills important and relevant to stakeholders' needs. Proactively promote, and be an example of, ethical behaviour as a responsible partner among peers, in the work environment and the community.
7. Achieve responsible use of and control over all assets and resources employed or entrusted with.

Benefits from Managing Ethics in Workplace

(a) **Attention to business ethics has substantially improved society:** Establishment of anti-trust laws, unions, and other regulatory bodies has contributed to the development of the society. There was a time when discriminations and exploitation of employees were high, the fight for equality and fairness at workplace ended up in establishing certain laws which benefited the society.

(b) **Ethical practice has contributed towards high productivity and strong team work:** Organisations being a collection of individuals, the values reflected will be different from that of the organisation. Constant check and dialogue will ensure that the employee aligns himself or herself to the values of the organisation which will in turn result in a better co-operation and an increased productivity.

(c) **Changing situations require ethical education:** During turbulent times, where chaos becomes the order of the day, one must have clear ethical guidelines to take right decisions. Ethical training will be of great help in those situations.

(d) **Ethical practices create strong public image:** Organisations with strong ethical practices will possess a strong image among the public. This image leads to strong and continued loyalty. Conscious implementation of ethics in organisations becomes the cornerstone for the success and image of the organisation. It is because of this ethical perception, that the employees of the TISCO and the general public protested in 1977 when the then Minister for Industries in the Janata Government, attempted to nationalise the company.

(e) **Strong ethical practices act as insurance:** Strong ethical practices of the organisation are an added advantage for the future function of the business. In the long run, it would benefit if the organisation is equipped to withstand the competition.

Characteristics of an Ethical Organisation

Mark Pastin in his work, *The Hard Problems of Management: Gaining the Ethical Edge* provides the following characteristics of ethical organisations:

(a) They are at ease interacting with diverse internal and external stakeholder groups. The ground rules of these firms make the good of these stakeholder groups the part of the organisation's own good.

(b) They are obsessed with fairness. Their ground rules emphasise that the other persons' interests count as much as their own.

(c) Responsibility is individual rather than collective, with the individuals assuming personal responsibility for actions of the organisation. These ground rules of the organisations mandate that individuals are responsible to themselves.

(d) They see their activities in terms of purpose. This purpose is a way of operating that members of the organisation highly value. And purpose ties the organisation to its environment.

(e) There will be clear communications in ethical organisations. A Minimised bureaucracy and control pave way for sound ethical practices.

Recognising Ethical Organisations

There are certain principles by which we will be able to identify the ethical organisation.

(a) **On the basis of corporate excellence:** Corporate excellence mainly centre on the corporate culture. Values and the practice of such values constitute the corporate culture. Values of the organisation give a clear direction to the employees. Values are found in the mission statement of the organisations. Often they remain as a principle and never put into practice. Only the practised value creates the organisation culture. When values act in tune with the goals of the organisation, we call it as the corporate culture of that organisation. Often we see conflicting interests between the value and the goal of the organisations. An organisation must eradicate such impediments to be identified as an ethical organisation.

(b) **In reference to the stakeholders:** Meeting the needs of the stakeholders by the activities of the managers determine whether the organisation is ethical or not. The top management represents the stakeholders and every decision taken must satisfy the needs of the stakeholder. The management in taking decisions must see that the stakeholders enjoy the maximum benefit of that decision. For example, Marico, the makers of Parachute Oil, discovered a harmless tint in the oil from one of its production lines. The company withdrew the batch from the market, shut down the production line, but kept the workers on their payroll and involved them in the investigation of the cause. Shortly, the workers located the cause, rectified it and resumed production.

(c) **In relation to corporate governance:** Managers are only stewards of the owners of the assets of the company. Thus they are accountable for the use of the assets to the owners. If they perform well in the prescribed manner, then there would not be much question of corporate governance. Such behaviour of the top managers would generate ethical practices or at least would encourage ethical practices in the organisation. If only the top management is paid as per their performance, this approach would work.

List of World's most Ethical Companies – 2017

Company	***Industry***	***Country***
3M Company	Industrial Manufacturing	The USA
Accenture	Consulting Services	Ireland
Aflac Incorporated	Accident & Life Insurance	The USA
Allstate Insurance Company	Property & Casualty Insurance	The USA
Alyeska Pipeline Service Company	Oil & Gas, Renewables	The USA
Applied Materials, Inc.	Electronics & Semiconductors	The USA
Arthur J. Gallagher & Co.	Insurance Brokers	The USA
Avnet, Inc.	Electronics & Semiconductors	The USA

(*Continued*)

Company	*Industry*	*Country*
Baptist Health South Florida	Healthcare Providers	The USA
BDP International, Inc.	Logistics & Transportation	The USA
Blue Shield of California	Health Insurance	The USA
Brightstar Corp.	Telecommunications	The USA
CA Technologies	Software & Services	The USA
Capgemini	Consulting Services	France
CareFirst BlueCross BlueShield	Health Insurance	The USA
CBRE Group, Inc.	Real Estate	The USA
Cementos Progreso, S.A.	Construction & Building Materials	Guatemala
CH2M	Engineering & Design Services	The USA
Cleveland Clinic	Healthcare Providers	The USA
Colgate-Palmolive Company	Consumer Products	The USA
Covenant Health	Healthcare Providers	Canada
Cummins Inc.	Automotive	The USA
CUNA Mutual Group	Financial Services	The USA
DCC	Conglomerate	Ireland
Deere & Company	Industrial Manufacturing	The USA
Dell Inc.	Technology	The USA
Delphi Automotive PLC	Automotive	The UK
Dun & Bradstreet	Business Services	The USA
Eastman	Chemicals	The USA
Ecolab Inc	Chemicals	The USA
EDP - Energias de Portugal, SA	Energy & Utilities	Portugal
Edwards Lifesciences	Medical Devices	The USA
Eli Lilly and Company	Pharmaceuticals	The USA
Fluor Corporation	Engineering & Design Services	The USA
Ford Motor Company	Automotive	The USA
GE	Conglomerate	The USA
Granite Construction Incorporated	Construction & Building Materials	The USA
GRUPO BIMBO	Food, Beverage & Agriculture	Mexico
H & M Hennes & Mauritz AB	Apparel	Sweden
HASBRO, INC	Consumer Products	The USA
Health Care Service Corporation (HCSC)	Health Insurance	The USA
Henry Schein, Inc.	Healthcare Products	The USA
Hospital Corporation of America (HCA)	Healthcare Providers	The USA
IBERDROLA	Energy & Utilities	Spain
illycaffé spa	Food, Beverage & Agriculture	Italy

(*Continued*)

Company	*Industry*	*Country*
Ingredion Incorporated	Food, Beverage & Agriculture	The USA
Intel Corporation	Electronics & Semiconductors	The USA
International Paper Company	Forestry, Paper & Packaging	The USA
Jones Lang LaSalle Incorporated	Real Estate	The USA
Kao Corporation	Health & Beauty	Japan
Kellogg Company	Food, Beverage & Agriculture	The USA
Kennametal Inc.	Machine Tools & Accessories	The USA
Knights of Columbus	Life Insurance	The USA
L'ORÉAL	Health & Beauty	France
Levi Strauss & Co.	Apparel	The USA
LinkedIn	Technology	The USA
ManpowerGroup	Staffing & Outsourcing Services	The USA
Marks & Spencer Plc	Retail	The UK
Marriott International, Inc.	Lodging & Hospitality	The USA
Massachusetts Mutual Life Insurance Company	Life Insurance	The USA
Mastercard	Payment Services	The USA
Microsoft	Technology	The USA
Milliken & Company	Industrial Manufacturing	The USA
MSA - The Safety Company	Security & Protection Services	The USA
National Grid	Energy & Utilities	The UK
NextEra Energy, Inc.	Energy & Utilities	The USA
NiSource Inc.	Energy & Utilities	The USA
Northern Trust	Financial Services	The USA
Northumbrian Water Group	Water & Sewerage Utility	The UK
Northwell Health	Healthcare Providers	The USA
Old National Bancorp.	Banking	The USA
ON Semiconductor	Electronics & Semiconductors	The USA
Oshkosh Corporation	Trucks & Other Vehicles	The USA
Parsons	Engineering & Design Services	The USA
Paychex, Inc.	Staffing & Outsourcing Services	The USA
PepsiCo	Food, Beverage & Agriculture	The USA
Petco	Retail	The USA
PKN ORLEN S.A.	Oil & Gas, Renewables	Poland
Praxair, Inc.	Chemicals	The USA
Premier Inc	Health Information Services	The USA
Principal Financial Group	Financial Services	The USA
Prudential Financial, Inc.	Financial Services	The USA

(*Continued*)

Company	*Industry*	*Country*
Realogy Holdings Corp.	Real Estate	The USA
Republic Services, Inc.	Environmental Services	The USA
Rockwell Automation	Diversified Machinery	The USA
Rockwell Collins	Aerospace & Defense	The USA
Royal Caribbean Cruises Ltd.	Leisure & Recreation	The USA
RTI International	Scientific & Technical Services	The USA
Schneider Electric	Diversified Machinery	France
Schnitzer Steel Industries, Inc.	Metals, Minerals & Mining	The USA
Sharp HealthCare	Healthcare Providers	The USA
Singtel	Telecommunications	Singapore
Starbucks	Specialty Eateries	The USA
Symantec Corporation	Software & Services	The USA
T-Mobile US, Inc.	Telecommunications	The USA
Target Corporation	Retail	The USA
Tata Steel Limited	Metals, Minerals & Mining	India
TE Connectivity	Electronics & Semiconductors	Switzerland
Teachers Mutual Bank	Banking	Australia
Teradata Corporation	Software & Services	The USA
Texas Instruments	Electronics & Semiconductors	The USA
The AES Corporation	Energy & Utilities	The USA
The Hartford	Property & Casualty Insurance	The USA
The Rezidor Hotel Group	Lodging & Hospitality	Belgium
The Timken Company	Industrial Manufacturing	The USA
Thrivent Financial	Financial Services	The USA
TIAA	Financial Services	The USA
TSYS	Payment Services	The USA
U.S. Bank	Banking	The USA
University Hospitals, Cleveland, Ohio	Healthcare Providers	The USA
UPS	Logistics & Transportation	The USA
USAA	Insurance	The USA
VF Corporation	Apparel	The USA
Visa Inc.	Payment Services	The USA
Vizient, Inc.	Business Services	The USA
Volvo Car Group	Automotive	Sweden
Voya Financial, Inc.	Financial Services	The USA
Waste Management	Environmental Services	The USA

(*Continued*)

Company	*Industry*	*Country*
Weyerhaeuser Company	Forestry, Paper & Packaging	The USA
William E. Connor & Associates Ltd.	Sourcing Services	Hong Kong
Wipro Limited	Information Technology Services	India
Wisconsin Physicians Service Insurance Corporation	Accident & Health Insurance	The USA
Wyndham Worldwide	Lodging & Hospitality	The USA
Xerox Corporation	Information Technology Services	The USA

CONCLUSION

With the globalisation of business, monopolistic market condition or state patronage for any business organisation has become a thing of the past. A business organisation has to compete for a share in the global market on its own internal strength, in particular, on the strength of its human resource, and on the goodwill of its stakeholders. While its state-of-the-art technologies and high level managerial competencies could be of help in meeting the quality, cost, volume, speed and breakeven requirements of the highly competitive global market, it is the value-based management and ethics that the organisation has to use in its governance that would enable it to establish productive relationship with its internal customers and lasting business relationship with its external customers. It is for these reasons that in the present day's environment the value based management and the practice of ethics have become imperatives in corporate governance, and also in the foreseeable future. "If values are the bedrock of any corporate culture, ethics are the foundation of authentic business relationships."

KEYWORDS

- Bribery
- Business ethics
- Changing situations
- Collection of values
- Conflict of interests
- Core Values-Integrity
- Corporate excellence
- Corruption
- CSR
- Deception
- Decision-making
- Ethical education
- Ethical organisations
- Ethical practices
- Ethics
- Ethics within organisation
- Ethics in organisations
- Evolution of ethics
- Excellence
- External stakeholder ethics
- GST
- High productivity
- Insider-trading
- Negative image
- Pollution
- Promoters ethics
- Societal ethics
- Stakeholders
- Strong public image
- Strong team work
- Tax evasion
- Unethical behaviour
- Unethical issues

DISCUSSION QUESTIONS

1. How would you define business ethics? Trace the evolution of business ethics over the years.
2. Discuss the importance and the relevance of ethics while conducting business.
3. Do you find a contradiction between running a profitable business and following the ethical practices? Substantiate your answer with suitable examples from the Indian business scenario.
4. Critically comment on the statement: "Corporates in India cannot afford to be ethical".
5. Why do businesses have a negative image? Explain the reasons behind the unethical behaviour of business organisations.
6. Discuss how ethics can make corporate governance more meaningful. Give suitable examples.

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15



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Corporate Governance and CSR

CHAPTER OUTLINE

- Introduction
- Definitions of Corporate Social Responsibility (CSR)
- Justification of CSR
- The Scope of Social Responsibility
- Social Responsibility and Indian Corporations

Introduction

Good corporate governance and corporate responsibility towards society are so inextricably interlinked that we cannot separate one from the other. If providing good governance to its stakeholders and the society at large is what is expected of a corporate, it is because business receives so much from the society that it is only appropriate that the corporate gives back to it at least something in return in the form of good governance. It is thus understood that good corporate governance itself is part and parcel of corporate responsibility to society.

Conflicting Perspectives on the Issue

The issue of social responsibility of business evokes varying—and often extreme—responses from both the intelligentsia and businessmen. Economists like Adam Smith and Milton Friedman were of the opinion that the only responsibility of business was to perform its economic functions efficiently and provide goods and services to society and earn for itself maximum profit and it was better to leave social functions to other institutions of the society like the government.

Economists like Adam Smith and Milton Friedman were of the opinion that the only responsibility of business was to perform its economic functions efficiently and provide goods and services to society and earn for itself maximum profit and it was better to leave social functions to other institutions of the society like the government.

To Adam Smith, "It is the profit-driven market system, also called price mechanism that drives business firms to promote social welfare, though they work for private gain". He observed further: "Every individual endeavours to employ his capital so that its produce may be of greatest value. He generally neither intends to promote the public interest, nor knows how much he is promoting it. He intends only his own security, only his own gain. And he in this is led by an invisible hand to promote an end, which was no part of his intention. By pursuing his own interest, he frequently promotes that of society more effectively than when he really intends to promote it."[1] Likewise, Prof. Milton Friedman does not give much credit to the concept of social responsibility. To Friedman, the advocacy of social responsibility of business is the green signal to pure socialism.[2] He argued: "Business has one and only one social responsibility, to make profits (as long as it stays within legal and moral rules of the game established by society). Few trends could so thoroughly undermine the very foundations of our free society as acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible."[3]

However, those holding the opposite view have criticised this highly materialistic viewpoint on several grounds. In their perception, governments cannot and need not be the sole repository for promoting the welfare of masses. It is an area where the corporate sector can play a significant role. They assert that it is imperative for business to be socially responsible. Prof. Paul Samuelson, for instance, advocates a spirit of social responsibility as an inherent feature of a modern business firm. This view is based on the argument that business organisations, corporate or otherwise, are part of the society and have to serve primarily its interests rather than work for the narrow economic gains such as making of profit.

According to T. F. Bradsha, a past president of the Atlantic Richfield Company in the United States, business could not ignore social expectations of the community of which it is a part. He joined issue with Friedman thus: "Milton Friedman is right but, of course, he does not go far enough. Friedman overlooks two things. First, the businessman does not exist solely in a world of cold grey economics; he also exists in a real world where people's needs go far beyond their economic needs. He is a man before he is a businessman. He feels pressures from within to become a part of the whole social pattern and to accomplish more than making a profit. Second, Friedman overlooks the fact that the rules have been changing and are going to change at an explosive rate in the future. We may yet reach that

state where a businessman is judged by the social goals he accomplishes as well as the profits he makes."

Further, Dr. Clark C. Abt, the president of the Abt Associates Inc., Cambridge, in the United States, felt that business organisations while determining socially responsible behaviour should first analyse its impact on short term and long term profitability of the organisation. He wrote: "Why cannot profitability and other socially responsible behaviours co-exist? Perhaps intolerance of the concept is based on too narrow a conception of profitability or socially responsible behaviour, or both. If profitability seeks profit maximisation within a very short period of time and constrained only by the law, then any additional operational or financial cost conflicts with that maximisation. Short-term costs of both social and financial investments conflict with short-term profit maximisation. Most businessmen would reject profit maximisation by elimination of investment in future capacity as shortsighted and doomed to mid-term failure, as resources become exhausted without replacements becoming available from previous investments. If they decide to maximise profits by eliminating social investments, it is because they either do not know the relationship between social investments and financial returns or believe that some other agency such as the government will make necessary social investments."

According to Prof. Robert Dahl, it is obligatory on part of business organisations to be socially responsible as they primarily exist to benefit society. He expressed his view thus: "Today, it is absurd to regard the corporation simply as an enterprise established for the sole purpose of allowing profit making. We, the citizens, give them special rights, powers and privileges, protection and benefits on the understanding that their activities will fulfill our purposes. Corporations exist because we allow them to do so. And we allow them to exist only as they continue to benefit us. Every corporation should be thought of as a special enterprise whose existence and decisions can be justified only in so far they serve public or social purposes."

Definitions of Corporate Social Responsibility (CSR)

What is Corporate Social Responsibility? It is not as simple as it sounds. The definitions differ vastly according to the perception and sensitivity of the analyst. The World Business Council for Sustainable Development in its publication "Making Good Business Sense" by Lord Holme and Richard Watts used the following definition: "Corporate social responsibility is the continuing commitment by business to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well as of the local community and society at large." The same report gave some evidence of the different perceptions of what this should mean from a number of different societies across the world. Definitions vary from being defined as "CSR is about capacity building for sustainable livelihoods. It respects cultural differences and funds the business opportunities in building the skills of employees, the community and the government" from Ghana, through to "CSR is about business giving back to society" from the Philippines.

In the United States, CSR has been defined traditionally much more in terms of a philanthropic model. Companies make profits unhindered except by fulfilling their duty to pay taxes. Then they donate a certain share of the profits to charitable causes. It is seen as tainting the act for the company to receive any benefit from the giving.

The European model is much more focussed on operating the core business in a socially responsible way, complemented by investment in communities for

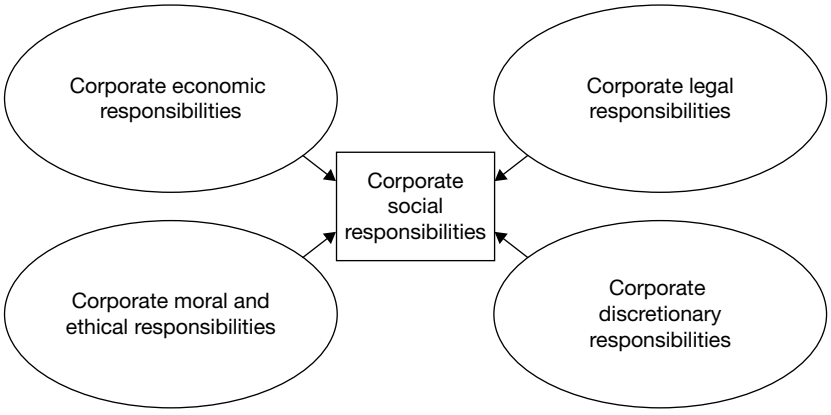
solid business case reasons. It is believed that this model is more sustainable because of the following reasons:

1. Social responsibility becomes an integral part of the wealth creation process — which, if managed properly, should enhance the competitiveness of business and maximise the value of wealth creation to society.
2. When times get hard, there is the incentive to practise CSR more and better — if it is a philanthropic exercise which is peripheral to the main business, it will always be the first thing to go when push comes to shove.

But as with any process based on the collective activities of communities of human beings (as companies are) there is no "one size fits all". In different countries, there will be different priorities and values that will shape how business acts towards its social goals.

Conceptual Framework of CSR

Social responsibility of business may be interpreted as the economic, legal, ethical and discretionary expectation that society has from business organizations at a given point of time. This concept emphasizes that the business should be accountable for its actions which has an impact on people, environment and the community. Hence, organizations have moral, ethical and philanthropic responsibility in addition to their responsibility to earn a fair return for the investment. The economic responsibility focuses on the role of business in satisfying the society's expectations of producing goods and services needed and desired by the community at an affordable price after complying the laws set by the governments. The ethical responsibility is concerned with societal expectations that go beyond the economic and legal requirements such that the organizations will conduct their affairs in a fair way. This means that the organizations must make proactive efforts to meet the norms of the society. Finally, the discretionary responsibilities refer to the society's expectations that organizations be good citizens by undertaking philanthropic programs benefiting the community. The relationship between all these responsibilities is represented in the following diagram.



Ten most socially responsible companies in the world:

1. Statoil–Oslo based oil and Gas Company of which 67 per cent stake is owned by Norwegian government.
2. Ferrovial–A Spanish conglomerate involved in transportation and urban infrastructure.
3. Walt Disney Company–An US based entertainment company.
4. Edison–The Milan based oldest energy company.

5. ENI–Milan based Energy Company specialised in oil, gas and petrochemicals.
6. Whole Foods Market–Supermarket chain specialised in organic products in US.
7. Total–A French oil and gas company.
8. Hochtief–Germany's largest construction company and leader in green real estate business.
9. Nestle–Swedish largest food manufacturing company.
10. Next Era Energy–Florida Power Light (Tie).

Corporate Social Responsibility and the Stakeholder

CSR is essentially a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis.

Corporate social responsibility is essentially a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis. This means, not only fulfilling legal expectations, but also going beyond compliance and investing in the human capital, the environment and the relations with stakeholders.

To put it in simpler terms, stakeholders are those organisations and individuals who have an interest or "stake" in the business or corporation and its success. That includes the clients, the population of small business people, other business assistance organisations, economic development organisations, legislators of the country, federal, and state levels, executive branches of government, executive departments and agencies, the staff and contracted consultants and trainers, vendors, and taxpayers. The list is very long and inclusive.

The development of CSR reflects the growing expectations of the community and stakeholders about the evolving role of companies in society and the response of companies to growing environmental, social and economic pressures. Through voluntary commitment to CSR, companies are hoping to send a positive signal of their behaviour to their various stakeholders and in so doing make an investment in their future and help to increase profitability.

Many driving forces are fostering the evolution of corporate social responsibility such as:

- New concerns and expectations from citizens, consumers, public authorities and investors in the context of globalisation and large scale industrial change
- Social criteria are increasingly influencing the investment decisions of individuals and institutions, both as consumers and as investors
- Increased concern about the damage caused by economic activity to the environment
- Transparency of business activities brought about by the media and modern information and communication technologies

CSR at present is mainly driven by large or multinational companies that rely extensively on their public reputation for continued viability.

The systematic implementation of CSR involves the use of the following features:

1. Adoption of strong organisational values and norms justifying as to which behaviours are appropriate toward a variety of stakeholders.
2. Continuous generation of intelligence about stakeholder issues, along with positive responses to these issues.

A Growing Global Role

It is obvious that the pressure on business to play a role in social issues will continue to grow. Over the last 10 years, those institutions which have grown in power and influence have been those which can operate effectively within a

global sphere of operations. These are effectively the corporates and the NGOs. Those institutions which are predominantly tied to the nation state have been finding themselves increasingly frustrated at their lack of ability to shape and manage events. These include national governments, police, judiciary and others.

There is a growing interest, therefore, in business taking a lead in addressing those issues in which they have an interest where national governments have failed to come up with a solution. That is not to say businesses will necessarily provide the answers—but awareness is growing that they are occasionally better placed to do so than any other actors taking an interest.

Justification of CSR

Social scientists have formulated several theories that justify the importance of corporates engaged in promoting social welfare of the society in which they operate. These theories are given below.

Trusteeship Model

The Trusteeship Model adopts a realistic and descriptive perspective in viewing the current governing situation of a publicly held corporation, drawing from the continental European concept of the corporation as a social institution with a corporate personality.

The Trusteeship Model adopts a realistic perspective of the corporation as a social institution with a corporate personality. The trusteeship model differs from the agency model in two ways: First, the fiduciary duty of the trustees is to sustain the corporation's assets, including not only the shareholders' wealth, but also broader stakeholders' value such as the skills of employees, the expectations of customers and suppliers, and the company's reputation in the community.

Kay and Silberston (1995) argue that a public corporation is not the creation of a private contract and thus not owned by any individual. Ownership is by definition where the owner has exclusive rights of possession, use, gain and legal disposition of a material object. Though shareholders own their shares in a company and trade their shares with others in the stock market, they do not have rights to possess and use the assets of the company to make decision about the direction of the company and to transfer the assets of the company to others. The residual claims of the shareholders are determined by the company and if the company's performance does not satisfy the shareholders' requirements, the shareholders are left with a single option of "exit" rather than "voice" as shareholders in general are in no way able to monitor the management effectively and neither are they interested in running corporate business. In this sense, the assumption that the corporation is owned by the shareholders is in fact meaningless. For Kay and Silberston, ownership rights are not important to business. Many public institutions such as museums, universities, and libraries perform well without clear owners.

Indeed, Company Law does not explicitly grant shareholders ownership rights because the corporation is regarded as an independent legal person separate from its members, and shareholders are merely the "residual claimants" of the corporation. The company has its own assets, rights and duties, and has its own will and capacity to act and is responsible for its own actions. Therefore, Kay and Silberston reject the idea that managers are the agents of shareholders. Instead, they suggest that managers are trustees of the corporation. The trusteeship model differs from the agency model in two ways: First, the fiduciary duty of the trustees is to sustain the corporation's assets, including not only the shareholders' wealth, but also broader stakeholders' value such as the skills of employees, the expectations of customers and suppliers, and the company's reputation in the community. Managers as trustees are to promote the broader interests of the corporation as a whole, not solely the financial interest of its shareholders. Second, managers have to balance the conflicting interests of current and future stakeholders and to develop the company's capacities in a long-term perspective rather than focus on short-term shareholder gains. To establish a trusteeship model, they ask for

statutory changes in corporate governance, such as changing the current statutory duties of the directors, ensuring the power of independent directors to nominate directors and select senior managers and appoint CEOs for a fixed 4-year term and so on.

The Social Entity Theory

The social entity conception of the corporation regards the company not as a private association united by individual property rights, but as a public association constituted through political and legal processes and as a social entity for pursuing collective goals with public objectives.

The social entity theory has, in recent years, been promoted by three major social thinkers—the democratic political theorist, Robert Dahl (1985) using economic democracy, Paul Hirst (1994) using associationalism, and Jonathan Boswell (1990) using communication notion of property. The social entity conception of the corporation regards the company not as a private association united by individual property rights, but as a public association constituted through political and legal processes and as a social entity for pursuing collective goals with public objections. "The social entity theory views the corporation as a social institution in society based on the grounds of fundamental value and moral order of the community. With the fundamental value of human rights and standard of a corporation's usefulness is not whether it creates individual wealth, but sense of the meaning of the community by honouring individual dignity and promoting over all welfare." (Sullivan argues that corporations are granted charter entity for a commercial purpose, but more importantly, as a social entity for general community needs). The corporation identity and executives are representatives and guardians of all corporate stakeholder's interests (Hall, 1989).

The recent resurgence of the moral aspect of stakeholder perspectives has been in general associated with the social entity conception of the corporation.

The Pluralistic Model

The pluralistic model supports the idea of multiple interests of stakeholders, rather than shareholder interest alone. It argues that the corporation should serve and accommodate wider stakeholder interests in order to make the corporation more efficient and legitimate.

It suggests that corporate governance should not move away from ownership rights, but that such rights should not be solely claimed by, and thus concentrated in, shareholders; ownership rights can also be claimed by other stakeholders, particularly employees. Stakeholders who make firm specific investments and contributions and bear risks in the corporation should have residual claims and should participate in the corporate decision making to enhance corporate efficiency.

It is asserted that if corporations practise stakeholder management, their performance such as profitability, stability and growth will be more successful.

What Are Corporates Expected To Do?

In support of the view that corporates have a moral and social obligation towards society, some economists argue that corporates depend on society for a number of facilities they enjoy such as developed infrastructure, peace and tranquility in the work place and a trained workforce. They also depend on society for the maintenance of law and order, without which they cannot carry on their productive or distributive activities, and also for reaching to their customers through mass media. Consumers of products, without whom they have no *raison d'etre*, are all drawn from society. If a business body draws so much from society, it has to make its own contribution to the welfare of the latter. It has a debt to pay in the first place. It has to behave as a good citizen inasmuch as it has to pay its taxes

in full and on time, observe the laws of the land and, going beyond it, ensure a clean and healthy environment, standards of operational and product safety and help in energy and resource conservation.

The corporations among the business community also have a moral responsibility to take a long and hard look at their values, practices and assumptions. They have to ensure that the country's fair name is not compromised abroad during their deals, either as exporters or importers. They have to ensure maintenance of the quality of their products, keeping up to the delivery schedule, etc. In the Indian context, socially responsible corporates are expected to create employment opportunities directly and set up ancillaries for the disadvantaged persons; provide financial resources in several ways such as financing customer related marketing; by sharing skills in marketing, technical and management areas in many ways; make available marketing support both by purchasing products and services from disadvantaged communities; and by sharing, company facilities of donating company's products and services.[4]

Private Sector Needs Goodwill of the Society

For historical and other reasons, private enterprise is not favoured much in countries like ours because its owners accumulate wealth for their own exclusive benefit at the expense of the public and are not generally seen to contribute to the common good. Corporates should, for their own good, come forward to erase such perception in the minds of the common public. In an era of intense competition, accentuated by the advent of MNCs, it is necessary for them to generate and sustain "*goodwill*" among their clients and the general public. Active participation in social welfare projects will definitely improve their visibility and place them on a pedestal of public esteem. They should understand the fact that economic goals and social responsibility objectives need not be contradictory to each other and that these could be achieved simultaneously. They should donate generously towards public causes and must get themselves directly involved in social welfare programmes, if they have to create goodwill among the public and to avoid being branded as profiteers and self-seekers.

Arguments in Favour and Against Social Responsibility of Business

Based on the above models of CSR the following major arguments are raised in favour and against the assumption of social responsibilities of business:

1. **Public expectations:** Social expectations of business have increased dramatically since the 1960s. Public opinion in support of business pursuing social as well as economic goals is now well solidified.
2. **Long run profits:** Socially responsible business tend to have more and secure long run profits. This is the normal result of the better community relations and improved business image that is responsible.
3. **Ethical obligation:** A business firm can and should have a conscience. Business should be socially responsible because responsible actions are right for their own sake.
4. **Public image:** Firms seek to enhance their public image to gain more customers, better employees, access to money markets and other benefits. Since the public considers social goals to be important, business can create a favourable public image by pursuing social goals.
5. **Better environment:** Involvement by business can solve difficult social problems, thus creating a better quality of life and a more desirable community in which to attract and hold skilled employees.

CSR has been supported by many people because of its unique advantages such as high public expectation, long run profitability, better public image, social obligation, etc. it is also criticized by many because of the dilution of profit maximization objective, cost involved in it and lack of effective public support.

6. **Discouragement of further government regulation:** Government regulation adds economic costs and restricts management's decision flexibility. By becoming socially responsible, business can expect less government regulation.
7. **Balance of responsibility and power:** Business has a large amount of power in society. An equally large amount of responsibility is required to balance it. When power is significantly greater than responsibility, the imbalance encourages irresponsible behaviour that works against the public good.
8. **Stockholder interests:** Social responsibility will improve the price of a business's stock in the long run. The stock market will view the socially responsible company as less risky and open to public attack. Therefore, it will award its stock a higher price earnings ratio.
9. **Possession of resources:** Business has the financial resources, technical experts and managerial talent to provide support to public and charitable projects that need assistance.
10. **Superiority of prevention over cures:** Social problems must be dealt with at some time. Business should act on them before they become serious and costly to correct and take management's energy away from accomplishing its goal of production goods and services.

Arguments Against the Assumption of Social Responsibilities by Business

1. **Violation of profit maximization:** This is the essence of the classical viewpoint. Business is mostly socially responsible when it attends strictly to its economic interests and leaves other activities to other institutions.
2. **Dilution of purpose:** The pursuit of social goals dilutes business's primary purpose, economic productivity. Society may suffer as both economic and social goals are poorly accomplished.
3. **Costs:** Many socially responsible activities do not pay their own way. Someone has to pay these costs. Business must absorb these costs or pass them on to consumers in higher prices.
4. **Too much power:** Business is already one of the most powerful institutions in our society. If it pursued social goals, it would have even more power. Society has given business enough power.
5. **Lack of skills:** The outlook and abilities of business leaders are oriented primarily toward economies. Business people are poorly qualified to cope with social issues.
6. **Lack of broad public support:** There is no broad mandate from society for business to become involved in social issues. The public is divided on the issue. In fact, it is a topic that usually generates a heated debate. Actions taken under such divided support are likely to fail.

The Scope of Social Responsibility

The scope of social responsibility is wide and could be considered in terms of different viewpoints, some of which are given below:

1. **Protecting and promoting stakeholders' interests:** Some consider social responsibility in terms of services rendered to claimants or stakeholders, who could be both insiders and outsiders. The insiders are employees and shareholders while outsiders include consumers, suppliers, creditors, competitors, government and the general public. Consumers expect quality

goods and services at fair prices, workers expect fair wages without being exploited, shareholders expect reasonable dividends and fair return on investments and managers expect challenging jobs with attractive salary. Government and the general public expect them to add to the wealth and welfare of the country without polluting the environment. In short, business organisations have to consider themselves the "custodians of public welfare", by rendering such services to the various sections of the society.

2. **Social concern and promotion of common welfare programmes:** Another way in which the scope of social responsibility could be viewed is in terms of social concern and promotion of common welfare programmes for the benefit of the poor and the indigent public. Companies have highlighted social issues and brought them to the notice of the public through hoarding and other means of drawing the attention of people to the issue in question and generate public awareness. There had been occasions, though limited in number, where corporates have joined hands to sponsor advertisements promoting public causes or issues of social concern such as pointing out the dangers of drug addiction and smoking. Business organisations could also consider social responsibility in terms of relatedness to their own activities. Producers of dental or eye care products organise mass clinics in villages and semi-urban areas where surgeons attend to the medical needs of the poor and indigent. Such attempts greatly relieve the burden on the finance-strapped state in a developing country like India where people, due to poverty and for historical reasons, depend solely on the government to render every type of service.
3. **As an act of philanthropy:** There are others who view social responsibility as philonthropy. J. R. D. Tata in his keynote address at the inauguration of the Tata Foundation for Business Ethics some 10 years ago outlined this equation thus: "The Tata industrialist ethos inherited from the great Jamsetji himself, tried to combine high standards and quality production with sincere concern for ethical values such as fair and honest management, product quality, human relations in industry and industrial philanthropy."[5] However, in a strict sense, the concept is restricted to the observance of rules and regulations that govern business transactions, and in a way facilitates a smooth running of business. "In a wider sense, it demands conformity with accepted norms and interpretations of the laws dealing with business activity." Moreover, in a business world, where cut-throat competition and survival of the fittest dictate the law and have the upper hand over humanity, philanthropy also means a display of humanity which will manifest itself in some form of benevolent activity among the larger public. It undoubtedly benefits some individuals or communities in need".[6]

J. R. D. Tata in his keynote address at the inauguration of the Tata Foundation 10 years ago emphasised the combination of high standards and quality production with sincere concern for ethical values and industrial philanthropy as several aspects of CSR.

Take the instance of how industrialists came to the rescue of the quake-devastated people in Gujarat. When Gujarat was shattered by the fury of the worst earthquake in recorded history over the past 50 years, a free phone facility set up by Care India, Bharti-BT and CISCO provided the most immediate emotional relief for people anxious for news of their families as well as access to medical assistance and advice. Industrialists through the Confederation of Indian Industry (CII) and the Federation of Indian Chambers of Commerce and Industry (FICCI) have committed large funds that have enabled several NGOs adopt villages that were most severely hit and provided several others a great deal of relief measures.[7] When the killer waves of Tsunami caused death and destruction on 26 December 2004 in Tamil Nadu, Andamans, Kerala and Andhra Pradesh, corporates came to the immediate succour of the affected with food packets, medicines and clothes. Corporates also poured in hundreds of crores to the prime minister's and chief ministers' relief funds to enable government to undertake permanent measures to rehabilitate the displaced fisherfolks with permanent homes, fishing nets and boats. Likewise, elsewhere when disaster struck New York and Washington in the aftermath

of terrorist attacks on 11 September 2001, American MNCs played their part as good corporate citizens. Most have donated substantial amounts towards the disaster relief funds and made generous gestures towards their social responsibility. While the US food giant McDonalds had offered food for the rescue workers at different locations across the country in addition to a donation of $2 million, General Motors, General Electric, Ford Motor and Unocal also had done their best to be of help and alleviate the sufferings of those affected by the tremendous human tragedy.

4. **Good corporate governance itself is a social responsibility:** Some social thinkers even view, in the Indian context, that good corporate governance itself is an ingredient of corporate social responsibility. For too long, Indian corporates have insulated themselves from wholesome developments evolving elsewhere. Corporate democracy, professional management and maximisation of long-term share-holder value which are attributes of good corporate governance, were lacking in the country. A closed economy, a sheltered market, limited need and access to global business/trade, lack of competitive spirit, a regulatory framework that enjoined mere observance of rules and regulations rather than realisation of broader corporate objectives, marked the contours of corporate governance for well over 50 years.

   Corporate governance has acquired a new urgency in India due to the changing profile of corporate ownership, increasing flow of foreign investment, preferential allotment of shares to promoters, gradual unwinding of the control mechanism by the state that had hitherto provided protective cover to even poorly managed corporates and the increasing role of mutual funds since 1991.[8]

Some industrial houses have been promoting activities that supplement the efforts of public authorities in certain areas that are important for all-round human development. The Tatas have contributed to the growth of fundamental and social sciences by building and nurturing institutions of higher learning in these areas. The Birlas have been building and maintaining beautiful and monumental places of worship in several cities in addition to popularising science through planetoriums.

5. **Corporates in the vanguard of rendering social service:** Some industrial houses have been promoting activities that supplement the efforts of public authorities in certain areas that are important for all-round human development. The Tatas have contributed to the growth of fundamental and social sciences by building and nurturing institutions of higher learning in these areas. The Birlas have been building and maintaining beautiful and monumental places of worship in several cities in addition to popularising science through planetoriums. Some corporates have been sponsoring sports events and helping sportspersons attain international standards. TISCO has made several contributions in such diverse areas as community, especially tribal area development, rural industrialisation. etc., SAIL has done its mite in agriculture, health care, drinking water supply, dairy and poultry farming. ITC Ltd. is socially active in agriculture, sports and pollution control, while Brooke Bond has interests in animal welfare, providing veterinary services and improvements in animal breeding. Down south, several corporates have done yeoman service in the field of education and related areas such as sports, building of institutions that train personnel as well as render social service.

   The Loyola Institute of Business Administration (LIBA) has instituted The Mother Teresa Award for Corporate Citizen to showcase as a role model a corporate that has rendered social services far beyond the call of its duty and responsibility for others to emulate. It has identified Titan Industries, Tamil Nadu Newsprints and Papers Ltd., Indian Oil, Polaris, TVS Motors, and Orchid Chemicals for the award so far in recognition of several socio-economic projects they have been running for the welfare of the disadvantaged sections of the society in and around the places where their factories are located. Some studies have shown that there are several others too who have done yeoman service to the people at large. Some of these are: TVS Group, Bajaj Auto, Balmer Lawrie, Bank of America, Business Standard, Coca-Cola India, Dr. Reddy's Laboratories, Forbes Marshall, Nicholas Piramal, Excel Industries, Hindustan Machine Tools, Amar Jyothi Industries, Hindustan Lever and International Business Machines, to mention a few major corporate players. While some

of them work for the welfare of the poor, handicapped and the marginalised sections of the society in and around where their plants, facilities and offices are located, others go beyond their locations and reach out to those who are in dire need of their services.

6. **Sponsoring social and charitable causes:** Some entrepreneurs had not only built industrial empires, but also contributed individually to certain social and charitable causes. J. R. D. Tata's contribution to the growth of the Indian airlines industry, population-related research, education of the underprivileged, etc. had been exemplary. Late D. C. Kothari, the chairman and managing director of Chennai-based Kothari Industrial Corporation Ltd., with his wide-ranging interests, had been the moving spirit behind several charitable trusts and institutions of higher learning, apart from being the prime-mover of the Standards movement in the country and earned the rare distinction of becoming the President of the International Organisation for Standardisation (ISO) from a third world country.
7. **Corporations should supplement state efforts:** There are several areas where corporates can supplement effectively the ever growing welfare activities the state is expected to undertake, but does not have the resources to carry on. Corporates can run schools, either in their own areas or in any other adopted village of their choice, providing good quality primary education. If each of the more than two lakh corporates the country has adopts three villages each, we will be able to cover the entire country and provide better primary and elementary education to our children. It will go a long way in promoting literacy and over-all development of the country. In this context, it should be borne in mind that the Asian Tigers like Thailand, Phillippines, South Korea, Indonesia, Malaysia and Singapore have achieved much higher growth rates before the currency crises overshadowed their achievements because of universalisation of primary education which they carried out since 1950s whereas we have failed to do so.

   Corporate resources can also be allocated to run family planning clinics, medium-sized hospitals in villages, literacy campaigns and adult education programmes, campaigns against smoking, pollution, AIDS, casteism and communalism and to provide housing, sports and recreational amenities for slum-dwellers, etc. Corporates can also contribute effectively towards urban management as has been done in places like Jamshedpur by Tata Steel.

   Another area where corporate concern for social welfare can be shown is in the maintenance of public health system. Corporates cannot be mute spectators to the deterioration in public health. Besides the moral and social aspects involved, they have to appreciate the fact that all their activities, business or otherwise, will come to a stand-still, if any disease of epidemic proportions breaks out. In 1999, The Hindu reported a unique government—industry partnership to improve public health in Tamil Nadu. In the first phase of the programme, 57 Primary Health Centres (PHCs) and 6 Government Hospitals were adopted by 19 industrial groups based in the state. According to official sources, 40 more PHCs were adopted in the second phase with more industries joining in due course. The then Chief Minister, while inaugurating the programme, commended the whole-hearted and voluntary participation of industrial houses that would go a long way in enhancing the welfare of the people.
8. **Social responsibility of corporates also lies in abiding by rules and regulations:** This view is widely accepted since it facilitates a smooth functioning of business. This demands conformity with accepted norms, and interpretations of the laws dealing with business activity.
9. **Ensuring ecological balance:** Several corporations such as Tata Steel, ITC, Srinivasan Services Trust of the TVS Group have been helping people to harmonise with nature by reducing pollution.

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10. **By focussing on human elements:** Social responsiblity also lies in improving quality of worklife; reducing hazard in the workplace; ensuring equality in employment opportunities and wages; ensuring settlements of disputes with workers within the legal framework; assisting employees to adjust themselves with ease to new environments while relocating plants; and to ensure job and retirement security of a reasonable nature.

Major Issues and Challenges of CSR Implementation

CSR has become an important component in the contemporary corporate governance. Lot of issues are still confronted by it namely, absence of proper guidelines, debate on whether it should be voluntary or compulsory, conflict of interest of stakeholders, absence of proper interpretation of ethical behavior, higher public expectations, attitude of different stakeholders such as government, management, owners and civil society.

Whether it should be voluntary or compulsory: The first question to be addressed is whether it should be optional or compulsory. Some people consider that CSR is basically a concept whereby companies decide voluntarily to contribute to a better society, better environment and sustainable development. This is in line with the Neoliberal view that CSR is fundamentally as the adoption of a set of voluntary policies, codes or guidelines initiated and driven by corporate. This view was also subscribed by people like Milton Friedman that there is one and only one social responsibility to business to use its resources and engage in activities designed to increase its profit so long as it is within the rule of the game, engages in open and free competition without deception or fraud. This view has been opposed by people like McAleer (2003) and Okctch (2004) who argue that today many would not be comfortable with such profit orientation alone.

Another extreme view of CSR is based on the assumption that global corporations are seen as possessing enormous power which is often wielded ruthlessly in their self-interest and frequently at the expense of the society and environment. Hence, a compulsory CSR regulatory framework is necessary to overcome the harm the companies are making to the society. More over this view emphasizes that the self-regulatory voluntary CSR practices are frequently and deliberately designed by corporate to divert attention away from the external regulations and control of corporate behaviour that are socially and environmentally destructive.

In between these two extreme views, Neo Keynesian writers argue that corporate actions can have negative impact to the society or environment through its wrong environmental policies, wrong work place practices, unethical production and marketing practices, etc. Hence, companies are responsible for appropriate CSR strategies to overcome problems caused by unfettered corporate behaviour, ensuring environmental sustainability and achieving other desirable social and economic goals.

Absence of Proper Guidelines

One of the complexities of the successful CSR implementation is in defining a good corporate citizenship. Some people talk in absolute terms while others speaks in terms of degrees. In this age of multi-facetted international companies practices with in and across the corporate boundaries may vary. Because of this, CSR practices of companies differ in their approach. While some companies increasingly recognize their social responsibility, many of them have yet to adopt prudent management practices that reflect it. To some companies it is the offer of school kits to nearby people or a free medical camp to local citizens, while to others it is about talking of global warming and environmental issues. Philanthropy, statutory legal obligations and voluntary practices are mixed by companies to confuse the society. Companies and management need clear vision and guidelines to implement generally accepted CSR practices. Big companies can help to formulate guidelines in these aspects and give training to managers to implement it. Critics suggest that better governmental and international regulations and enforcement, rather than voluntary measures are needed to ensure that companies behave in a socially responsible manner. In this context the guidelines formulated by the Global Reporting Initiative is worth noting.

CSR Guidelines Proposed by Global Reporting Initiative

Economic	*Social*	*Environment*
• Revenues	• Human rights (% of screen suppliers)	• Raw material used / recycled
• Operating costs	• Employees trained on human rights	• Energy used / saved
• Employee compensation	• Number of incidents of discrimination	• Renewable energy
• Charitable donations	• Incidents of use of child/forced labour	• Water use and origin
	• Number of incidents of violations of rights of indigenous people	• Water recycled / reused
	• Workforce by employment type, region, age group, gender, ethnicity	• Land and biodiversity
	• Occupational health (injuries/fatalities, training)	• Habitats protected / restored
	• Employee training	• Greenhouse gas (GHG) emissions
	• Customer satisfaction / complaints	• Emissions of ozone depletes
	• Regulatory non-compliance and fines	• NOx, SOx and other air emissions
	• Corruption and fines	• Water discharge
		• Waste produced / disposed
		• Accidental spills
		• Packaging waste
		• Permit compliance breaches
		• Transport of goods

The 2013 Indian Companies Act address this issue and a detailed list of CSR activities have been given in the schedule.

Conflict of Interest of Stakeholders

Another issue preventing the successful implementation of CSR is the conflict of interest among the different stakeholders. Investors who are the major stakeholders mainly interested in profit and share price especially in short run. Any action negatively affecting this will be opposed by them even if it is good for the society. Similarly, employees are always concerned with the reward and better labour conditions. All corporate actions positively contributing to this will be appreciated by this segment. But this may involve additional cost and may affect profitability and share price. Customers who are other major stakeholders always concerned with the product/service quality, performance and price. They always appreciate better quality product/service with lower price.

Needless to say that developing good corporate citizenship through CSR involves additional cost and slightly higher price to the end user of the product/service as compared to those companies who are not involved in good CSR practices. When both these companies compete in the same market who will be the winner is a big question. Some of the studies in this direction show positive correlation between CSR practices and corporate financial performance. CSR actually reduces financial risk and organisations of all size benefits financially from socially responsible actions in the long run (Orlitzky 2005). But at the same time, the studies conducted by Hopkins (2003) conclude that the CSR policies have not positively contributed to the demand for share and its price. So in order to make CSR effective there must be some sort of synergy in the goals of all stakeholders. All of them must be willing to sacrifice some of their self-interest for the common good of the society and long term survival.

High Public Expectation of CSR

Since the concept of CSR has become popular, public expectation from corporates are also very high. Now the public are very much aware about the social and environmental exploitation of corporate in pursuit of profit and wealth. Hence, they expect not only quality product/service at an affordable price but also expect the corporate to address everything they require from charity to global warming especially in the context of decreasing the government role. This high expectation is putting pressure on corporate to successfully implement CSR activities.

Absence of Proper Interpretation of Moral/Ethical Behaviour

What constitutes ethical and moral behaviour is a highly relative subject. Some actions which are ethical and moral for one type of stakeholders at one point of time may be unethical to some others or to the same group at another point of time. These divergent views are confusing the society and corporate executives are taking advantage of this situation. For example, the Walmart's environmental reforms are projected as socially responsible behaviour, but at the same time they are following its retrograde labour policies. Similarly, Enron engaged in large scale philanthropy while being guilty of moral misconduct. According to Mattera, (2006) IT companies all over the world are considered as top environmental performers but at the same time generating toxic wastes through computer components.

The Attitude of the Government towards the Corporate Social Responsibilities

Good Corporate Governance includes socially responsible business practices. A socially responsible approach to business would involve attention to social and environmental concerns in addition to economic goals and encourage companies to balance the financial profits, the economic value addition and the social goodness. Being part of the 'State' every Public Sector Undertakings (PSUs) has a high level of public accountability towards the society. A Committee of Public Undertakings (COPU) in 1992 examined the issue relating to social obligation of Central Public Sector Enterprises and observed that 'every Public Sector Enterprise (PSE) has a moral responsibility to play an active role in discharging the social obligations endowed on a welfare state, subject to the financial health of the enterprise'. Based on the recommendation of the COPU, Department of Public Enterprises (DPE) issued general guidelines in November 1994. These guidelines basically left it to the Board of Directors of the PSEs to devise socially responsible business practices in accordance with their Articles of Association, under the general guidance of their respective Administrative Ministry/Department.

Years after, The Ministry of Corporate Affairs had released a Voluntary Guidelines of CSR in 21 December 2009 as the first step towards mainstreaming the concept of Business Responsibilities among Indian companies. Keeping in view of the feedback from stakeholders, they had decided to revise the same with a more comprehensive set of guidelines that encompasses social, environmental and economic responsibilities of business. The *National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business* released on July 2011 emphasize that businesses have to take effort to become responsible towards the society, so that their every action leads to sustainable growth and economic development. Accordingly, the Guidelines use the terms 'Responsible Business' instead of Corporate Social Responsibility (CSR) as the term 'Responsible Business' encompasses the limited scope and understanding of the term CSR.

The Guidelines have been articulated in the form of nine (9) Principles with the Core Elements to actualize each of the principles. A reading of each principle, with its attendant Core Elements, should provide a very clear basis for putting that principle into practice. Since these guidelines are applicable to large and small businesses alike, a special section has also been included on how micro, small and

medium enterprises (MSMEs) can be encouraged to adopt the guidelines. For the first time in India, 2013 Indian Companies Act section 135 explicitly mentioned provisions to remove all sorts of ambiguities in this respect.

The Attitude of Various Regulating Authorities Towards Corporate Social Responsibilities

Ministry of Finance, Government of India controls the financial sector in India. The Reserve Bank of India is an apex institution in controlling banking system in the country. Its monetary policy acts as a major weapon in India's financial market. Securities and Exchange Board of India (SEBI) is the regulatory authorities for India's capital market.

In 20 December 2007, the Reserve Bank of India (RBI) has asked the banks to pay special attention towards integration of social and environmental concerns in their business operations. Stressing the need for Corporate Social Responsibility (CSR), RBI pointed out that these initiatives by the banks are vital for sustainable development.

RBI has issued guidelines to start non-financial reporting, which will be used to audit their initiatives towards the Corporate Social Responsibility (CSR). Such a reporting will cover the work done by the banks towards the social, economic and environmental betterment of the society.

RBI has also stepped into spread awareness about banking and other monetary practices to the common man. Recognising its role as the Central Bank of the country, RBI is working towards empowering every individual, especially kids with information about mainstream banking activities and how they can preserve their wealth.

RBI has launched two comics viz. Raju and the Money Tree and Money Kumar and the Monetary Policy towards spreading financial awareness among the kids in an interactive, fun and easy to digest way. RBI has also made few films depicting the security features of various currency notes so that people can identify fake notes. These films are available on the RBI's website. Interactive games, which help kids, learn about currency notes and money are also available on RBI's website.

The Securities and Exchange Board of India (SEBI) by its Circular dated 21 February 2000 directed Stock Exchanges to amend the Listing Agreement between them (i.e., stock exchange) and entities whose securities were listed and to include a new clause 49 in such Listing Agreement. This clause was amended in October 2004 and the revised clause has been made effective from 1 January 2006. Clause 49 of the Listing Agreement among other things specifies that a qualified and independent Audit Committee shall be set up, giving the terms of reference.

According to the Clause 49II (D) (4) of Listing Agreement, the Audit Committee was mandated to review the annual financial statements before submission to the Board for approval, with particular reference to matters required to be included in the Director's Responsibility Statement to be included in the Board's report in terms of clause (2AA) of section 217 of the Companies Act, 1956. Thus, the Audit Committee has to oversee Company's financial process and disclosures of its financial information, etc.

The institute of company secretaries of India (ICSI) the apex body in India which regulates the Company Secretary profession has suggested deduction of expenditure incurred for CSR in its corporate taxation pre budget memorandum for union budget 2012–13.

The Attitude Civil Society Towards Corporate Social Responsibilities

Civil society engagement with CSR issues has expanded considerably since the 2000s, with numerous NGOs and NGO networks, as well as consumer groups and trade unions, raising issues such as child labour, sweatshops, fair trade, the rights of indigenous peoples, toxic chemicals, oil pollution, tropical deforestation,

and other forms of environmental degradation. Various factors account for the upsurge in CSR activism and the involvement of NGOs in advocacy, economic and regulatory activities.

First, the NGO sector was expanding rapidly, gaining legitimacy as a development actor and seeking new areas of engagement. For example, SAP India in partnership with Hope Foundation, an NGO that works for the betterment of the poor and the needy throughout India, has been working on short and long-term rebuilding initiatives for the tsunami victims. They also started the SAP Labs Center of HOPE in Bangalore, a home for street children, where they provide food, clothing, shelter, medical care and education.

Second, not only 'neo-liberals' but also some activists and NGOs were critical of what in reality or perception were the failed attempts by government and international organisations to regulate TNCs. They sought a 'third way' centred on voluntary approaches, collaboration, and partnerships. Changes in tactics and strategies, involving both service delivery and advocacy, also supported this approach. As NGOs were drawn increasingly into service-delivery functions and market relations, an increasing number became part of a growing CSR industry of service providers.

Third, to traditional concerns about the negative developmental impacts of TNCs were added another set of issues. There was growing recognition that globalisation and economic liberalization were altering the balance of rights and obligations that structure the behaviour of corporations. TNCs were enjoying new rights and freedoms as a result of economic liberalisation and globalisation without commensurate obligations and responsibilities.

Fourth, several environmental and social disasters and injustices, linked to large corporations or specific industries, became high-profile international issues around which activists mobilized. For example, the Union Carbide gas leak in Bhopal.

The Attitude of Management Towards Corporate Social Responsibilities

A Mumbai based NGO Karmayog has studied the commitment of management towards the CSR activities in India. Their study depicts the performance of 500 largest Indian companies as follows:

Results of the Karmayog CSR Ratings of the 500 Largest Indian companies – 2010

Karmayog CSR rating 2010	*No. of cos.*	*Percentage*
Level 5 (highest)	0	0%
Level 4	12*	2%
Level 3	66	13%
Level 2	161	32%
Level 1	148	30%
Level 0 (lowest)	113	23%
Total	500	100%

* Companies with a Level 4 rating are: Ballarpur Industries, HDFC, Infosys Technologies, Jubilant Organosys, Kansai Nerolac, Larsen and Toubro, Mahindra and Mahindra, Moser Beer, Tata Consultancy, Tata Steel, Titan Industries and Wipro.

Karmayog recommends that a company must spend a minimum of 0.2% of its sales on CSR activities. In 2010, the largest 500 companies had estimated a total sale of ₹37,00,000 crores and 0.2% of this constitute ₹7400 crores. Companies must spend at least this amount on CSR activities. However, the performance of Indian companies in this aspect is far from satisfactory. From the table it can be

understood that majority of the Indian companies come under the level 2 rating which means they are merely satisfying the recommendations of the government.

CSR Provisions of Indian Companies Act 2013

Indian Company's Act 2013 has introduced several new provisions which change the face of Indian corporate business. One of such new provisions is Corporate Social Responsibility (CSR). The concept of CSR rests on the ideology of give and take. It is a fact that industrial enterprises all over the world exploit natural resources of the community directly or indirectly for the creation of wealth to its owners. Sometimes they are harming the society through industrial pollution, global warming, displacement of local people, bad labour practices, promoting consumerism, social exclusion, human right violation, etc. Some people argue that business is creating utility that the society demands and hence it is their right to use the natural resources. In that way business entity generates wealth to its owners and welfare to the society in different ways.

Public awareness of this type of exploitation by business entities is catching attention and people's movements against them are emerging all over the world. Problems faced by global companies like Walmart; Coca-Cola in recent years is the best example to this. Walmart, the biggest retail chain in the world was once called 'Corporate Criminal' by US social activists because of the socially unacceptable practices followed by the company like discrimination against women, blocking of unionization, discrimination in favour of Latino immigrants, etc. In the words of a Californian legislator Loin Hancock, "Wall-mart's fortune has been built on human misery". Hence, now the corporate organizations have started to redefine their role to contribute to the overall development of the people by managing their operations in such a way to enhance the economic growth and increased competitiveness at the same time promoting socially responsible actions. They have now slowly started in adopting a broad view of its existence that includes not only to direct stakeholders benefits but also to many other constituents like employees, suppliers, local community, government, non-governmental organizations and other special interest groups.

Ministry of Corporate Affairs has recently notified Section 135 and Schedule VII of the Companies Act as well as the provisions of the Companies (Corporate Social Responsibility Policy) Rules, 2014 (CRS Rules) which has come into effect from 1 April 2014.

For the first time Indian companies Act 2013 introduced several provisions in the act which makes it compulsory for companies to undertake CSR activities. Every company whose net worth is ₹500 Crore or more or turnover of ₹1000 Crore of more and a net profit of ₹5 Crore ore more has to spend 2% of the average annual profit of the last three years for CSR activities. Further, the act tries to define CSR activities and recommended for the constitution of a CSR committee of directors in each company for monitoring the CSR activities.

Applicability

Section 135 of the Companies Act provides the threshold limit for applicability of the CSR to a Company, i.e., (a) net worth of the company to be ₹500 crore or more; (b) turnover of the company to be ₹1000 crore or more; (c) net profit of the company to be ₹5 crore or more has to set apart two per cent of the average annual net profit for CSR activities. Further as per the CSR Rules, the provisions of CSR are not only applicable to Indian companies, but also applicable to branch and project offices of a foreign company in India.

CSR Committee and Policy

Every qualifying company requires spending of at least 2 per cent of its average net profit for the immediately preceding 3 financial years on CSR activities. Further, the qualifying company will be required to constitute a committee (CSR Committee) of the Board of Directors (Board) consisting of 3 or more directors. The CSR Committee shall formulate and recommend to the Board, a policy which shall indicate the activities to be undertaken (CSR Policy); recommend the amount of expenditure to be incurred on the activities referred and monitor the CSR Policy

of the company. The Board shall take into account the recommendations made by the CSR Committee and approve the CSR Policy of the company. However, CSR Rules exempts unlisted public companies and private companies that are not required to appoint an independent director from having an independent director as part of their CSR Committee and stipulates that the committee for a private company and a foreign company need to have a minimum of only 2 members.

Definition of the term CSR under Indian Companies Act 2013

One of the major problems in CSR has been the definition of CSR, because people prefer to define it according to their convenience as to what they do. This has created a lot of confusions in its implementation. The present Act has tried to define the term in order to eliminate the ambiguity.

The term CSR has been defined under the CSR Rules which includes but is not limited to:

- Projects or programs relating to activities specified in the Schedule; or
- Projects or programs relating to activities undertaken by the Board in pursuance of the recommendations of the CSR Committee as per the declared CSR policy subject to the condition that such policy covers subjects enumerated in the Schedule.

This definition of CSR assumes significance as it allows companies to engage in projects or programs relating to activities enlisted under the Schedule. Flexibility is also permitted to the companies by allowing them to choose their preferred CSR engagements that are in conformity with the CSR policy.

Activities under CSR

The activities that can be done by the company to achieve its CSR obligations include eradicating extreme hunger and poverty, promotion of education, promoting gender equality and empowering women, reducing child mortality and improving maternal health, combating human immunodeficiency virus, acquired immune deficiency syndrome, malaria and other diseases, ensuring environmental sustainability, employment enhancing vocational skills, social business projects, contribution to the Prime Minister's National Relief Fund or any other fund set up by the Central Government or the State Governments for socio-economic development and relief and funds for the welfare of the Scheduled Castes, the Scheduled Tribes, other Backward Classes, minorities and women, protection of national heritage and art and culture, measures for the benefit of armed forces veterans, war widows and their dependents, training to promote rural, nationally recognised, Olympic sports, relief and welfare of SC, ST, OBCs, minorities and women, contributions or funds provided to technology incubators located within academic institutions approved by the Central government and rural development projects and such other matters as may be prescribed.

Local Area

Under the Indian Companies Act, preference should be given to local areas and the areas where the company operates. Company may also choose to associate with two or more companies for fulfilling the CSR activities provided that they are able to report individually. The CSR Committee shall also prepare the CSR Policy in which it includes the projects and programmes which is to be undertaken, prepare a list of projects and programmes which a company plans to undertake during the implementation year and also focus on integrating business models with social and environmental priorities and process in order to create share value.

The company can also make the annual report of CSR activities in which they mention the average net profit for the 3 financial years and also prescribed the CSR expenditure but if the company is unable to spend the minimum required expenditure, the company has to give the reasons in the Board Report for non-compliance so that there are no penal provisions attracted by it.

Further the CSR Rules says that the net worth, turnover and net profits are to be computed in terms of Section 198 of the 2013 Act as per the profit and loss statement prepared by the Company in terms of Section 381 (1) (a) and Section 198 of the 2013 Act. While these provisions have not yet been notified, it has been clarified that if net profits are computed under the Companies Act, 1956 they needn't be recomputed under the 2013 Act. Profits from any overseas branch of the company, including those branches that are operated as a separate company would not be included in the computation of net profits of a company. Besides, dividends received from other companies in India which need to comply with the CSR obligations would not be included in the computation of net profits of a company.

A company can also undertake its CSR activities through a registered trust or society, a company established by its holding, subsidiary or associate company or otherwise, provided that the company has specified the activities to be undertaken, the modalities for utilization of funds as well as the reporting and monitoring mechanism. If the entity through which the CSR activities are being undertaken is not established by the company or its holding, subsidiary or associate company, such entity would need to have an established track record of three years undertaking similar activities. Companies can also collaborate with each other for jointly undertaking CSR activities; provided that each of the companies is able individually to report on such projects.

Further the report of the Board of Directors attached to the financial statements of the company would also need to include in annual report on the CSR activities of the company in the format prescribed in the CSR rules setting out inter alia a brief outline of the CSR policy, the composition of the CSR Committee, the average net profit for the last three financial years and the prescribed CSR expenditure. If the company has been unable to spend the minimum required amount on its CSR initiatives, the reasons for not doing so are to be specified in the Board Report. Where a company has a website, the CSR policy of the company need to be disclosed on such website.[9]

Social Responsibility and Indian Corporations

Philanthropy is no longer limited to signing cheques for social causes and welfare programmes. The corporate world is now reaching out to the community. The commitment is getting much deeper as a large section of employees, including members of the top management, are now doing their bit for the causes close to their heart.[10]

According to Sunil Rajshekhar of Times Foundation, "Corporate contribution earlier was limited to financial donations. This is giving way to more holistic approach as employees are now getting involved and companies like GE, Tatas, Infosys, Hughes Software and Agilent encourage their employees to give back to communities who sustain their business".

And the initiative does not end with an odd blood donation. More companies are joining hands with NGOs to set up labs, adopt schools and even villages, educate kids and women in slums, and start welfare programmes for cancer and AIDS patients.

At GE, for instance, the initiative runs right from the top as Scott Bayman, president and CEO, GE (India) finds satisfaction in his endeavour to develop

confidence among young school drop-outs and help restart their education and help them gain skills for employment. "About 60 of our employees are involved in voluntary programmes and at least 30 of these are very very active", says Bayman and added, "GE has implemented many such initiatives globally but I had some apprehension about how popular it would be in India. Thankfully, our people embraced it very fast".

Indian industry is also equally aggressive in its drive to being socially responsible. North Delhi Power Ltd. (NDPL), a joint-venture of Tata Group and the Delhi government, has joined hands to help out AIDS patients and improve awareness in industrial areas of Naraina. Badri Naryan, NDPL says, "The migrant population in the 1,500 industries is here, living away from their families for over eight months every year and hence AIDS awareness is very important".

The attempt to pay back the communities who sustain one's businesses are proving to be an effective HR measure too. Hewlett Packard's subsidiary, Agilent, boasts of an attrition level of about 8 compared to over 30 seen by competitors and attributes it to their employees' satisfaction level achieved from social causes. Venkatesh Valluri, Managing Director, Agilent India asserts: "People really feel good about it. It's easy for people to donate money and clothes, but actually working for society shows how we can make a difference. It might sound tough initially but soon becomes more like a habit and slowly takes the shape of a movement."

For others like HSS, adopting villages, helping physically and mentally challenged kids comes as naturally as forming a cricket club. The company has created an NGO called Jagriti within the company. Social responsibility is among corporates' top priorities today. "Being socially responsible is a part of being successful, being a great company and being a respected company", sums up Scot Bayman.

A large number of Indian companies discharge their social responsibilities quite satisfactorily. There are many companies which have excelled in such activities but when seen in the light of the country's vast needs, the achievements fall short of requirements. The money spent for social causes by companies is generally an insignificant proportion of their turnover.

Here are a few illustrations of the different social responsibility functions that Indian companies typically perform:

- **Asian Paints** funded a large-scale community development project to enable farmers to use local resources effectively.
- **BHEL** has contributed to the development of the quality of life in rural areas, health care and family welfare, adult education, etc.
- **Brooke Bond** has been interested in animal welfare, providing veterinary services, and improvements in animal breeding.
- **Colgate Palmolive** did pioneering work in the promotion of sports, dental health, and small industry development.
- **Escorts Ltd.** has worked for farm mechanisation, agricultural development, health care, etc.
- **Infosys Technologies** has helped through its Infosys Foundation schools in rural areas acquire classrooms, libraries and buildings. It has also helped higher education and research. It has promoted several public health programmes too.
- **ITC Ltd.** is socially active in the areas of agriculture, culture, sports and pollution control.
- **SAIL** contributes to the sectors of agriculture, industry, education, health care, dairy, poultry, fisheries, and drinking water supply.
- **Tata Steel** has been a pioneer in discharging social responsibility and has made several contributions in areas such as community development, social welfare, tribal area development, agriculture and related activities, rural industrialisation, etc.[11]

Indian Companies Performance of CSR Activities

Since it has been compulsory for every company to spend 2 per cent of its profit for CSR activities as per the Indian Companies Act 2013 most of the companies are adhering to these provisions in a good manner. KPMG has conducted a study among 100 top companies in India in 2016 about the performance in this respect and the main findings of the survey are given below.

Particulars	***Percentage compliance***
Availability of CSR policy and web link policy	98
Availability of Vision/ Mission/ Philosophy in CSR policy	97
Disclosure of area of intervention in CSR policy	84
Disclosure of mode of implementation of CSR policy	88
CSR governance structure in CSR policy	88
Disclosure of treatment of surplus program	96
Details of CSR committee in CSR policy	90
Standalone CSR committee	90
Disclosure of composition of CSR committee in directors annual report	96
Members in CSR committee	36% have statutory 3 members, 65% have more than 3 members
Independent directors in CSR committee	53% have one direct, 25% have 2 directors, and 21% have 3 directors.
CSR committee meetings	46% have less than 3 meeting, 17% have 3 meetings, and 26% have more than 3 meetings.
Disclosure on CSR in directors report	98
Disclosure of details of outreach programs in directors report	25
Companies which have CSR vision/mission /philosophy	50
Disclosure of details of amount spend in directors report	49
Disclosure of details of unspent balance	100
Total amount actually spent and amount to be spend as per low	Amount as per low Rs. 7233 crore Amount actually spent Rs. 6518 crore
Number of companies actual spending against the spendable amount	14% companies spent less than 1 %, 30% companies spent 1 to 2 %, 17% companies spent 2% and 33 % companies spent more than 2%.
Purpose wise spending	Education 30%, Health 27%, Environment 23%, Rural development 10%, Reducing inequality 3% and art and culture 1%.

Source: KPMG in India Analysis based on India's CSR reporting survey 2016.

CONCLUSION

Corporate social responsibility has become the byword of the socially conscious corporate world. Only an infinitesimally small number of companies remain untouched by the ever-increasing importance of CSR. Even those corporations that are overwhelmingly guided by the profit motive have now realised that if they do not appear to give back to society what they have received from it in terms of trained manpower and material and physical resources, they cannot justify their existence and future growth. This is a strong enough reason and justification as to why an ever-increasing number of corporations are investing both its human and material resources in various CSR activities. Moreover, this appreciation has also prompted many of them to integrate their CSR activities into their business practices. CSR is no more a stand-alone philanthropy, but a part and parcel of business strategy.

KEYWORDS

- Act of philanthropy
- Charitable causes
- Common welfare programmes
- Conflicting perspectives
- CSR, Global role
- Goodwill
- Justification
- Pluralistic model
- Private sector
- Social concern
- Social Entity Theory
- Stakeholders' interests
- Supplementing state efforts
- Systematic implementation
- The stakeholder
- Trusteeship model
- Vanguard of rendering social service

DISCUSSION QUESTIONS

1. What is corporate social responsibility? Explain why there are conflicting perspectives on the subject.
2. If CSR is an essential feature of modern businesses, why do economists like Milton Friedman think otherwise?
3. Explain the Trusteeship Model of CSR. What was Gandhiji's contribution to this line of thinking on CSR?
4. For long, CSR was equated with the concept of corporate philanthropy. How and why do modern thinkers differ from this view?
5. Discuss the scope of CSR with suitable illustrations.
6. To what extent is CSR being practised in India? Give examples. Do you think Indian corporates adequately give back to society compared to what they have received from it.
7. Explain the ethical framework of a corporation.
8. What constitute deception? Explain the concept with suitable examples.
9. What is CSR?. Explain the components of CSR.
10. What is GST? Explain its various implications on various sectors of economy.
11. Critically examine the arguments in favour and against CSR.
12. Explain the conflict of interest among stakeholders in the case of CSR
13. Explain the attitude of stakeholders towards CSR.

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16



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Corporate Governance and Public Policy

CHAPTER OUTLINE

- Introduction
- Framing of Public Policy
- Involvement of Business in Public Policy Decision Making
- Public Policy and Business
- Economic Policy
- Monetary Policy
- Fiscal Policy
- Physical Controls
- Government Regulations in Business
- Public Policies and Government Regulations in India
- Workplace Safety and Health
- Functional Regulations
- Goods and Service Tax (GST)
- Consumer Protection Act
- The Insolvency and Bankruptcy Code, 2016
- The Competition Act 2002
- Public Policies for the Global Village

Introduction

Public policy may be explained as a definite course or method of action selected from among alternatives and in the light of given conditions to guide and determine present and future decisions of governments or public authorities. It is thus a plan of action undertaken by government to achieve some broad public purpose. In the words of Senator Patrick Moynihan: 'Public policy is what government chooses to do or not to do.' Public policy, while being different from nation to nation, is the basic set of goals, plans, and actions that each nation and government will follow in achieving its objectives. For instance, economic policy of a government is the statement of its objectives and how these are realised through the subset of policies such as monetary policy, fiscal policy and commercial policy. Likewise, a budget is an instrument of economic policy.

Definition of Public Policy

According to writers on the subject public policy is whatever a government chooses to do or not to do. A government performs a variety of functions from resolving conflicts within the society to distributing a great variety of symbolic rewards and material services to members of the society. To perform these functions, it needs money, which it collects from its citizens in the form of taxes, levies, cesses and administrative charges. Therefore, public policies may be regulative, distributive, organisational or extractive and a government may engage all of these to achieve its objectives either singly or collectively at the same time.

Public policy may deal with a wide variety of issues, both vital and trivial. It may deal with such important areas as defence, education, public health, taxation, welfare, housing, employment, relief for calamities such as floods, earthquakes and Tsunami, equitable distribution of income and wealth, labour laws, rural development, inflation and recession, while it cannot ignore trivial issues such as changing the colour of the currency notes.

Prof. V. Subramaniam in his book 'Problem and Recognition in Public Policy and Business Management' says: 'Public policy is governed by inertia and incrementalism: Often the best predictors of budgetary allocations for this year.... It can emanate from a variety of sources within the government and can be intended to fulfill a number of often incompatible objectives. Similarly, policy is devised to serve a number of purposes, some of which co-exist simultaneously at different levels. For example, a policy may be distributive, regulatory and symbolic at once. A wide range of forces and interests bear on the process of policy formulation. These forces exist in the 'environment' of the political system and increasingly within the political institutions themselves. They are often in conflict with one another, but affect policy outcome nonetheless. Public policy needs to be justified, explained or rationalised to various 'publics'. Such rationalisations frequently ignore or contradict the 'true' purposes and objectives of policy and often disguise or deliberately misrepresent the pressures and interests that helped generate the policy.'

Government and Public Policy

There is a close relationship between public policy and governments or public authorities. No policy becomes public policy unless it is adopted, implemented and enforced by some governmental institution. Government gives public policy three distinctive characteristics: (i) It lends legitimacy to policies. Government policies are generally regarded as legal obligations which are easily observed by citizens.

While people may regard policies of society's other groups and associations as important and even binding, they give policies emanating from government greater respect and comply with them easily because of the legal obligations it imposes. (ii) Government policies involve universality as these extend to all sections in society unlike the policies of other groups such as corporations, churches, civic associations etc. that reach only a part of the society and (iii) Government alone can exercise coercion in society-only government can legitimately imprison violators of its policies.

Classification of Public Policy

Public policy can be organised along the following five lines—regulatory, distributive, redistributive, capitalisation, and ethical. Regulation is one of the more visible types of public policy generally enforced through criminal law statutes which generally stipulate how people should act toward one another.

Public policy can be organised along the following five lines: (a) regulatory (b) distributive, (c) redistributive, (d) capitalisation and (e) ethical. Regulation is one of the more visible types of public policy generally enforced through criminal law statues which generally stipulate how people should act toward one another. Distributive policies provide for goods and services such as welfare and health to specific segments of the population. All public assistance welfare programmes are distributive in character. Redistributive policies, on the other hand, aim at rearranging one or more of the basic schedules of social and economic reward as in the case of progressive tax policies which tax away proportionately more money from the rich than from the poor. Incomes thus obtained may be spent on the welfare of the poor. Basic alterations in productive arrangements as in government nationalising industry, or changes in comprehensive services as in socialised medicine, or provision of scholarships to poor students, old age pensions and unemployment insurance are also redistributive in their rearrangement of wealth.

Business and local governments also receive distributive largesse from the central government which aim at increasing the productive capacity of society's institutions. Although normally included in sample distributive policies, capitalisation policies are not like the primary consumptive distribution of welfare programmes. They include: (i) cash payments to farmers to improve agriculture, and (ii) tax subsidies to encourage exploration and production in selected industries and audit subsidies. In recent times, several moral and ethical issues such as death sentences, cloning of humans, euthanasia, the practice of killing hopelessly sick persons have come to the fore and created heated public debates for and against these issues. The courts do not settle such moral issues. Public policies, on the other hand, follow the court's directives and set out what ought and ought not to be done in an area marked off by deep moral convictions. On such moral or ethical issues, the executive wing of the government may enact legislations or evolve policies on what the courts dictate them to do.

Areas of Public Policy

The area, extent and the reach of public policies have been increasing since the days of the Great Depression. While justifying the legitimacy of government intervention in economic matters, took some time, as Adam Smith and economists of his ilk considered capitalism as a self-evolving and self-correcting system in which government intervention was unwarranted and unnecessary and even lead to the failure of the system. But once it was proved that their assumption was wrong and that government has a role to play to maintain effective demand, competition, freedom of enterprise, and the very market economy itself, the role of government began to expand

Buchhoz in his book *Business Environment and Public Policy* says that the major public policy areas that stemmed from the Great Depression were economic

management, where government assumed responsibility for correcting such economic down-turns, labour management relations with government support for the right of labour to bargain collectively, and the beginning of a welfare system, originally designed to relieve the distresses of the Depression. This line of argument justifies the following areas of public policies:

1. **Economic management:** Economic problems are one of the important areas of public policy. Prior to the onset of the Great Depression, it was assumed, as explained earlier, that each economy is self-correcting and moves toward the right direction and restore the nation's economic health. But the Great Depression has changed this view. The so-presumed self-correcting economy has been found to be totally inefficient to deal with the problems of Depression. Now with the emergence of stabilisation measures adopted by governments to combat recession and depression and the concept of welfare state, it is assumed that state interevention is essential and even inevitable in economic activities. Whatever the social welfare works the state does, they constitute the major part of public policy.
2. **Labour management relations:** Another area of public policy that came out of the Depression days is the area of labour-management relations. Industrial revolution has effectively challenged the outdated thinking of the management that labour is like a vendible commodity that can be bought or sold at any time. The concept of industrial democracy is popular in all countries, which has made it imperative that a national labour policy should be adopted by the state to protect the rights of workers of unions. In fact, in several countries such as Germany, labour is given a vital role in corporate managements.
3. **The welfare state:** The Depression also has brought about a metamorphosis in the thinking of people and has led to the emergence of another set of public policy measures that can be grouped loosely under the title of 'welfare'. Previously, it was designed to alleviate distress. Society has now conceded that the unemployed were not necessarily to be blamed for their plight and is willing to accept a government's responsibility to help victims of unemployment and old age. People were not allowed to stirve while waiting for the market to correct itself and make jobs available again. Now, it is believed that every man has the right to a good job, decent food, clothing and shelter. It is the responsibility of the government to guarantee these rights. In fact, this philosophy has led to a whole series of measures, such as social security, aid to families with dependent children, education, medicare—all designed to help people whose basic needs have not been met for one reason or the other by the market system.
4. **Shaping of Public Policies affecting Corporate Sector:** Stakeholder expectations, if unmet, trigger action to transform social concern into pressure on business and government. A gap between the expected and actual performance stimulates public issue. We need to understand the reason for public issues and how they get transformed into public policy in the macro environment view.

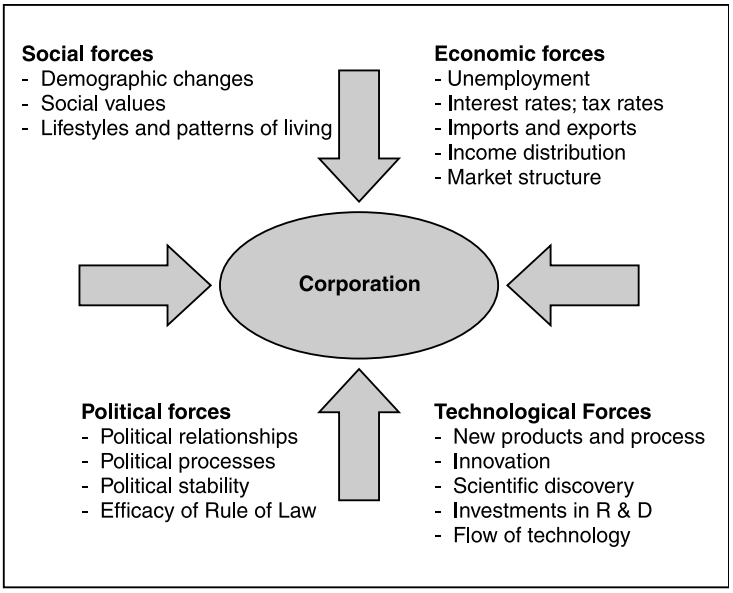
Need for Public Policy in Business

As shown in Figure 16.1, public policies that affect corporations are shaped by (i) social forces (ii) economic forces (iii) political forces and (iv) technological forces. Social forces include the size and composition of population which have a definite effect on both the demand and supply of goods and services that corporates deal in; social forces that include lifestyles and patterns of living dictate corporate strategies to cater to the whims and fancies of consumers. Economic forces are those that shape corporate behaviour as well as the reaction of government to solve the problems arising therefrom. Political forces have an impact on government

making and how governments are prompted to shape their policies affecting corporate. Technological forces are very important as far as shaping of corporate policies are concerned since these allow corporations to update their products, processes and help them meet competition.

Figure 16.1

Shaping of public policies



1. **To create a competitive environment:** Public policies help the market to have perfect competition by way of controlling monopolies through license or by creating a competitive market mechanism. It helps in providing a level playing field for enterprises to operate and to encourage companies to effectively and efficiently utilise available resources.
2. **To have control on foreign investment:** Government interferes in regulating foreign investments in certain industries which is very critical for the country, as for example, oil industry, financial institutions. So the government tries to set some cap on these investments. Sometimes the objective is to encourage local investment when the domestic economy is doing well. To stem the flow of too much of foreign investment, government may adopt protectionist policies for the following reasons:
   - To protect the growing local industries (in the nascent stage), government may enact policies by way of preventing free flow of goods from other countries, and offering tax holidays and other benefits
   - To regulate demand and supply, where the resources are scarce
   - To regulate the prices in the unhealthy competitive environment through administrative pricing mechanism and to promote consumer product safety
   - To protect the environment (through effluent treatment and other anti-pollution measures

Different Levels of Public Policy

There are different levels/layers of public policy depending on the intended geographic reach and the degree of sovereignty the authority concerned enjoys: national level, state level, regional level, international level.

There are different levels/layers of public policy depending on the intended geographic reach and the degree of sovereignty the authority concerned enjoys.

1. **National level:** At the national level, public policy is applicable across the country. For instance, the Industrial Development and Regulation Act (IDRA) and the Monopolies and Restrictive Trade Practices (MRTP) Act had an all India reach.
2. **State level:** Policies adopted by a state government is applicable only to the particular state as in the case of policies to protect ground water from contamination, policies to take over the wine shops in states like Tamil Nadu.
3. **Regional level:** There may be certain policy perspectives that apply to certain regions such as the Common Agricultural Policy (CAP); sharing of river water among riparian states.
4. **International level:** Global level policies are the ones that are adopted by international organisations with worldwide ramifications such as Intellectual Property Rights, (IPRs), Trade Related Investment Measures (TRIMs) and so on.

Elements of Public Policy

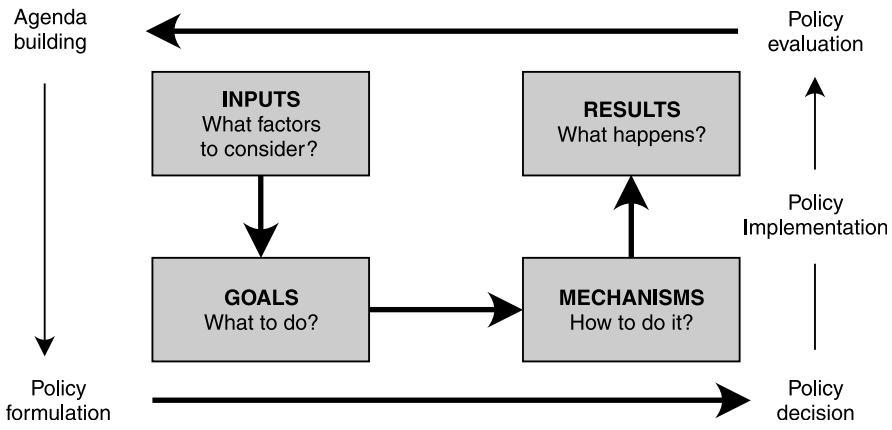
A government action that goes into its making in terms of public policy and execution can be understood in terms of several basic elements. Many factors or *inputs*, influence the development of public policy. Government may determine its course of action on the basis of several factors such as economic or foreign policy concerns, domestic political pressure from constituents and interest groups, technical information, concensus that has emerged in national politics, tax imperatives and sometimes as reaction to natural or national calamities. All of these inputs can help shape what the government chooses to do and how it chooses to do it.

Public policy *goals* can be ideal oriented or narrow and self-serving. National values, such as freedom, democracy, and equitable distribution of income and wealth to share in economic prosperity have led to the adoption of civil rights laws and assistance programmes for the weaker sections of society. Narrow, self-serving goals are more evident when nations decide how tax legislation will allocate the burden of taxes among various interest and income groups. Public policy goals may vary widely, but it is always important to inquire whether it served the citizens of the country whose welfare it intends to serve, as for instance, a policy with regard to public expenditure is expected to ensure what is dictated by the Principle of Maximum Social Advantage, i.e., the greatest good to the largest number of people.

Governments use different tools of public policy for *instruments*, to realise their policy goals. In budget negotiations, for example, much discussion is likely to focus on alternative ways to raise revenue, graduating tax rates for individuals and businesses, reduced deductions, excise duties, sales taxes on selected items (e.g., luxury automobiles, cosmetics, cigarettes, petrol, alcohol). In general, the instruments of public policy are those combinations of incentives and disincentives that government uses to prompt citizens, including businesses, to act in ways that achieve policy goals. Governmental regulatory powers are broad and constitute one of the most formidable instruments for accomplishing public purposes.

Figure 16.2

Key element of the public policy process



Public policy actions always have *effects*. Some are intended; others are unintended. Since public policies affect millions of people, corporations and other interests, it is almost inevitable that such actions will please some and displease others. Regulations may cause business to improve the way toxic substances are used in the workplace, thus reducing health risks to employees. Yet it is possible that other goals may be obstructed as an unintended effect of compliance with such regulations. For example, when the government of India provided for pre-natal and post-natal leave with full salary for pregnant women, many companies in India did not employ women employees. This action was seen as a form of discrimination against women that conflicted with the goal of equal employment opportunity. The unintended effect (discrimination) of one policy action (protecting employees) conflicted head-on with the public policy goal of equal opportunity.

Post *et al.* say that in assessing any public policy, it is important for managers to develop answers to the following four questions:

- What inputs will affect public policy?
- What goals are to be achieved?
- What instruments are being used to achieve goals?
- What effects, intended and unintended, are likely to occur?

The answers to these questions provide a foundation for understanding how any nation's public policy actions will affect the economy and business sector.

1. **Agenda building:** The public policy agenda consists of those major issues or problems to which officials give serious attention and upon which they feel compelled to act. Not all public issues or problems get enough attention or support to become agenda items. The actions of an interest group also may put an issue on the public policy agenda, as the group swings into action to protect its members by advocating greater government participation. For instance, in India in recent times representation of women in Parliament and legislatures to the extent of 33% is an issue that has been gathering momentum among various interest and advocacy groups.
2. **Policy formulation:** Policy formulation occurs when interested groups take a position on some public issue and try to persuade others to adopt their viewpoints as public policy. If consensus among the participating groups can be reached, the proposed public policy moves towards the decision stage. In the example quoted above, i.e. women's sizeable representation in India's legislative bodies, various interest and pressure groups are trying to reach a concensus as to how to work out an acceptable formula for all political shades of opinion.
3. **Policy decision:** A policy decision occurs when some arm of the government, either authorises or fails to authorise the course of action. For example, the government may issue an executive order forbidding trade with another country. The courts—another branch of government, may hand down the decision that becomes a precedent for paying claims to victims of train accidents. The policy decision occurs when a law is passed, a regulation is adopted, an executive order is issued or a court opinion is announced. Failing to act can also be a form of a policy decision. For instance, in September 2010, when the High Court of Delhi in response to a Public Interest Litigation on rotting foodgrains directed the government of India to distribute them free to the poor, the Prime Minister did not oblige as a matter of public policy and politely suggested that courts have no say in policy decisions of the executive.
4. **Policy implementation:** Policy implementation occurs when action is taken to enforce a public policy decision. Once a law is accepted or court decision is handed down, business can still wield significant influence in the implementation of the public policy. Business has greatly improved its understanding of, and participation in, the formulation and implementation of public policy. This understanding of how the political process works can be most beneficial to managements.
5. **Policy evaluation:** Policy evaluation occurs when the impact of public policy becomes evident. Groups which initially were opposed to a policy may take an 'I told you so' attitude and try to prove that it has been a bad one from the beginning to end. Basically, the policy evaluators try to find out whether the benefits have been more than the cost incurred, and the same goals could have been achieved in another, more efficient, less expensive way.

The Corporation and Public Policy

1. **Limits to powers of democratic government:** In matters of public policy or its implementation, governments do not have unfettered powers. Their powers are restricted under
   - **Constitutional law:** Defines the limits of government to act, the powers in each level of government, and the rights of citizens.
   - **Common law:** Established, adjudicated precedents giving the government the right to act in the interest of justice and fairness. The common law is regulated by the judiciary.
2. **Limits to powers of non-democratic monarchy, dictatorship, religious rulers, socialist state:** No limits on the power of government except the tolerance of the public. When these governments exceed public tolerance, the usual result is violent actions to change the government, as it happened in several countries where monarchies, dictatorships and theocratic governments were pulled down and dethroned, as under the French and Russian Revolutions, or more recently the Uganda uprising which saw the downfall of the country's dictator Idi Amin.

Framing of Public Policy

Powers of Government

1. **Constitutional governments:** In a constitutionally elected system of governance, the will of the people and their desires get reflected in public policies. *Vox Populi, Vox Dei* (The will of the people is the will of God). Petitions through elected representatives, public debate in election campaigns, promises given in election manifestoes, media promotion and exposure as was amply demonstrated by the check on use of tobacco causing cancer, public demonstration, etc are some of the ways of framing public policy under constitutional method.
2. **Non-democratic governments:** Special interest lobbying of the leadership elite, complete with illegal bribes and payments, international pressure for change, public demonstration and civil disobedience play decisive roles in shaping public policies. Media is controlled very much under these governments. Public is uninformed about the policy and gets frustrated. Demonstration and possible violence force change. As in the case of Serbia and Indonesia, incidents forced for a change through severe violence. Public expect action by government. Elections provide the best data on clear preferences or public ambiguity.

In a constitutionally elected system of governance, the will of the people and their desires get reflected in public policies. In non-democratic governments special interest lobbying of the leadership elite complete with illegal bribes and payments, international pressure for change, public demonstration and civil disobedience play decisive roles in shaping public policies.

Involvement of Business in Public Policy Decision Making

There are two different schools of thought about businesses participating in public policy decision making. These are as follows:

1. **Business should be involved:** According to this school of thought it is imperative that business enterprises should be involved in policy making as they have a high stake in the manner of policy making and the way these are implemented. These stakes are: (i) a pluralistic system invites many participants and, business being an important constituent, should not be left

out; (ii) economic stakes are high for firms and industries and public policy decisions might promote or mar their interests; (iii) business counterbalances other social interests since it has an overriding influence and impact on society through production and distribution of goods and services, income generation and employment; and (iv) business is a vital stakeholder of government, being a provider of revenues and the conduit for executing government policies.

2. **Business should not be involved:** On the other hand, there is another school of thought which stresses the fact that business and politics should be separated as their combination will have several toxic effects. There are other reasons as well, such as (i) executives are not fit to engage in political debates, they are not equipped to do so, by training or by inclination; (ii) business is naïve about politics, as politicians can outsmart them both by rhetoric and tall promises which businessmen trust implicitly, as they do in their lines of business but come to know later after burning their fingers that politicians did not mean what they said and said so due to their own political compulsions; (iii) business is too big and too powerful, while politics is fragmented by its very nature and makes gains by divide-and-rule policy, and (iv) business risks its credibility by engaging in partisan politics, as has been demonstrated time and again by naïve businessmen losing both their wealth and credibility by entering into politics.

Business and Politics—Levels of Involvement

There are three levels of business involvement in political activities and distribution of goods and services, income generation and employment. They are financial involvement, organisational involvement, and strategic public policy involvement.

There are three levels of business involvement in political activities and distribution of goods and services, income generation and employment. They are discussed below:

Level 1: Financial Involvement

1. **Formation of Political Action Committee (PAC):** In some democratic societies, direct contributions by corporations to political candidates running for federal offices are forbidden by law, and some states also place similar restrictions on corporate contributions in state elections. However, in countries such as the US, companies have been permitted to spend company funds to organise and administer a Political Action Committee (PAC). PAC may solicit contributions from stock-holders and employees and then channel the funds to those seeking political office. Even companies that have influence and impact on society through production might promote or mar their interests in organised PACs, though, are not permitted to donate corporate money to the PAC. Donations must come from individuals. Similarly, unions and other organisations may solicit contributions from members. Thus in countries where such political contributions and formation of PACs are permitted, such a course of action will lead to direct business political involvement.
2. **Trade association support:** The techniques used by business to participate in governmental politics are similar to those of other interest groups. Many large corporations place full-time liaison officers in national capitals to keep abreast of developments in the government that may affect the company, or to influence taking of favourable policy decisions through various public relations activities.

Smaller companies, as well as many large ones who join trade associations such as FICCI, CII, ASSOCHAM and other chambers of commerce which bring diverse business groups together to lobby for or against particular piece of legislation, have proved to be effective.

Level 2: Organisational Involvement

- **Lobbying:** Lobbying involves direct contact with a government official to influence the thinking or actions of that person on an issue or public policy. It is usually done through face-to-face contact, sometimes in lengthy discussions or in meetings that may last only minutes. Several media reports suggest that fast growing companies like Reliance resort to such lobbying.
- **Employee grassroot involvement:** Grassroot programmes are organised efforts to get constituents to influence government officials to vote or act in a favourable way. In the US, many companies are reported to have asked their shareholders to participate in grassroot efforts to persuade their congressional representatives to reduce capital gain taxes and thereby make stock purchases and other investments more lucrative. These programmes send a strong message to elected officials that the desired action is supported by a large number of voters.

Level 3: Strategic Public Policy Involvement

Other kind of public policy involvement is through executive participation where the representatives participate in decision making by acting as the part of the executive. Involvement with industry working groups and task forces, policy position development are the other kinds.

Public Policy and Business

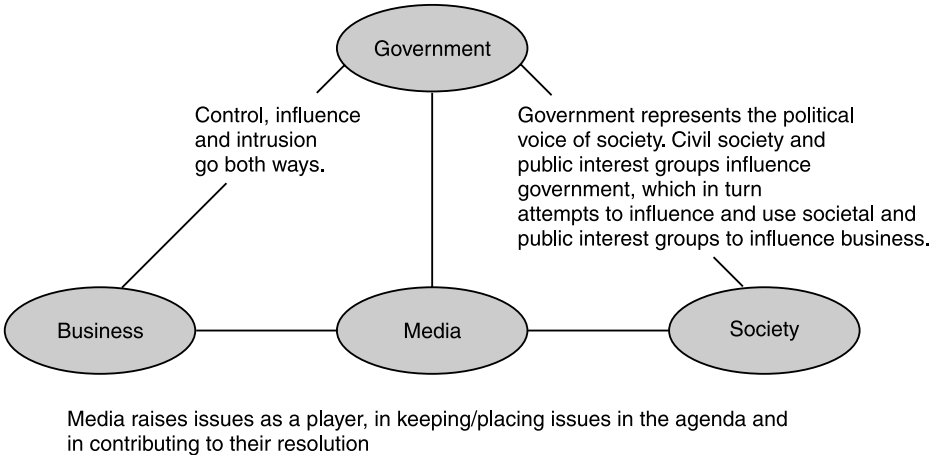
Governments everywhere significantly influence business activities. Federal or central governments try to promote economic development of their countries by using appropriate economic policies whose constituents are monetary, fiscal and commercial policies. State governments shape the business environment through a slew of the state-specific economic policies. Local self governments, on the other hand, impact business through policies that involve permits, licenses, and various clearances. Thus, a nation's prosperity is entwined with its economic and social policies. Public policy of the three layers of government—the executive, judiciary and legislature—has both direct and indirect impacts on business by creating an environment in which companies do business in the nation and across the world.

National Economic Growth

The role of government as an agent representing citizens of a country, and as such has to play its part in managing the modern economy, is widely accepted today. Businessmen understand and accept the fact that governments can create or destroy the basic conditions necessary for business to compete and citizens to prosper.

Figure 16.3

Business-government-society-media relationship



Modern governments, administer their economies through macro-economic policies. Today's social environment is tied to the effectiveness of government in creating conditions for growth of the modern economy.

Governments generally accept the view that their key role is to create appropriate public policy that promotes economic growth. Experience has proved that healthy economic growth is affected by many factors, thereby requiring continuing efforts by government to manage the macro-economy. Economic growth is stimulated by government policies that encourage investment (e.g., providing tax exemptions for domestic investments, inviting foreign investors to locate facilities in the country); foster technology development (e.g., patent protection); provide key services (e.g., infrastructure, public health and police protection); and create a capable workforce through education. Each year, dozens of laws are proposed by legislators to improve the nation's business climate and promote economic growth.

Poor economic development will accelerate a nation's social problems, including high unemployment, pushing people below poverty line and bring in pressures to raise taxes. An expanding economy means job opportunities for trained workers but also higher labour costs for businesses. On balance, political leaders favour economic growth because it creates increased national wealth. Figure 16.4 illustrates the complex nature of how economic policy works through its various constituents.

Economic Policy

Every government pursues an economic policy that reflects the broad objectives it wants to realise for the benefit of its people. The most basic and fundamental of these are economic growth, reduction in inequalities of income and wealth, full employment, price stability and balance of payments equilibrium. The objectives of economic policy can be achieved through monetary policy, fiscal policy and commercial policy.

Every government, irrespective of the economic system it has adopted or its political affliations, pursues an economic policy that reflects the broad objectives it wants to realise for the benefit of its people. Though there are many objectives depending on the stage and degree of development of the economy and special circumstances in which the country has been placed, five are considered, to be the most basic and fundamental. These are: (i) faster economic growth, (ii) reduction in inequalities of income and wealth, (iii) full employment, (iv) price stability and (v) balance of payments equilibrium. The emphasis on any one of these objectives to be the most or least important may change depending on the circumstances in which the country's economy is placed. At the same time, the government has to ensure that the realisation of one objective has not been done at the cost of others.

The objectives of economic policy can be achieved through (i) monetary policy, (ii) fiscal policy and (iii) commercial policy, as illustrated in Figure 16.4.

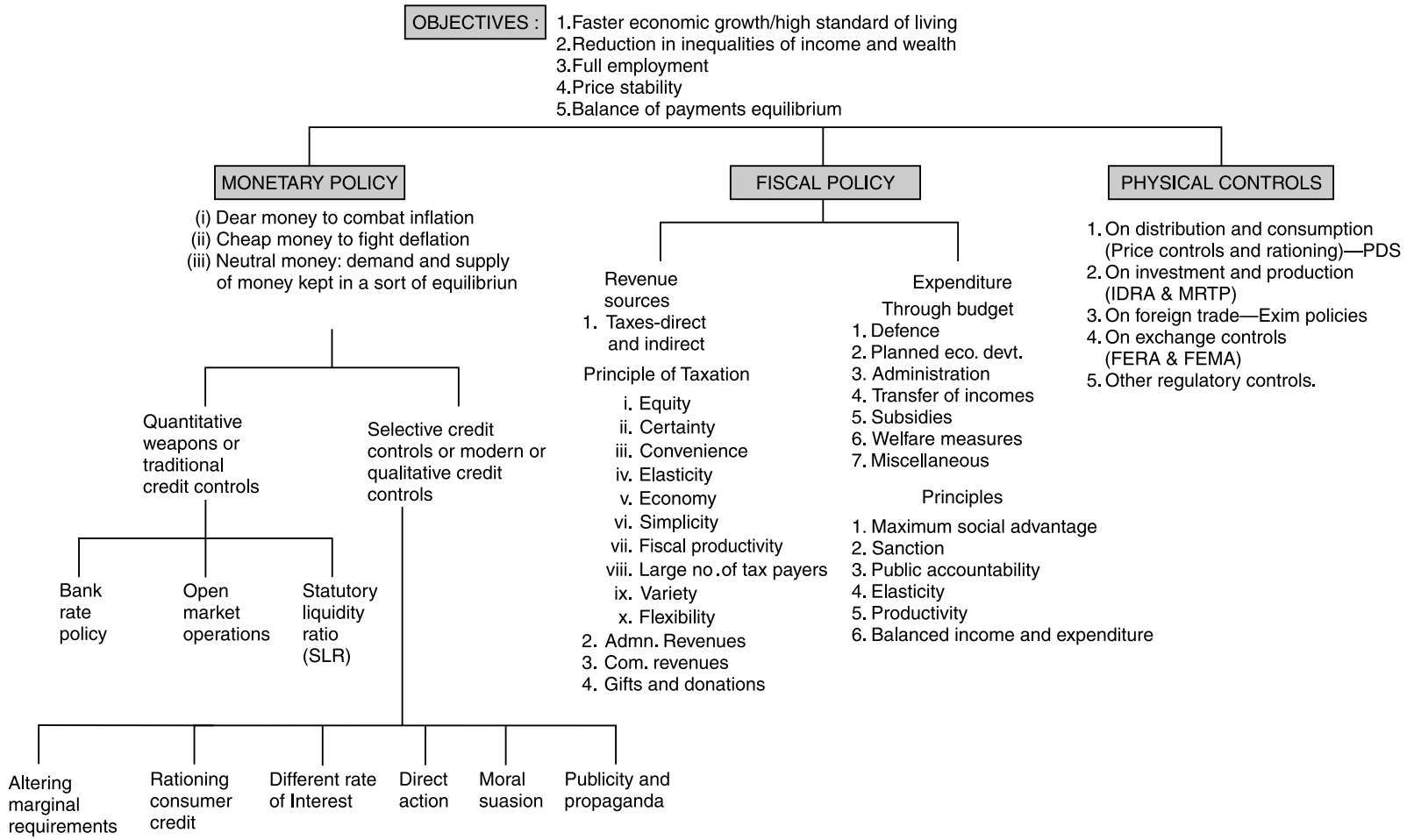
Monetary Policy

Monetary Policy refers to the policy adopted by the monetary authority, with respect to the supply of money. The basic goals of the monetary policy have been identified as maximum feasible output, high rate of growth providing more employment, price stability, greater equity in the distribution of income and wealth and favourable balance of payments. The ideal policy, which the monetary authority should follow, is the policy of long-run neutral money which involves maximum feasible output and price-stability in the long-run. This monetary policy serves all the policy goals in the best possible manner.

The monetary authority uses various instruments to control the supply of money. These instruments are known as instruments of credit control. These instruments can be divided into two categories: quantitative and qualitative credit controls. There are three main methods of quantitative credit control, viz. bank rate policy, open market operations and changes in statutory reserve requirements. These methods are used to control the quantum of credit on the

Figure 16.4

Economic policy



whole. The qualitative methods of credit control are also known as selective credit control methods. These include credit rationing, direct action, changes in margin requirements, moral suasion, etc.

1. **Bank rate policy:** Bank rate policy operates through changes in bank rate by the central bank. Bank rate is defined as the official minimum rate at which the central bank rediscounts bills of exchange. The bank rate is the rate at which the central bank is ready to buy or rediscount eligible bills of exchange and other commercial paper. The RBI gives a large proportion of its advances to the commercial banks against government securities and as refinance. When the central bank raises the bank rate, obtaining funds from the central bank becomes costlier for the commercial banks. It is through dear rediscount policy that the central bank restricts credit creation by the commercial bank and the money supply in the economy. The reverse happens when the bank rate is lowered during the period of depression.
2. **Open market operations:** The open market operations refer to the purchase and sale of government securities and other approved securities by the central bank. An open market sale decreases the money supply and a purchase increases the money supply. The Reserve Bank of India, which is our central bank transacts with public as well as banks. During the boom, the RBI sells the government and other approved securities from its portfolio in the open market in order to reduce the aggregate supply of money in the economy. The reverse happens when there is a slump. However, the open market operations policy has not proved to be a very effective policy of monetary control in India.
3. **Cash reserve requirement:** It refers to that portion of banks' total cash reserves which they are statutorily required to hold with the RBI. The remaining portion of the total cash reserves of the banks refers to excess reserves which banks keep themselves to facilitate their normal functioning. An increase in the legal cash reserves ratio decreases of the banks' and their optimum credit creating capacity. The reverse is true when the RBI increases the statutory cash reserves ratio.
4. **Statutory liquidity ratio:** The commercial banks in India are required to maintain a particular level of liquidity. The main role of the statutory liquidity ratio is to allocate bank credit between government and commercial sectors. This instrument is also used to control the supply of money. The commercial banks are statutorily required to hold a proportion of their total demand and time liabilities in the form of excess reserves, investment in unencumbered government and other approved securities and current account balances with other banks.
5. **Selective credit controls:** The methods of credit control discussed above are the quantitative control methods. The selective credit controls are used to regulate credit for specific purposes. These controls operate on the distribution of total credit by encouraging the flow of credit into certain sectors and discouraging its flow into certain other sectors of economy. The important selective credit controls include credit rationing, direction against the erring banks, changes its margin requirements, differential rate of interest and moral suasion.

The Great Depression of 1930s gave birth to fiscal policy under Keynes' influence. Changes in government expenditure and revenue programmes that aim at the short run goals of full employment and economic stability are called fiscal policy. Usually, the government expenditure programmes are expansionary in effect and revenue or taxation is contractionary in effect.

Fiscal Policy

Objectives of Fiscal Policy

The Great Depression of 1930s gave birth to fiscal policy under Keynes' influence. Changes in government expenditure and revenue programmes that aim at the short run goals of full employment and economic stability are called fiscal policy.

Usually, the government expenditure programmes are expansionary in effect and revenue or taxation is contractionary in effect. The net effect of the combined revenue-expenditure programme is likely to be expansionary because of the operation of the multiplier effect. The government manipulates its expenditure and taxation programmes in such a way that full employment as well as price stability can be attained. The name 'fiscal policy' is given to such deliberate adjustments in revenue and expenditure policies.

The attainment of full employment is regarded as the primary objective of fiscal policy. However, in the true sense of the term, full employment is not attainable. Thus, '..... a situation of full employment may be regarded as one in which there are no significant number of factor units continuously unemployed for any period of time'. It is to be noted that the reduction or elimination of unemployment enables a country to promote the welfare of the largest number of people.

The attainment of full employment is regarded as the primary objective of fiscal policy. Other goals of fiscal policy are the stability of the general price level, resource mobilisation and income redistribution to reduce income inequalities or to ensure social justice. Finally, fiscal policy has the objective of reducing income and wealth inequalities.

Another short run goal of fiscal policy is the stability of the general price level. Fluctuations in the price level may upset all mathematics of economic calculation. For instance, a sharp fall in the general price level dampens the possibility of attaining full employment. Similarly, a high rate of price inflation has also adverse effects on the economy. In view of this, a stable general price level has been accepted as an important objective of fiscal policy.

In this connection, one must take note of the possible conflict of the two aspects of economic stability. According to Keynes, fiscal policy (i.e., decrease in tax rates and increase in government expenditure) boosts aggregate demand until full employment is reached without any danger of inflation. Similarly, by lowering aggregate demand via fiscal policy, a rise in price level can be avoided when demand threatens to exceed the full employment output. Thus, in the Keynesian framework, price stability and full employment can be achieved simultaneously. But, post-Keynesians have shown that there are cases of conflict between price stability and full employment. A. W. Phillips in the late 1950s has shown that these two stability requirements cannot be achieved simultaneously, and the government has to take a policy decision whether to pursue one or the other or a suitable combination of the two.

With the development of the Harrod–Domar growth model, which is a logical extension of the Keynesian economics, fiscal policy has shifted its emphasis more on economic growth, i.e. an annual rate of increase in total output. This objective has assumed an increasing importance in less developed countries than mature economies. Attainment of a higher growth rate requires: (i) improvement in levels of education and technical and organisational skills and (ii) higher rate of capital accumulation. Without government backing and patronage the possibility of rising capital formation is difficult. So government must play an active role in promoting growth.

In the context of growth with equity, the two other important goals of fiscal policy are: (i) resource mobilisation and (ii) income redistribution to reduce income inequalities or to ensure social justice. Economic development requires the transfer of funds from savers to the government for the financing of various government activities. The primary instrument of resource mobilisation for purposes of development is, of course, taxation which involuntarily curtails consumption. Another instrument is public borrowing. Fiscal policy should not only aim at mobilisation of resources but also aim at allocation of resources in the socially desired lines or in accordance with plan priorities. In order to strike a higher growth rate, the fiscal policy should aim at attaining a socially optimum pattern of investment.

Finally, fiscal policy has the objective of reducing income and wealth inequalities. By manipulating various types of taxes and expenditures, the government

may help uplift the poor. This explains why the Taxation Inquiry Commission, appointed by the Government of India, in its report in 1953–54 had made the following comment: 'The demand that the instrument of taxation should be used as a means of bringing about a redistribution of income more in consonance with social justice cannot be kept in abeyance.'

So we can sum up the role of fiscal policy by referring to its main objectives thus: (i) attainment of the rate and pattern of growth of national income and hence economic development in accordance with the country's objectives and priorities, (ii) mobilisation of resources and its efficient and rational allocation for economic development, (iii) reasonable price level stability and, finally, (iv) reduction of inequalities in income and wealth.

The main instruments of tax policy of the government of India through which the objectives of resource mobilisation and income redistribution are sought to be achieved are various types of direct and indirect taxes.

Taxes tend to fall into two categories: direct and indirect. Direct taxes are levied directly on an individual's income or wealth whereas indirect taxes are levied on consumers' expenditure or outlay. Major Indian direct taxes are personal income tax and corporation tax, and major Indian indirect taxes are sales tax, excise duties and customs duties. Payment of direct taxes is compulsory even though there is no quid pro quo, while it is not so with the indirect taxes. In the case of direct tax, the impact and incidence of the tax is on the same person while in indirect tax, the impact may be the on the manufacturer and the incidence is on the ultimate consumer.

1. **Direct taxation:** Examples of direct taxation include income tax, corporation tax (on companies' profits), capital gains tax (a tax on the profits of sales of certain assets), wealth tax (imposed by certain countries, which is a tax on ownership of property or wealth) and a capital transfer tax (a tax on gifts to replace death duties). Direct taxes are mainly collected by the central government.
2. **Indirect taxation:** Examples of indirect taxation include customs duties, motor vehicle tax, excise duty, octroi and sales tax. Indirect taxes are collected both by the central and state governments, but mainly by the central government.

In a good tax system, there should be a proper balance between direct and indirect taxes. The revenue will be optimum and loss of incentives minimum.

Non-tax revenue is derived from the following sources: (i) fiscal and other services, (ii) interest receipt, (iii) profits and dividends of public sector enterprises and (iv) general services.

Physical controls refer to various financial and commercial initiatives of the government to supplement monetary and fiscal policies to achieve certain socio-economic objectives. During period of low economic growth or when the country has launched planned economic development these controls on production, consumption, trade and foreign exchange become necessary to conserve scarce resources in order to direct their uses to the most appropriate sector of economic development.

Physical Controls

Physical controls refer to various financial and commercial initiatives of the government to supplement monetary and fiscal policies to achieve certain socio-economic objectives. During the period of low economic growth or when the country has launched planned economic development these controls on production, consumption, trade and foreign exchange become necessary to conserve scarce resources in order to direct their uses to the most appropriate sector of economic development. But these controls get relaxed when they are not so needed during periods of faster economic growth or when tightening of the economy becomes superfluous. For instance, many of the physical controls that were found necessary during the early stages of India's economic development are seen to be unwanted in the present juncture of a market-driven economic growth.

Government Regulations in Business

What is Government Regulation?

Government regulation of business is a mechanism for implementing social choices and helps in creating the basic conditions that lead to economic prosperity. People rely on government to institute and maintain rules of conduct for citizens as well as organisations. If citizens have to live peacefully, they expect the local government to regulate traffic, supply of basic necessities such as water and transportation; at the state level, they want the government to regulate industries so that they would observe labour laws and also create employment. The central government is expected to regulate trade and monetary and fiscal policies. Since government operates at so many levels, modern enterprises face 'complex web of regulations'. Companies hire lawyers, public relation officers and liaison officers to monitor and manage the interaction with the government.

Government regulation of business is a mechanism for implementing social choices and helps in creating the basic conditions that lead to economic prosperity.

Justification of Government Regulation

1. **Market failure:** Using regulation to add the social costs of a product that are not otherwise demanded in the market.
2. **Ethical failure:** Regulation ensures fairness and justice, and adds this cost to the product.
3. **Stakeholder demands:** Special interest groups lobby for more government intervention in environmental conservation, consumer protection etc.
4. **Public reaction:** Communication of national events has made most 'accidents' more visible and less acceptable.
5. **Political advocacy:** Organisations representing minorities and women call for government being proactive in these areas.

Types of Government Regulation

1. **Industry specific:** Prevention of abuse to buyers in markets where market forces are distorted, usually by monopoly or other market power by suppliers. (Transportation, communications, energy, banking)
2. **Industry wide:** Primary social issues that affect all business. (Environment, safety, pensions, healthcare, employment)
3. **Functional:** Specific to certain business operations. (Stock trading, anti-trust, labour, energy)
4. **Media attention:** Media connect communities globally. Events are chronicled as they occur, the public and government officials see social needs that should be highlighted. For example, Oil spillovers in the ocean when ships break midseas causing irreparable harm to fish, pengiuns, etc.

Problems of Government Regulation

1. **Cost/Benefit:** All regulations add cost to products. When government mandates operations that would not otherwise occur, or interfere with the operations of markets, costs or premiums are added to products, raising the price to the consumer. The trend in government is increasing cost and new rules.

2. **Effectiveness:** Is the intended purpose achieved and what are the unintended consequences and costs?
3. **Deregulation:** Stakeholders resist deregulation, even when cost/benefit and effectiveness clearly favour deregulation.
4. **Policy confusion:** TV and cable systems of delivery has caused confusion.

Economic and Social Costs of Public Policies

Following are the costs involved in framing and implementation of public policies. Although these costs were considered while framing the policies, most of the time, people's welfare is given preference over the costs by the government. The same methodology has to be followed by corporates also. The different kinds of costs are given below:

- Administrative and compliance costs
- Paperwork
- Higher prices and taxes (public pay)
- Opportunity costs
- Unintended impacts of regulations
- Economic and social trade-offs

Although the administration and compliance of the public policies may cost more to the companies, they have to keep in mind that following the rules and policies meticulously would lead them to achieve higher profits and long-term goals.

Public Policies and Government Regulations in India

Environmental Protection Law

The Air (Prevention and Control of Pollution) Act, 1981

Industrialisation and urbanisation have resulted in a profound deterioration of India's air quality. Of the 3 million premature deaths in the world that occur each year due to outdoor and indoor air pollution, the highest numbers are assessed to have occurred in India. According to the World Health Organisation, the capital city of New Delhi is one of the top ten most polluted cities in the world. Surveys indicate that in New Delhi the incidence of respiratory diseases due to air pollution is about 12 times the national average. The Act provides for the prevention, control and abatement of air pollution. It also provides for the establishment of boards with a view to carrying out the aforesaid purposes.

Decisions were taken at the United Nations Conference on the Human Environment held in Stockholm in June 1972, in which India also participated, to take appropriate steps for the preservation of the natural resources of the earth which, among other things, include the preservation of the quality of air and control of air pollution. The Air (Prevention and Control of Pollution) Act, 1981 extends to the whole of India.

Effects of Air Pollution on Human Beings

Hydrocarbons emitted by automobiles are toxic and react with hemoglobin in the blood. The effect of nitrogen is adverse and permanent. It increases children's susceptibility to diseases like influenza. Sulphur dioxide in the air spreads

air acidity and corrodes buildings. It causes irritation to various parts of the respiratory systems.

The heart may be damaged by air pollution, secondary to lung diseases. Nitrogen dioxide results in pulmonary edema and aggravation of coronary disease. Toxic effects of lead pollution include impaired IQ and development defects in children. These are few of the many effects of air pollution on human beings.

The Environment Protection Act, 1986 provides for protection and improvement of environment and for matters connected therewith. It also provides for the protection of wild animals, birds and plants and for matters connected therewith or ancillary or incidental thereto.

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The United Nations Conference on Human Environment held in Stockholm in June 1972, proclaimed that 'Man is both creator and moulder of his environment, which gives him physical sustenance and the opportunity for intellectual, moral, social and spiritual growth. In the long and tortuous evolution of the human race on this planet, a stage has reached when through the rapid acceleration of science and technology, man has acquired the power to transform his environment in countless ways and on unprecedented scale. Both aspects of man's environment, the natural and man made, are essential to his well being and to the enjoyment of basic human rights, even the right to life itself'. Under this Act the meanings of words/phases used would be as follows:

1. **Environment:** It includes water, air, and land and the interrelationship that exists with human beings, other living creatures, plants, microorganism and property.
2. **Environmental pollutant:** It means any solid, liquid or gaseous substance present in such concentration as may be, or tend to be injurious to environment.
3. **Hazardous substance:** It means any substance or preparation which, by reasons of its chemical or physico-chemical properties or handling, is liable to cause harm to human beings, other living creatures, plants, micro-organism, property or environment.
4. **Environmental pollution:** It means imbalance in environment. The materials or substances when after mixing in air, water or land alters their properties in such manner, that the very use of all or any of the air, water and land by man and any other living organism becomes lethal and dangerous for health.

The Wildlife Protection Act, 1972

The Act provides for the protection of wild animals, birds and plants and for matters connected therewith or ancillary or incidental thereto. It extends to the whole of India, except the State of Jammu and Kashmir. The meaning of words/phases used in the Act would be as follows:

1. **Animal:** includes amphibians, birds, mammals, and reptiles, and their young ones, and also includes, in the cases of birds and reptiles, their eggs.
2. **Animal article:** means an article made from any captive animal or wild animal, other than vermin, and includes an article or object in which the whole or any part of such animal has been used and ivory imported into India and an article made therefrom.
3. **Hunting:** includes the following:
   (a) Capturing, killing, poisoning, snaring, and trapping any wild animal and every attempt to do so.

(b) Driving any wild animal for any of purposes specified in sub clause.

(c) Injuring or destroying or taking any part of the body of any such animal, or in the case of wild birds or reptiles, damaging the eggs of such birds or reptiles, or disturbing the eggs or nests of such birds or reptiles.

4. **Taxidermy:** With its grammatical variations and cognate expressions means the curing, preparation or preservation of trophies.
5. **Trophy:** means the whole or any part of any captive animal or wild animal, other than vermin, which has been kept or preserved by any means, whether artificial or natural, and includes the following:
   (a) Rugs, skins, and specimens of such animals mounted in whole or in part through a process of taxidermy.
   (b) Antler, horn, rhinoceros horn, feather, nail, tooth, musk, eggs and nests.
6. **Uncured trophy:** It means the whole or any part of any captive animal, other than vermin, which has not undergone a process of taxidermy, and includes a freshly killed wild animal ambergris, musk and other animal products.
7. **Vermin:** It means any wild animal specified in Schedule V of the Act.
8. **Wildlife:** It includes any animal, bees, butterflies, crustacean, fish and moths and aquatic or land vegetation which forms part of any habitat.

Workplace Safety and Health

Trade Unions Act, 1926

The Trade Unions Act, 1926 provides for registration of trade unions with a view to rendering lawful organisation of labour to enable collective bargaining. It also confers on a registered trade union certain protection and privileges. Registration of a trade union is not compulsory but is desirable since a registered trade union enjoys certain rights and privileges under the Act. Minimum seven workers of an establishment (or seven employers) can form a trade union and apply to the Registrar for its registration.

The Trade Unions Act, 1926 provides for registration of trade unions with a view to rendering lawful organisation of labour to enable collective bargaining. It also confers certain protection and privileges on a registered trade union.

The Act extends to the whole of India and applies to all kinds of unions of workers and associations of employers, which aim at regularising labour management relations. A trade union is a combination whether temporary or permanent, formed for regulating the relations not only between workmen and employers but also between workmen and workmen or between employers and employers.

Registration

Registration of a trade union is not compulsory, but is desirable since a registered trade union enjoys certain rights and privileges under the Act. A minimum of seven workers of an establishment (or seven employers) can form a trade union and apply to the Registrar for its registration.

(i) The application for registration should be in the prescribed form and accompanied by the prescribed fees, a copy of the rules of the union signed by at least seven members, and a statement containing the following:
   (a) The names, addresses and occupations of the members making the application
   (b) The name of the trade union and the addresses of its head office
   (c) The titles, names, ages, addresses and occupations of its office bearers.

(ii) If the union has been in existence for more than a year, then a statement of its assets and liabilities in the prescribed form should be submitted along with the application.

(iii) The Registrar may call for further information for satisfying himself that the application is complete and is in accordance with the provisions, and that the

proposed name of the union does not resemble any other name registered with the Registrar.

(iv) On being satisfied with all the requirements, the Registrar shall register the trade union and issue a certificate of registration, which shall be conclusive evidence of its registration.

Legal Status of a Registered Trade Union

(i) A registered trade union is a body corporate with perpetual succession and a common seal.

(ii) It can acquire, hold, sell or transfer any movable or immovable property and can be a party to contracts.

(iii) It can sue and be sued in its own name.

(iv) No civil suit or other legal proceeding can be initiated against a registered trade union in respect of any act done in furtherance of a trade dispute under certain conditions.

(v) No agreement between the members of a registered trade union shall be void or voidable merely on the ground that any of its objects is in restraint of trade.

Obligations of Registered Trade Unions

(i) The general funds of a registered trade union should be spent only for the objects specified such as, payment of salaries, allowances and expenses of its office bearers, its administrative and audit expenses, prosecution or defence af any legal proceeding for securing or protecting its rights, conduct of trade disputes, compensation for loss arising out of trade disputes, provision of educational, social or religious benefits and allowances on account of death, old age, sickness, accident or unemployment to its members, publication of labour journals, etc. The trade union may set up a separate political fund for furtherance of civic and political interest of members. Contribution to this fund is not compulsory.

(ii) The account books and membership register of the union should be kept open for inspection by any of its office-bearers.

(iii) A copy of every alteration made in the rules of the union should be sent to the Registrar within 15 days of making the alteration.

(iv) An annual statement of receipts and expenditure and assets and liabilities of the union for the year ending on the 31st December, prepared in the prescribed forms and duly audited should be sent to the Registrar within the prescribed time. This statement should be accompanied by a statement showing changes in office bearers during the year and a copy of the rules as amended up to date. Penalties imposed in case of the defaults made by any trade union in its annual report are as follows:

Offence-Penalty

(i) If the registered trade union/its office bearers or members fail to give any notice or send any statement as required under the Act, they are fined upto ₹5 plus additional fine upto ₹5 per week in case of continuing offence. (Maximum fine imposable ₹50.)

(ii) If any person wilfully makes any false entry in the annual statement of the union or its rules, he is fined up to ₹500.

Payment of Bonus Act, 1965

The Payment of Bonus Act provides for payment of bonus to persons employed in certain establishments on the basis of profits or of production or productivity and for matters connected therewith. It extends to the whole of India and is applicable to every factory and to every other establishment where 20 or more workmen are employed on any day during an accounting year.

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It extends to the whole of India and is applicable to every factory and to every other establishment where 20 or more workmen are employed on any day during an accounting year.

Eligibility for Bonus

Every employee receiving salary or wages upto ₹3500 per month and engaged in any kind of work whether skilled, unskilled, managerial, supervisory, etc. is entitled to bonus for every accounting year if he has worked for at least 30 working days in that year.

However, employees of LIC, universities and educational institutions, hospitals, chambers of commerce, RBI, IFCI, UTI and social welfare institutions are not entitled to bonus under this Act.

Disqualification for Bonus

Notwithstanding anything contained in the Act, an employee shall be disqualified from receiving bonus, if he is dismissed from service for fraud or riotous or violent behaviour while in the premises of the establishment or theft, misappropriation or sabotage of any property of the establishment.

Duties/Rights of Employer

Duties of the employers are as follows:

- To calculate and pay the annual bonus as required under the Act.
- To submit an annul return of bonus paid to employees during the year in Form D to the Inspector, within 30 days of the expiry of the time limit specified for payment of bonus.
- To co-operate with the Inspector, produce before him the registers/records maintained, and such other information as may be required by him.
- To get his account audited as per the directions of a Labour Court Tribunal or of any such other authority.

Rights of the employers are as follows:

- Right to forfeit bonus of an employee, who has been dismissed from service for fraud, riotous or violent behaviour, or theft, misappropriation or sabotage of any property of the establishment.
- Right to make permissible deductions from the bonus payable to an employee, such as festival/interim bonus paid and financial loss caused by misconduct of the employee.
- Right to refer any disputes relating to application or interpretation of any provision of the Act to the Labour Court or Labour Tribunal.

Rights of employees are as follows:

- Right to claim bonus payable under the Act and to make an application to the government, for the recovery of bonus due and unpaid, within 1 year of its becoming due.
- Right to refer any dispute to the Labour Court/Tribunal. Employees, to whom the Payment of Bonus Act does not apply, cannot raise a dispute regarding bonus under the Industrial Disputes Act.

- Right to seek clarification and obtain information, on any item in the accounts of the establishment.

The Employee's Provident Funds Act, 1952

The Employees' Provident Funds and Miscellaneous Provisions Act provides for compulsory contributory fund for the future of an employee after his retirement or for his dependents in case of his early death.

It extends to the whole of India except the State of Jammu and Kashmir and is applicable to the following:

(a) Every factory engaged in any industry specified in Schedule I in which 20 or more persons are employed
(b) Every other establishment employing 20 or more persons or class of such establishments which the central government may notify.
(c) Any other establishment so notified by the central government even if employing less than 20 persons.

The Employees' Provident Funds and Miscellaneous Provisions Act provides for compulsory contributory fund for the future of an employee after his retirement or for his dependents in case of his early death.
It extends to the whole of India except the State of Jammu and Kashmir Every employee, including the one employed through a contractor who is in receipt of wages upto ₹6,500 per month, shall be eligible for becoming a member of the funds.

Employees' Entitlement

Every employee, including the one employed through a contractor (but excluding an apprentice engaged under the Apprentices Act or under the standing orders of the establishment and casual labourers), who is in receipt of wages up to ₹6500 per month, shall be eligible for becoming a member of the Employee's Provident Funds.

The condition of three months' continuous service or 60 days of actual work, for membership of the scheme, has been done away with, w.e.f. 1 November 1990. Workers are now eligible for joining the scheme from the date of joining the service.

Employer's Contribution

The employer is required to contribute the following amounts towards Employees' Provident Fund and Pension Fund.

(a) In case of establishments' employing less than 20 persons or a sick industrial (BIFR) company or 'sick establishment' or any establishment in the jute, beedi, brick, coir or gaur gum industry—10% of the basic wages, dearness allowance and retaining allowance, if any.
(b) In case of all other establishments' employing 20 or more persons—l2% of the wages, D.A., etc.

A part of the contribution is remitted to the Pension Fund and the remaining balance continues to remain in Provident Fund account. Where, the pay of an employee exceeds ₹5000 per month, the contribution payable to Pension Fund shall be limited to the amount payable on his pay of ₹5000 only, however, the employees may voluntarily opt for the employer's share of contributions on wages beyond the limit of ₹5000 to be credited to the Pension Fund.

Functional Regulations

Custom Law and Procedures

Custom duty is a tax which the state collects on goods imported into or exported out of the boundaries of a country. Custom duties now form a significant source

of revenue for all countries, more so in the case of developing countries like India. In India, custom duties are levied on the goods and at the rates specified in the Schedules to the Customs Tariff Act, 1975. Export duties are practically non-existent at present. They are levied occasionally to mop up excess profitability in international price of goods in respect of which domestic prices may be low at a given time. But sweep of import duties is very wide, almost universal, barring a few goods like food grains, fertilizer, life saving drugs and equipment etc. Import duties generally consist of the following:

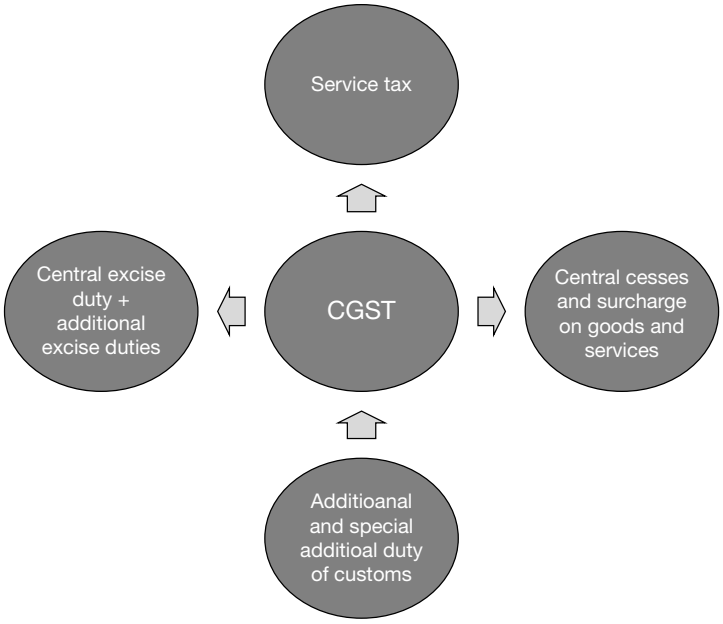
1. **Basic duty:** It may be at the standard rate or, in the case of import from some countries, at the preferential rate.
2. **Additional custom duty:** It is equal to central excise duty leviable on goods produced or manufactured in India. It is commonly referred to as countervailing duty or C.V.D.
3. **Special additional duty of customs:** It is at the rate of 4% in order to provide a level playing field to indigenous goods which have to bear sales tax. This duty is to be computed on the aggregate of the following:
   - Assessable value
   - Basic duty of customs
   - Surcharge
   - Additional duty of customs leviable under Section 3 of the Customs Tariff Act, 1975 (C.V.D.)
4. **Additional duty of customs:** It is at the rate of ₹1 per litre on imported motor spirit (petrol) and high speed diesel oil.
5. **Anti-dumping duty/safeguard duty:** This is for import of specified goods with a view to protecting domestic industry from unfair injury.

Goods and Service Tax (GST)

One of the landmark reform in the indirect tax system in India since independence is the introduction of GST in 2017. By adopting the concept of One Nation One Tax, the government has converged almost all indirect taxes levied by the Central Government and State Governments into a single tax system called Goods and Services Tax. It made India a single market as far as indirect tax administration is concerned. GST comprises of CGST levied by Central Government, SGST levied by the State Govenrment and IGST imposed on interstate supply of goods and services and is levied by the Central government and shared between the Central and State Governments.

The passage of the 122nd Constitutional Amendment Bill, the Model GST Law has been widely discussed among all stakeholders and corporate since 2016 because of its possible impact on governance and its performance. With the introduction of this amendment, a uniform indirect tax regime across India became a reality. The GST was introduced in India with effect from 1 July 2017 which is applicable throughout India. It is governed by GST Council and the tax rate is 0%, 5%, 12%, 18% and 28%. There is a special rate of 0.25% on rough precious and semi-precious stones and 3% on gold. In addition, a cess of 15% on other rates on top of 28% GST applies on few items like aerated drinks, luxury cars and tobacco products. The service, manufacture and sale have been properly defined to levy tax from the people and organisations. The word 'Levy' in the common parlance means charge or imposition or collection of tax on tax. For the purpose of collecting tax, the authority should have powers to levy tax. The Constitution of India in Article 265 sets out that no tax shall be collected without authority of law. Article 300A specifies that no property should be deprived on account of taxes. The fundamental right to equality (Article 14) and right to carry on business or profession (Article 19) cannot in any case be infringed/trampled down. Under Central Excise Act 1944, excise duty is levied by Central Government on production/manufacture of excisable goods removed for domestic consumption in India.

GST Framework in India



GST is the country's most comprehensive and biggest tax reform since independence. GST subsumed at least 11 central and state taxes and Government has given a slogan 'One Nation One Tax'. Its implementation will bring new opportunities for Chartered Accountants, consultancies, IT enabled services, logistics and supply chain management. The GST comprises of the following elements namely:

- CGST: Central Goods and Service Tax levied by the Centre.
- SGST: State Goods and Service Tax levied by the State.
- IGST: Integrated Goods and Service tax will be imposed on inter-state supply of goods and services and will be levied and collected by the Central government.

Accordingly, the term input tax has been defined under GST as the IGST, CGST and SGST charged for any supply of goods or services used or intended to be used in the course of furtherance of business and also include tax paid under reverse charge mechanism. The input tax credit means the credit of input tax which is so defined. The basic scheme of input tax credit in the Model Law is that every registered taxable person is entitled to take credit of input tax admissible to him and the said amount shall be credited to the electronic credit ledger of such person maintained by him in GST Network. The amount available in the electronic credit ledger may be used for making any payment towards tax payable by him it is subject to such conditions and within such time as may be prescribed.

GST has now enabled the corporate to move the goods and services in a hassle-free manner and time and energy required for the transportation is minimized and the presence of check posts are done away with. Consequently transparent tax regime has emerged in India; the vengeance of the officialdom will become a history. The tax reform will boost the economy in the long run.

Impact of GST on Corporate Governance

The major impact of GST on the ease of doing business without interference from the officials of government and therefore, it has been appreciated by the corporate sector throughout the world.

The possible impacts of GST are in the following area:

1. Advocacy
2. Indirect tax impact assessment
3. Accounting and reporting
4. Technology refresh
5. Compliance
6. Programme management
7. Change management and training
8. Supply chain

1. **Advocacy:** GST will bring the entire system of corporate governance more transparent and accountable. Corporations cutting across nature and character will aim to influence decisions within political, economic and social systems. Corporations are going to opinion makers and policy decisions of the government in a more vigorous manner. They are going to participate in the agenda setting on matters related to their industry and also form a pressure group on government. Every commission and omission on the part of matters related to certain industry group is determined by the kind of advocacy proposed by the companies. The companies are going to get increased role in budgeting of the government thus forcing the government more socially responsible and accountable. It promotes transparency in the system. Now the government will have to hear the voice and address the concerns raised by them. Companies will get an opportunity to express their views and concerns and access to information and services. Defend and promote their rights and responsibilities.
2. **Indirect tax impact assessment:** Prior to the enactment of the GST, indirect tax has no uniform nature throughout the country. Therefore, different government had different approach to products manufactured and distributed across the country. The company in turn find it difficult to formulate strategies for a pan India presence. GST implementation is going to affect various sectors differently. The service tax component of GST will be taxed by Centre and State government against the central government exclusive right. GST will transform most of the infrastructure sector like power, road, port, railways, mining, oil and natural gas sector.
3. **Accounting and reporting:** Accounting is mandatory for companies and enterprises to ensure proper tax credit. Transactions if not accounted properly are going to adversely affect the profitability of the organisation. Manufacturers, traders and service providers across India have been placed under one unified tax umbrella and no longer need to work with a tedious array of 17 distinct types of taxes they to comply with. The industry, prior to GST, was struggling to get on with the destination based tax from an origin based tax structure. The shift from the previous tax regime and carry forward the input credits into GST is the biggest challenge that business are facing post GST tax regime. In this circumstances, accounting and reporting is mandatory and brings transparency in the system.
4. **Technology refresh:** Business undertaking are forced to map the accounting software and IT Systems in line with the new tax provisions, to create GST invoices and extract required reports. Tax and accounting professionals jointly need to ensure that their clients' current systems are compatible with their GST service provider. Technology solutions are essential feature of post GST business operations.

5. **Compliance:** GST is going to have an overall impact on the prices of various commodities, investment opportunities and the business operations, in all sectors of the economy. GST is a procedure driven system where timely and accurate compliance are necessary. The major compliance are charge GST on supplies, file return on time, pay tax and claim input tax credits, keep proper business and accounting records, inform GST authority of changes, reconcile account at time of de-registration, etc.
6. **Programme management:** GST implementation in corporations require elaborated preparedness such as registration, organisation realignment, alignment of invoicing, readiness of IT system, updating the GSTIN in the network, input tax credit arrangement, understanding of various GST tools and its working, monitor progress and taking the confidence of employees, periodical review. Each of these stages must be done carefully for the better result of governance and internal compliance.
7. **Change management and training:** Since, GST is a complete overhauling of business operations. The routine activities done by the employees need to be changed thoroughly to implement GST. Employees are trained properly to take up challenges and ensure the smooth implementation of GST in organisation. This process will ensure a smooth transition and hassle free business environment. Tax compliance will ensure transparent business operations as envisaged in the corporate governance.
8. **Supply chain:** The motto of GST is 'one India one market and one tax'. With the introduction of GST, goods and services will move from one place to another without any hassles. The minimum interference of the government will do away with the need and necessity of tax offices and checking and cross checking. Interstate check posts will be a history. This has profound influence of logistics and supply chain industries.

The single tax structure on the supply of goods and services, right from the manufacturer to the consumer has transformed the indirect tax regime in India. The GST regime will ensure easy compliance, uniform tax rate and structure throughout the country, removal of cascading effect of tax, improved competitiveness will ensure good corporate governance and it will positively affect all stakeholders of the company. Single and transparent tax proportionate to the value of goods and services will ensure transparency of taxes paid to the final consumer. Because of efficiency gains and prevention of leakages, the overall tax burden on most commodities will come down, which will benefit consumers. With the subsuming of nearly 12 central and state have level taxes will smoothen the business operations. For the implementation of GST in the country, the Central and State Governments have jointly registered Goods and Service Tax Network (GSTN) as a not-for profit, Non-government Company to provide shared IT infrastructure and services to Central and State governments, tax payers and other stakeholders. The key objectives of GSTN are to provide a standard and uniform interface to the taxpayers and shared infrastructure and services to Central and State/UT governments.

Demonetisation

The formal announcement of demonetisation of high value currency denomination of ₹ 500 and ₹ 1000 worth nearly 15.4 trillion, constituting about 87 per cent of the currency in circulation, took place on 8 November 2016 is seen as a ground work for the implementation of GST. The move aimed at curbing corruption, black money, eliminating counterfeit currency and terrorism funding. Alongside, the

move aimed at the promotion of a cashless economy mainly through digitalization, converting the informal economy to a formal one, increasing the scope for financial inclusion, enhancement of financial savings, larger scope for strengthening of treasury accounts of the government ultimately to be utilised for development of finance.

The demonetisation move is multi-targeted in terms of reducing black money (unaccounted income) in the system, curbing funding of illegal activities and addressing the problem of fake currency notes. The move also aims to create the shift from more of an informal economy to a formal one. The launch of various schemes of the government such as Jan Dhan Yojana, digital India mission, goods and services tax lunch are proof to the same argument. On the corporate front, the government has identified the shell companies who are in the process of whitening the black money is seen as a major step to bring good corporate governance in India. Demonetisation will strengthen institutional framework by reducing tax avoidance and corruption. It would result in efficiency gains through greater formalisation of economic and financial activity which would help broaden the tax base and expand usage of the financial system? It would be positive for large organised players in retail sectors and banking sector.

Consumer Protection Act

In the history of consumer protection, the General Assembly of United Nations adopted a set of general guidelines for consumer protection on 9 April 1985. The UN General Assembly started persuading the member to adopt policies for consumer protection. Such policies should be formulated on seven vital areas. This in fact set in motion for enacting several legislations posing more challenges to the corporate in its governing process. The seven vital areas are listed below:

1. Physical safety
2. Protection and promotion of the consumer's economic interest
3. Standards for the safety and quality of consumer goods and services
4. Distribution facilities for consumer goods and services
5. Measures enabling consumers to obtain redress
6. Measures relating to specific areas (food, water, and pharmaceuticals) and
7. Consumer education and information programme

As a sequel to the above guidelines, India enacted a piece of legislation known as Consumer Protection Act 1986 to protect the interest of the consumer's rights on account of the following reasons.

- Rapidly increasing variety of goods and services which modern technology has made available.
- Growing size and complexity of production and distribution system.
- High level of sophistication in marketing and selling practices in advertising and other forms of production.
- Removal of personal relationship of buyer and seller as a result of mass marketing methods.
- Increased mobility of consumers.

Important Features of Consumer Protection Act 1986

The Act applies to all goods and services unless specifically exempted by the Central government. It covers all the sectors-private, public and cooperative. The provisions of the Act are compensatory in nature. It provides adjudicatory authorities, which are simple speedy and less expensive.

Consumer Rights under the Act – The Act ensures the following rights on consumers:

- The right to be protected against the marketing of goods and services which are hazardous to life and property.
- The right to be informed about the quality, quantity, potency, purity, standard and price of goods or services as the case may be so as to protect the consumer against unfair trade practices.
- The right to be assured, wherever possible access to variety of goods and services at competitive prices.
- The right to be heard.
- The right to seek redressal against unfair trade practices or unscrupulous exploitation of consumer.
- The right to consumer education.

The Act provides for the establishment of the Consumer Protection Councils at the National, State and District levels. The objectives of these councils are to help the respective governments in adopting and reviewing policies for promoting and protecting the rights of consumers. The composition of these consumer councils are broad based. The citizens and organisations representing different interest groups having implications for consumers' rights protection are members of these councils. Consumer councils are to be constituted on public private partnership basis for better feedback and thereby review of the policy in the area of consumers' right protection. The main objective of these councils is to promote and protect the rights and interests of consumers in the society. It also provides for Consumer Disputes Redressal Adjudicatory Bodies established at three levels, i.e., District, State and National. They are known as District Forums, State Commissions and National Commission.

Reliefs Available to Consumers

The following reliefs are available to consumers under the Act.

- Removal of defects from the goods.
- Replacement of the goods.
- Refund of the price paid.
- Award of compensation for the loss or injury suffered.
- Discontinue and not to repeat unfair trade practices or restrictive trade practices.
- Not to offer hazardous goods for sale.
- To withdraw hazardous goods from sale.
- To cease manufacture of hazardous goods and desist from offering services which are hazardous in nature.
- If the loss or injury has been suffered by a large number of consumers who are not identifiable conveniently to pay such sum (not less than 5 per cent of the value of such defective goods or services provided) which shall be determined by the Forum.
  - To issue corrective advertisement to neutralise the effect of misleading advertisement and
  - To provide adequate costs to parties.

Consumer Protection: Implications for Good Governance

An effective, efficient and fair implementation of the Consumer Protection Act is one of the conditions precedents for promoting the culture of good governance and thereby ensuring the better promotion and protection of the rights of consumers. If the rights of the consumers in relation to the quality of goods and services are assured and taken care of then there will be no cause for complaints. This situation would certainly create an atmosphere wherein the clients, customers and consumers would feel satisfied with the things needed most to them. In this context the concerns of the good governance need to be mentioned briefly with the view to establish linkage with the concern of consumer protection law and institutions. Generally speaking, the thrusts of the good governance movement are efficiency, effectiveness, ethics, equality, economy, transparency, accountability, empowerment, rationality, impartiality and participation.

In view of these requirements of the good governance one can easily and with success establish the co-relations with the concerns of the consumer protection law and policies. From the point of view of the concerns of the consumer protection law, it may generally be emphasized that the concerns of consumer protection law, it may generally be emphasized that the concerns of consumer's rights protection are to ensure fair trade practices, quality goods and deficiency free services with information in regard to quality, quantity, potency, components and price with a view to provide opportunity to the consumers in regard to their choices.

The Honourable Supreme Court of India has observed the following with regard to the concept of public accountability.

'The administrative law of accountability of public authorities for their arbitrary and even ultra vires actions has taken many strides. It is now accepted that the state is liable to compensate for loss or injury suffered by a citizen due to arbitrary actions of its employees… No functionary in exercise of statutory power can claim immunity…. Public authorities acting in violation of constitutional or statutory provisions oppressively are accountable for their behaviour….In each hierarchy the Act is empowered to entertain a complaint by the consumer for value of the goods or services but also to compensate a consumer for injustice suffered by him'.

In continuation, it was further observed that the award of compensation is not the only issue today. The concept of public functionary has undergone tremendous change with passage of time and change in socio-economic outlook…. In modern society no authority can arrogate to itself the power to act in a manner which is arbitrary….It is now imperative and implicit in the exercise of power that it should be for the sake of society. It is therefore, necessary that the commission when it is satisfied that a complainant is entitled to compensation for harassment or mental agony or oppression…then it should further direct the department concerned to pay the amount to the complainant from the public fund immediately but to recover the same from those who are found responsible for such unpardonable behaviour.

The Insolvency and Bankruptcy Code, 2016

Needless to say, business and industry plays a significant role in the economic development of any country. Along with direct contribution to the GDP, it also creates jobs to millions. One of the most important requirements of growth and development of business and industry in any country is the creation of a friendly and easy environment of doing business which is popularly known as 'Ease of doing business. Over the years in India we have introduced several restrictions

and checks which made the task of doing business most complicated and tough. Identifying this, by simplifying the regulatory environment of business and industry, the government of India has taken several measures during the last few decades in the form of delicensing, introduction of single window system, abolishing of controller of capital issues, etc., which had made the task of doing business simple and easy. But still our position in this respect is 130 out of 200 countries ranked by World Bank in 2016. In the case of ease of resolving insolvency we stand 136th position out of 189 countries. Right now, the insolvency resolution is being dealt with the Indian Companies Act which is very time consuming, unscientific and laborious.

Banks are the major source of short term and medium term financing of companies in India. These banks are now facing huge problem of NPA because of the corporate defaults. A recent release by the RBI shows that 12 companies accounts for half of ₹3.5 lakhs crore of NPA of public sector banks of India. Continuation of non-performing assets in any economy leads to locking of funds and physical assets, which generally lead as a cause for big concern for the lender who have provided loan and financial assistance to the NPA business entity. The World Bank says that resolving insolvency takes over four years in India and the average recovery is 25 cents to the dollar. Several measures have been initiated to improve this in the form of the **Sick Industrial Companies Act** (SICA) and the **Board of Industrial Financial Reconstruction** (BIFR). But both failed to speedily revive or liquidate companies and recover assets. Recognising that reforms in the bankruptcy and insolvency regime are critical for improving the business environment and alleviating distressed credit markets, the Government introduced the Insolvency and Bankruptcy Code Bill in November 2015 which came into effect from 2016.

Over the years business and industry in India have been demanding the removal of restrictions in entry to this country and exit as and when required. As part of globalization government has removed several entry restrictions both the domestic and global companies during the last two decade. Exit was again a problem. Trade and industry has been demanding a simple time bound procedure for exit also. In 2016 Government of India has introduced a new law called the Insolvency and Bankruptcy Code to facilitate simple time bound, creditor initiated procedure for dealing with insolvency and bankruptcy of companies and getting maximum value to the assets of the insolvent firm through an institutional mechanism consisting of all stakeholders for timely resolution of insolvency process.

What is Insolvency and Bankruptcy Code 2016?

It is an Act to consolidate and amend the laws relating to reorganisation and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner for the maximization of value of assets of such persons, to promote entrepreneurship, availability of credit and balance the interests of all the stakeholders including alteration in the order of priority of payment of government dues and to establish an insolvency and Bankruptcy Board of India, and for matters connected therewith or incidental thereto.

At present, there are multiple overlapping laws and adjudicating forums dealing with financial failure and insolvency of companies and individuals in India. The current legal and institutional framework does not aid lenders an effective and timely recovery or restructuring of defaulted assets and causes undue strain on the Indian credit system. Hence the new code is introduced to overcome these problems. There are 255 Sections, 11 Schedules, 5 Parts and 21 Chapters under IBC. The code repeals the Presidency Towns Insolvency Act 1909 and the Provincial Insolvency Act 1920, as well as amends various laws, including: the Indian Partnership Act 1932, The Indian Companies Act 2013, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, the Limited Liability Partnership Act 2008, the Sick Industrial Companies (Special Provisions) Repeal Act 2003.

The Code has Five Parts Namely

- Part I: Preliminary – Section 1 to 3.
- Part II: Insolvency resolution and liquidation for corporate bodies – Section 4 to 77 with 7 chapters.

- Part III: Insolvency resolution and bankruptcy for individuals and the partnership firms – Section 78 to 187 with 7 chapters.
- Part IV: Regulation of Insolvency Professionals, agencies and information utilities – Section 188 to 223 with 7 chapters.
- Part V: Miscellaneous.

Major Highlights of the New Code

1. The code offers a uniform, comprehensive insolvency legislation encompassing all Companies, Partnerships and individuals (other than financial firms) and all insolvency related legislations under different acts.
2. It aimed at early identification of financial failures and getting maximum value for assets of insolvent firms as against low realisation value for asset in case of distress sale.
3. The code allows creditors to assess the viability of a debtor as a business decision, and agree upon a plan for its revival or a speedy liquidation.
4. The code creates a new institutional framework, consisting of a regulator, insolvency professionals, information utilities and adjudicatory mechanisms, that will facilitate a formal and time bound insolvency resolution process and liquidation.
5. The code proposes a paradigm shift from the existing debtor initiated process to creditor initiated process. This is a significant departure from the existing legal framework under which the primary initiation comes from the debtor for debt restructuring. The defaulting corporate debtor, its shareholders or employees, may also initiate voluntary insolvency proceedings.
6. As per the code, to start debtors initiate insolvency process the default should be at least ₹100,000 ($1495) for which its limit may be increased up to $10,000,000 ($149,500) by the Government. For individuals and unlimited partnerships, the code applies in all cases where the minimum default amount is ₹1000 ($15) and above (the Government may later revise the minimum amount of default to a higher threshold).
7. The code aimed to solve insolvency in a strict and time bound manner and easy debt collection. A moratorium period of 180 days which is extendable to 270 days is allowed for the company insolvency professionals to take over the management of the company.
8. As compared to previous insolvency laws which gave higher priority to government dues, this law gives lower priority to government dues. Government dues were immediately below the claims of secured creditors and workmen in order of priority as per earlier laws. Now it is below unsecured creditors.
9. Clearly defined order of priority is fixed for repayment of liabilities in the case of insolvency. The order of priority are:
   (a) Insolvency related cost
   (b) Secured creditors
   (c) Workmen dues up to 24 months
   (d) Other employee's salary up to 12 months
   (e) Unsecured creditors
   (f) Government dues up to two years
   (g) Any remaining debtors
   (h) Balance to equity share holders

10. The code envisages provision for investigation of related party transactions in case of illegal diversion of assets by directors or auditors. It also contains provisions for demanding personal contribution with the order of the court from such people at the time of insolvency.
11. The code propose the establishment of Insolvency and Bankruptcy Board as an independent body for the administration and governance of Insolvency and Bankruptcy Law which (i) overseeing the functioning of insolvency intermediaries, i.e., insolvency professionals, insolvency professional agencies and information utilities and (ii) regulating the insolvency process.
12. Introduction of qualified insolvency professionals as intermediary to oversee the process with strict code of conduct and professional ethics. The code further provides for insolvency professionals to play a key role in the efficient working of the bankruptcy process. In the resolution process, the insolvency professional verifies the claims of the creditors, constitutes a Creditors Committee, runs the debtor's business during the moratorium period and helps the creditors in reaching a consensus for a revival plan. In liquidation, the insolvency professional acts as a liquidator and bankruptcy trustee.
13. The code envisages the constitution of a Creditor's Committee and revival plan. Operational Creditors above a certain threshold limit are allowed to attend meetings of the committee but do not have voting power. Each decision of the creditors committee requires a 75 per cent majority vote. Decisions of the creditors committee are binding on the corporate debtor and all its creditors.
14. Under the code, a corporate debtor may be put into liquidation in the following scenarios:
    (i) A 75 per cent majority of the Creditor's Committee resolves to liquidate the corporate debtor at any time during the insolvency resolution process.
    (ii) The Creditor's Committee does not approve a resolution plan within 180 days (or within the extended 90 days).
    (iii) The NCLT rejects the resolution plan submitted to it on technical grounds and
    (iv) The debtor contravenes the agreed resolution plan and an affected person makes an application to the NCLT to liquidate the corporate debtor.

Once the NCLT passes an order of liquidation, a moratorium is imposed on the pending legal proceedings against the corporate debtor, and the assets of the debtor (including the proceeds of liquidation) vest in the liquidation estate.[1]

The Competition Act 2002

Since 1969 we had a Monopoly and Restrictive Trade Practice Act with several provisions aimed to prevent formation of monopoly and other restrictive trade practices followed by business as part of the growth strategies. By realising the fact that this Act failed to achieve the basic aim of preventing monopoly in market and putting several types of restrictive trade practices such as Price Pigging, imposing entry and exit restrictions, monopolizing raw materials, etc., during the last three decades of its inception, the government has decided to repeal the Act and introduce another Act as part of Public Policy for promoting competition among business and industry. The Finance Minister in his Budget Speech on 27 February 1999 stated that, The Monopolies and Restrictive Trade Practices Act have become obsolete in certain areas in the light of international economic developments relating to competition laws. We need to shift our focus from curbing monopolies to promoting competition. The Government has decided to appoint

a Commission to examine these issues and propose a modern competition law suitable for the conditions'. In a market economic system healthy competition is very essential for the improving the operational efficiency, introduction of innovations and creation of value to consumers. But unfortunately the MRTP Act had not addressed this issue.

Objectives of the Law

Keeping in view of the economic development of the country the new law aimed for the following:

1. The establishment of a Commission to prevent practices having adverse effect on competition.
2. To promote and sustain competition in markets.
3. To protect the interests of consumers and to ensure freedom of trade carried on by other participants in markets, in India.
4. For matters connected therewith or incidental thereto. Competition Act has enacted by Parliament in the Fifty-third Year of the Republic of India.

What is Competition?

Competition refers to healthy economic rivalry amongst enterprises to control market for goods and services. The level of competition does not depend upon the number of players in an industry but depend on degree of contestability. This involves ease of entry and exit in the relevant market in terms of geographical area or products category or any other manner. In India several types of hurdles were put by big companies for preventing newer once to enter into the market, there by monopolizing the market .The aim of the act is to discourage such practices and ensure fair transparent and healthy competition.

Benefits of Competition

- Promotes efficiency
- Leads to higher productivity
- Punishes the laggards
- Enhances choice, improves quality
- Reduces costs
- Facilitates better governance

Components of Competition Act

The act has four components as follows.

Anti-Competition Agreements

As per the Act any agreements between the producers or distributors preventing competition in the form of price rigging, exclusive distribution, putting entry exit restrictions, forming pool or cartel type arrangement for production and marketing of any product or service, etc., are considered as Anti-Competition Agreement. For example, the commission has found Cement Manufacturers in violation of the provisions of the Competition Act, 2002 which deals with anti-competitive agreements including Cartels. An order was passed pursuant

to investigation carried out by the Director General (DG) upon information filed by Builders Association of India. The commission has imposed penalty on eleven Cement Manufacturers at the rate of 0.5 times of their profit for the year 2009–10 and 2010–11. The penalty so worked out amounts to more than six thousand six hundred crore rupees.

Abuse of Dominance

Abuse of Dominant Position refers to misuse of the superior or monopoly position in the market and using it for preventing competition in the market. Under Section 4 of the Competition Act, a dominant position shall be deemed to be held by one or more business undertakings or an association of business undertakings, who, either within the entire country or within a given region, hold an exclusive right or other dominant position in a specified product market so as to significantly control the price level or terms of delivery of that product, or who, in some other corresponding manner, influence the competitive conditions on a given level of production or distribution. A dominant position may in some instances be jointly held by more than one undertaking without any of them holding a dominant position individually. In practice, the existence of collective dominance requires that there are financial ties between the undertakings which enable them to adopt the same market behaviour and hold a dominant position in relation to other undertakings. A dominant position manifests itself as a de facto possibility to prevent effective competition in the market and to behave in an independent manner of competitors, customers and suppliers. A dominant undertaking does not encounter a sufficient amount of competitive pressure and a significant amount of the market power of the undertaking is thus related to the dominant position.

In India the Competition Commission of India has initiated an investigation against the global internet giant Google, for its alleged involvement in anti-competitive practices in India. Google is currently battling antitrust probes in five continents. Similarly, the action was initiated against Coal India Limited for supplying poor quality coal which is lumpy and sticky. It was brought to the notice of CCI that due to the monopoly position of CIL, it has been able to indulge in abuse of its monopoly power by way of enforcing a non-transparent contract regarding the quality and other parameters of coal. The international practice of washing coal is also not being followed by CIL. CCI found that there exists a prima facie case and directed the DG to investigate the same.

Combination Regulations (Mergers)

Broadly, combination under section 5 of the Act means acquisition of control, shares, voting rights or assets, acquisition of control by a person over an enterprise where such person has control over another enterprise engaged in competing businesses, and mergers and amalgamations between or amongst enterprises when the combining parties exceed the thresholds set in the Act. The thresholds are unambiguously specified in the Act in terms of assets or turnover in India and abroad. Entering into a combination which causes or is likely to cause an appreciable adverse effect on competition within the relevant market in India is prohibited and such combination would be void. The thresholds for the combined assets/turnover of the combining parties are:

(a) Combined assets of the enterprises value more than ₹1000 crores or combined turnover is more than ₹3000 crores.

(b) In case either or both of the enterprises have assets/turnover outside India also, then the combined assets of the enterprises value more than US$ 500 million, including at least ₹500 crores in India, or turnover is more than US$1500 million, including at least ₹1500 crores in India.

Competition Advocacy

Competition Advocacy refers to publicity campaign. This act mandates competition advocacy to promote competition, create awareness and impart training about competition issues. CCI had initiated a print publicity campaign as part of advocacy initiative. Advertisements were released all over the nation in Hindi, English as well in prominent regional languages.

Highlights of Competition Act 2002

The major highlights of the Competition Act 2002 are as follows:

- It provides for the establishment of a Competition Commission of India 'CCI' to prevent practices having adverse effect on competition, to promote and sustain competition in markets, to protect interests of consumers and to ensure freedom of trade carried on by other participants in markets.
- CCI prohibits enterprises to enter into anti-competitive agreements, abusing their dominant position and forming combinations.
- CCI shall look into any alleged violations under the Act, (a) either on its own motion, or (b) on receipt of a complaint from any person, consumer or their trade association, or (c) on references made by the Central government, State governments or any statutory authority.
- Exclusion of jurisdiction of civil courts— No civil court has the jurisdiction to entertain any suit or proceeding which CCI is empowered by or under the Act to determine. Also, no injunction can be granted by any court or authority in respect of any action taken or to be taken in pursuance of any power conferred by or under the Act.
- CCI is not bound by the procedure laid down by Code of Civil Procedure, 1908 and must only follow the principles of natural justice. CCI, thus has the power to regulate its own procedure.
- If any party to such agreement is outside India; or if any enterprise abuses its dominant position is outside India; or a combination has taken place outside India; or any party to combination is outside India; or any other matter or practice or action arising out of such agreement or dominant position which causes an appreciable adverse effect on competition in the relevant market in India.
- CCI has the power to grant interim relief award compensation, impose penalty and to grant any other appropriate relief. To levy penalty for contravention of its orders by making of false statements or omission to furnish material information, etc.
- Division of dominant enterprise: CCI can recommend the Central government division of a dominant enterprise to ensure that it does not abuse its position. On the recommendation, the Central government under Section 28 may direct division of such an enterprise.
- Extent of penalty: For abusing its dominant position or entering in anti-competitive agreements, CCI can levy penalty to the extent of 10 per cent of the average of the turnover for the preceding three financial years. The penalty is higher in case of such abuses by cartels and Pools types of entities.[2]

Foreign Exchange Management Act, 1999 (FEMA)

A bill based on the recommendations of the Task Force, was introduced in the Lok Sabha on 4 August 1998. The bill was referred to the standing committee on Finance which submitted it's report to the House on 23 December 1998 with suggestion and modifications. The 12th Lok Sabha was dissolved before any decision could be taken on the bill. The bill subsequently lapsed. The bill was again introduced in the 13th Lok Sabha on 25 October 1999. The Presidential Assent was received on 6 January 2000. Finally the FEMA came into operation w.e.f. 1 June 2000.

To Whom is the Act Applicable?

The FEMA is applicable to

- The whole of India
- Any branch, office and agency, which is situated outside India, but is owned or controlled by a person who is resident of India
- Any contravention of provisions of FEMA, by all those, who are covered under the above two aspects committed outside India.

Public Policies for the Global Village

India went for globalisation because every other country in the world had adopted it. It was a kind of compulsion from the WTO for the developing countries. The developing countries had no other choice of allowing foreign competitors into their market to stabilise their economies. There are some public policies which have to be followed globally.

Intellectual Property Rights (IPR and TRIPS)

Patents, designs, copyrights and trademark are industrial property as they are used in some form of industry or business. They are also aptly termed intellectual property since they are the products of pure intellectual effort. Attempts have been made from time to time to expand the boundaries of intellectual property and to convert a protective law into a source of monopoly.

Anti-dumping Policies

Trade 'Dumping'

Dumping occurs when a product is exported to and sold in another country at less than its normal value in the exporting country, and such sales cause injury to producers in the importing country. In essence, the product is 'dumped' onto the importing country's domestic market.

What Protection Does the Anti-dumping Agreement Offer?

In cases where dumped imports threaten or materially injure a nation's domestic industry, injured nations may impose 'anti-dumping measures' in the form of duties—in addition to the standard tariffs applied—to imports from 'dumping' foreign sources. This protection is granted under the GATT 1994 Agreement (Article VI), commonly called the WTO Agreement on Anti-Dumping.

How Is It Determined Whether or Not Goods Are Being Dumped?

- The 'normal value' of the good is determined
- The 'export price' is established
- A 'fair value comparison' of the export price and normal value is made, including any necessary allowance and adjustments that circumstances of the sale and product differences might dictate

How Is It Determined Whether or Not Dumping Has Caused Injury to Domestic Industry?

- Investigators examine the volume and value of dumped imports, and the effect on the industry in the domestic market for identical or similar products
- Future threats are assessed on the basis of dumping rates, inventories, exporter capacities and price projections on goods in the market

How Are Punishment Measures Set?

- Dumping margins are calculated (the difference between the normal value and the export price)
- The importing country then typically collects duties on imports from the dumping source country
- In lieu of collecting anti-dumping duties, members may elect to negotiate higher price agreements with the offending exporters
- The WTO measure establishes rules for the duration of anti-dumping duties and price undertakings

Transparency of the Process

- Investigating authorities must provide public notice of all non-proprietary information regarding the details of all preliminary and final rulings and determinations.
- Extensive details are provided along with official responses to arguments, to ensure transparent, consistent and fair implementation of the Agreement.

CONCLUSION

Businessmen generally do not expect governments to interfere in their day-to-day affairs. They want to be left alone to mind their businesses and run them as they would like to conduct them. However, even hardcore entrepreneurs would like governments to create a conducive business atmosphere so as to enable them to conduct their business smoothly. It is in this context that public policies play an important and decisive role. It is also important that businessmen understand the context and environment in which governments adopt business policies and the manner in which they impact their business decision-making. In this chapter, we have studied them in detail so as to enable us to follow the ensuing chapters with ease and better understanding.

KEYWORDS

- Abuse of dominance
- Advocacy
- Anti competition agreement
- Bankruptcy
- BIFR
- Cascading effect of tax
- Combination regulation
- Commercial policy
- Compensation
- Competition Advocacy
- Competition commission
- Consumer council
- Consumer grievances
- Consumer Protection Act 1986
- Creditors committee
- Demonetisation
- District council
- Dominant enterprise
- Financial involvement
- Fiscal policy
- Framing public policy
- GST
- Hon: Supreme Court of India
- Informal sector
- Insolvency
- Insolvency and Bankruptcy Board of India
- Insolvency related cost
- Monetary policy
- Monopoly
- National council
- National economic policy
- NCLT
- NPA
- Organisational involvement
- Policy decision making
- Political involvement
- Public policy in business
- Public Private Partnership
- Restrictive Trade Practice
- Shaping of public policies
- Shell companies
- SICA
- SRFAESI Act-Secured creditors
- State council
- Strategic public policy involvement
- Tax network
- Tax rate
- Taxation policy
- Technology adaption
- UN General Assembly
- United Nations
- Unsecured creditors

DISCUSSION QUESTIONS

1. What is public policy? What is the need for public policy in business?
2. What are the areas in which public policy is applicable? Discuss its limitations.
3. Discuss the key elements in the public policy process. Illustrate the process with a suitable diagram.
4. Discuss the involvement of business in public policy decision-making.
5. What is economic policy? What are the constituents of economic policy? Explain briefly each one of them.
6. What is the need for the regulation of business by the government? Explain the problems associated with government regulation.
7. What is GST? State its objectives.
8. State the impact of GST on corporate governance.
9. Explain briefly the mechanism of GST Network.
10. State the importance of demonitisation on GST and its impact of corporate governance.
11. State the objectives of Consumer Protection Act.
12. State the important features of Consumer Protection Act.
13. What are the Consumer Rights under the Consumer Protection Act?.
14. State the implication for good governance under consumer protection Act.
15. What are the observations made by Honorable Supreme Court of India with regard to the need and necessity of good governance?

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17



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Corporate Governance in the Developed and Emerging Economies

CHAPTER OUTLINE

- Introduction
- Corporate Governance Issues in the Developed Countries
- Problems Faced by Developing and the Transitional Economies
- Defining Corporate Governance
- Corporate Governance Models
- The Institutional Framework for Effective Corporate Governance
- Corporate Governance Challenges in Developing, Emerging and Transition Economies
- Current Corporate Governance Settings in Transition Economies
- Corporate Governance in the UK
- Corporate Governance in Russia
- Chinese Corporate Governance
- Australian Corporate Governance
- The US Corporate Governance
- Corporate Governance in South Africa
- Corporate Governance in New Zealand
- Corporate Governance in Indonesia
- Corporate Governance in Israel

Introduction

The 20th century witnessed innumerable corporate failures, triggered by frauds and scams worldwide. Company managements with the connivance of board members and auditors conspired to defraud their stakeholders, both the internal and the external. A Lack of transparency and disclosures and inequitable treatment of shareholders, window-dressing, fudging of accounts and funneling of corporate funds into private channels had all becoming very common. Earlier, the common perspective of corporate governance was to respect the individual system of each country.

The third quarter of the 20th Century witnessed innumerable corporate failures, triggered by frauds and scams worldwide. The reasons for such failures went far beyond just corporate misgovernance. Company managements with the connivance of the board members and the auditors conspired to defraud their stakeholders, both the internal and the external. The problems of misgovernance were deep-rooted and did not emanate only from the dichotomy between the ownership and the management. A Lack of transparency and disclosures and inequitable treatment of shareholders, window-dressing, fudging of accounts and funnelling of corporate funds into private channels had become very common. These developments created a popular stir and the collective conscience of the world was rudely awakened to the murky going-ons among some of the corporates that adversely impacted their interests and well being. Steps were mooted to root out the misdemeanours of the ill-behaved corporations. However, there was a problem. While it was easy to incorporate the required transformational changes in the corporate sphere of the advanced countries where the systems, procedures and regulatory bodies to combat and arrest the declining standards were mostly in place, these were absent in the case of the developing and the transition economies where everything had to be built from the scratch.

Earlier, the common perspective of corporate governance was to respect the individual system of each country. But, in the context of globalisation, with its attendant enhanced transnational movement of goods and services and for borderless capital markets, a set of global standards for corporate governance is being attempted in recent times. In such a scenario, it is imperative that the developing and the transition economies should try to put in place the required systems and institutions with a view to benefiting from the world-wide application of the principles and precepts of the best corporate governance practices. In this chapter, we will analyse the problems and issues confronted by the transition economies, how best these can be surmounted and how well these societies can work out a framework and system to absorb the essence and core of corporate governance practices and radiate it to bring growth interspersed with equity in their efforts while developing their economies.

Corporate governance has become a topic of a worldwide political debate because of its apparent importance for the economic health of the corporations and the society in general. The Asian economic crisis, the continuing turmoil in Russia post-1991 reforms, and the experience of the Czech economy have combined to push the issue of corporate governance from the sidelines to the centrestage. The failure of Enron, WorldCom, and other mega corporations of the US and the moral turpitudes of auditing firms such as Arthur Andersen have added an urgency to remove all those factors that led to corporate misgovernance. There is now a need to have an interdisciplinary approach to study the problem of corporate governance since it spans multiple disciplines, including finance, strategic management, sociology and political science. The framework of corporate governance also depends on the legal and regulatory environment. In addition, the factors such as corporate responsibility and ethics are significant in the study of corporate governance.

Corporate governance is a means whereby a society can be sure that large corporations are well-run institutions to which the investors and the lenders can confidently commit their funds. It is now increasingly clear that having a transparent and fair system to govern the markets, an equitable treatment of all stakeholders, and a chance for every entrepreneur with a good product to be successful, is as important to a democracy as political institutions, and are crucial to sound market economies. Corporate governance creates safeguards against corruption and mismanagement, while promoting fundamental values of a market economy in a democratic society.

Corporate Governance Issues in the Developed Countries

The Developed countries have a long history of corporate governance, a good institutional framework for formulating and administering regulations, structured legal system, comprehensive public policy, developed capital market, large sized companies which makes higher social impact on the society, outsider domination ownership pattern, high media pressure, better ethic and value system, etc., which makes the corporate governance more responsible, transparent and efficient protecting the interest of different stakeholders. Despite all these positive aspects, a series of corporate scams and failures took place during the last two decades resulting in a huge loss of investors' money. This has opened the eyes of regulators, social public, media and government to look in to the issues relating to the problems of corporate governance in the developed countries and redress it. The following are the some of the problems of corporate governance in the developed countries.

Intense Competition

Different countries are having different corporate governance systems. For instance, in the UK and the US, it is understood that the threat of takeover of the company is a factor which ensures that the managers have to act in the promotion of the interests of the shareholders. In the countries like Germany, France and Japan, it is understood that the financial institutions like banks act as monitors for the corporate governance. But neither of the systems is fool-proof. At the same time, it may be argued that the competition among the corporations can act as the most efficient mechanism for ensuring the corporate governance. It affects the productivity of a firm in a positive manner. Stiff competition in the product market ensures that the management does not avoid its responsibilities, even if its internal monitoring is weak. Competition ensures that the management lethargy is less and less. It can definitely be claimed that competition provides a benchmark for measuring the performance of a company from inside, i.e., the management. The managers are forced to rely on a high performance; otherwise, they may end up in bankruptcy or closer. Competition induces the managers to put greater efforts for the purpose of costs reduction so as to avoid any possibility of being bankrupt. Managers sometimes adopt hook and crook means to avoid competition which ultimately lead to wrongdoings and misgoverning. Many corporate failures in the developed countries are pointing towards the competition act as a contributory factor for corporate failure.

Aggressive Business Strategy

Aggressiveness strategies are rated, according to their marketing assertiveness, their risk propensity, financial leverage, product innovation, speed of decision making, amongst others. Typically, the range of aggressiveness strategies is classified into four categories such as prospector, defender, analyser and reactor. A prospector enters newer areas of business without much thought. Little time is spent on research. The intention of such companies is to become market leader or improve the market share. This process often leads to some setbacks leading to the corporate failure. The defender strategy on the other hand his strategy entails a decision not to aggressively pursue markets. As a result, they tend to do none of the things prospectors do. A defender strategy entails finding and maintaining a secure and relatively stable market. Rather than being on the cutting edge of technological innovation, product development, and market dynamics; a defender tries to insulate themselves from changes wherever possible. This process also

results in the failure of corporations. The analyser is in between the defender and prospector. They take less risk and make fewer mistakes than a prospector, but are less committed to stability than the defenders. Most firms are analysers. They are seldom a first mover in an industry, but are often second or third place entrants. A competency based growth is compromised in this process leading to questionable actions on the part of the people on the governance side. A reactor has no proactive strategy, often reacting to events as they occur. They respond only when they are forced to by macro environmental pressures. This is the least effective of the four strategies. It is without a direction or a focus.

Investor's Pressure for Higher Growth and Returns

Investors are owners of companies. It is quite natural that the expectation about the investment will be a concern for them. Investors range from the individuals, the institutions and the promoters. Managers who steer the company are always under pressure to green the bottom line. A competitive pressure on both the investors and on the managers has a natural victim. They wish to see the organisation as a goose always laying golden egg and are pressurized to perform better and better. Sometimes the pressure goes beyond the saturation point only to burst at one point.

Personal Motives of Management

A decade ago taking a directorship position in a company was considered to be a very honorable job but with very little effort or accountability. Today this job has become a very onerous job. One has to keep himself well informed about the affairs of the company as well as other regulatory aspects. The board is accountable to the company and the shareholders. Its prime responsibility is to provide strategic guidance to the management. It is also responsible for effective monitoring of the management. Specifically, the board should review and give guidance on the business plans of the company, evaluate and approve major capital expenditure decisions, acquisitions and divestitures, look into risk management and set performance objectives. It is also responsible for monitoring the effectiveness of company's governance practices and recommending changes, as and when necessary. The board should apply high ethical standards, take into account the interests of stakeholders and exercise an objective independent judgment on corporate affairs. Contrary to this, sometimes fraudulent, illegal transaction is entered by the company due to some personal motives. This may lead to a few corporate failures. The developed economies are not immune to this personal motive despite having high ethical practices at the personal and the organisational level.

Creation of Special Purpose Vehicles

The Creation of SPVs is an easy route to kill organisations as is evidenced in the collapse of the Enron Corporation. The Enron tried to solve the finance dilemma by allegedly looking for outside investors to help finance its investments. These 'joint investments' were typically structured as separate entities (joint ventures or more often, so called special purpose vehicles, sometimes both) to which the Enron and other investors contributed assets or other consideration; the entities could borrow from the credit markets, possibly with guarantees or other credit support from the Enron. The Enron used SPVs in many aspects of its business:

(i) Synthetic lease transactions.
(ii) Sales to SPVs of debt or equity interest owned by the Enron.

(iii) Sales to merchant 'hedging' SPVs of the Enron stock or of contracts enabling them to receive the Enron stock.

(iv) Transfers to SPVs of assets, often at above market value.

The objective of the Enron was to avoid having to consolidate such SPVs in their entirety into the Enron's balance sheet and to treat them as an investment by the Enron, i.e., it was to take advantage of a treatment known as 'off-balance-sheet', which would have allowed the Enron to present itself more attractively as measured by the ratios favoured by the Wall Street analysts and rating agencies. The Enron's 'off-balance-sheet' treatment of the SPVs was based on accounting rules which require the fulfilment of two conditions:

(i) The independent owner of the SPV must have made a substantive equity investment in the SPV (3 per cent of the total value of the assets being the minimum acceptable equity requirement), provided that such investment must actually be at risk during the entire term of the transaction.

(ii) The independent owner must have exercised control over the SPV (control being determined not only by a reference to majority ownership or day-to-day operation of the SPV, but also to the rights of investors).

The Enron established more than 3000 off-balance sheet subsidiaries and partnerships. The developed economies with such instances of misgovernance lead to the collapse of high profile corporations.

Complex Accounting Procedure

Information asymmetries and conflicts of interest between contracting parties are considered important reasons for the commitment to increased transparency and higher quality financial reporting. The information environment plays a central role both in determining the extent of these conflicts and in designing the mechanisms to mitigate them. In particular, detailed information about firms' operating systems, financing and investing activities, is essential for the efficiency of contracting arrangements. Accounting is a fundamental part of contracting mechanisms since it provides information for designing and evaluating contracts. This implies that certain contractual arrangements are more efficient than others in reducing agency costs, depending on the accounting numbers that are used in contracts. Higher quality financial reporting is essential to decrease the severity of information asymmetry between managers and market participants. A potential problem, resulting from information asymmetry, is the incentive problems, which arise when the manager's actions are unobservable to the principal. Due to the incidence of these problems and the conflicts of interests between the managers and shareholders, arise contracting and monitoring costs. In this respect, accounting information plays a central role in designing contracts that aim at mitigating agency costs. The important role of financial accounting information here is mainly related to the limitations of relevant information for monitoring managerial behaviour, which is fundamental for efficient contract mechanisms.

The large focus on the role of financial reporting and accounting information in corporate governance and, in particular, compensation contracts owes to the fact that these contracts are incomplete and need to be supplemented with more information. Increased transparency and higher quality financial reporting can enhance the efficiency of contracting and governance mechanisms and potentially reduce agency conflicts between managers and shareholders. For example, in compensation contracts, improved transparency facilitates the performance evaluation and rewarding of management by filtering out factors that are irrelevant to management's actions on performance. Furthermore,

financial reports with credible, timely and relevant information are important means of communication with other parties, such as independent directors. High quality financial reports can enhance the monitoring performance of the board of directors. In fact, even though the board of directors typically has access to internal reports, the demand for public information and corporate transparency is still great. This is mainly because public disclosures and financial information are subject to various rules and enforcement and they are also monitored by auditors. Auditors insist on compliance based on norms set by accounting standard laid down by regulators and norms set by International Financial Reporting Standards. It is indeed a tough task on the people on the governance side. Some of the corporate scandals happened because of the collusion between the auditors and the managers whose primary intention is to manipulate the accounts. Developed countries are not immune to this kind of collusion leading to manipulation of accounts.

Absence of Whistle Bowling Mechanism

Whistleblowing is an early warning system for an organisation. Instead of encouraging this early warning some of the organisation treats it as an interruption to the routine work. Ultimately the dissent is either ignored or suppressed. In corporate governance the whistleblowing is a part of the corporate policy and it is being encouraged systematically adhering to the fact that it will bring transparency and governance more effectively and efficiently. In the developed countries, whistleblowing mechanism, at least in certain cases, is ignored and suppressed leading to corporate failure.

Passive Role of Non-executive Directors

The role of the non-executive director has the following key elements:

1. **Strategy:** Non-executive directors should constructively challenge and help develop proposals on strategy.
2. **Performance:** Non-executive directors should scrutinize the performance of management in meeting agreed goals and objectives and monitor the reporting of performance.
3. **Risk:** Non-executive directors should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible.
4. **People:** Non-executive directors are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing and where necessary removing, executive directors and in succession planning.

In order to fulfil their role, non-executive directors will meet from time to time, if appropriate, as a group without executive directors being present and at least once a year without the Chairman being present. In this case, the meeting is led by the Senior Independent Director. Be entitled to seek independent professional advice, at the Company's expense, in the furtherance of their duties. Non-executive directors may be asked by the Board to serve on one or more of the board committees. If appointed to a board committee, non-executive directors will be advised of the committee terms of reference and any specific additional responsibilities involved. Contrary to the above said responsibilities of the independent director, remain silent or mute spectator will become a triggering factor of corporate failure. Some of the developed countries, independent directors do not contribute to the expectation to which they are appointed for.

Corporate Ethics and Value System

It is a well-known fact that management plays a vital role in shaping the future of any organisation as the optimum utilization of all resources hinges upon the efficacy of the management. The core of a successful management lies in its clarity of vision, plan of action and more importantly execution of the plan of action, the real gamut of operations as it were, and it is here, that the importance of Corporate Governance and ethics comes into being. Organisations are managed by policies, guidelines and systems. These are dynamic instruments and therefore need to be reviewed from time to time to gauge their efficacy to the said organisation. This review is all the more necessary when a lapse or an untoward incident takes place. It could happen that the review undertaken reveals that the said policy is very much sound and in place, however over a period of time wrong practices have come into being and which are the reasons for the problems that have occurred, therefore corrective steps need to be taken forthwith.

A review could also reveal that the problems have occurred in spite of the policy in place, and which means that the policies would need to be modified or amended as the case may be in the best interest of the organisation. Normally, decisions are being taken within the framework of the policies and guidelines in place. Now, there could be critical situations wherein the policy in question would need to be slightly deviated from, in order to take the right decision, in the best interests of the organisation. In such situations, a very clear and precise note should be brought out giving the reasons which necessitated the said deviation from the policy. The said note should also contain the implications to the organisation if the decision was not taken. This would serve as a very Transparent and an Objective analysis, bringing out the need for deviation from the policy on this 'case specific' issue, whereas the said policy in principle would continue in the same manner.

The two major reasons for corporate failures have been 'Greed' and 'Excess Leverage'. The moot point is whether these two need to be completely done away with? If so, what is the incentive for an aggressive growth and competition? If not, how are these to be kept within controllable limits and yet higher growth achieved? It is here that business ethics and corporate governance need to be focused on.

Issues of Governance Related to Remuneration Process

- The governance of remuneration/incentive systems has often failed because negotiations and decisions are not carried out at arm's length. Managers and others have had too much influence over the level and conditions for performance-based remuneration with boards unable to or incapable of exercising objective, independent judgement.
- In many cases it is striking how the link between performance and remuneration is very weak or difficult to establish. The use of company stock price as a single measure for example, does not allow to benchmark firm specific performance against an industry or market average.
- Remuneration schemes are often overly complicated or obscure in ways that camouflage conditions and consequences. They also tend to be asymmetric with limited downside risk thereby encouraging excessive risk taking.
- Transparency needs to be improved beyond disclosure. Corporations should be able to explain the main characteristics of their performance related remuneration programs in concise and non-technical terms. This should include the total cost of the program; performance criteria and how the remuneration is adjusted for related risks.

- The goal needs to be remuneration/incentive systems that encourage long term performance and this will require instruments to reward executives once the performance has been realised (i.e., ex-post accountability).
- Defining the structure of remuneration/incentive schemes is a key aspect of corporate governance and companies need flexibility to adjust systems to their own circumstances. Such schemes are complex and the use of legal limits such as caps should be limited to specific and temporary circumstances. The balance between the fixed and the variable components of remuneration packages should be carefully considered at the company level, and the regulatory framework should not induce a shift towards excessive fixed remuneration components.
- Steps must be taken to ensure that remuneration is established through an explicit governance process where the roles and the responsibilities of those involved, including consultants and risk managers, are clearly defined and separated. It should be considered a good practice to give a significant role to the non-executive independent board members in the process.
- In order to increase the awareness and attention, it should be considered good practice that remuneration policies are submitted to the annual meeting and as appropriate subject to the shareholder approval.

Issues of Governance Related to Effective Implementation of Risk Management

- A major failure of risk management was because in many cases risk was not managed on an enterprise basis and not adjusted to corporate strategy. Risk managers were often kept separate from the management and not regarded as an essential part of implementing the company's strategy. Most important of all, the boards were in a number of cases ignorant of the risk facing the company.
- Both financial and non-financial companies face a similar range of risks that need to be managed including operational, strategic and market risks. However, for financial companies, the volatility of risk tends to be greater requiring even more efforts by them to manage risks. Unique for banks is the liquidity risk since they are involved in borrowing short and lending long (maturity transformation) and the systemic risk that this entails forms the basis for a great deal of prudential oversight.
- It should be fully understood by the regulators and other standard-setters that an effective risk management is not about eliminating risk-taking, which is a fundamental driving force in business and entrepreneurship. The aim is to ensure that risks are understood, managed and, when appropriate, communicated.
- An Effective implementation of risk management requires an enterprise-wide approach rather than treating each business unit individually. It should be considered a good practice to involve the board in both establishing and overseeing the risk management structure.
- The board should also review and provide guidance about the alignment of corporate strategy with risk-appetite and the internal risk management structure.
- To assist the board in its work, it should also be considered a good practice that the risk management and the control functions being dependent of profit centres the 'chief risk officer' or equivalent, should report directly to the Board of Directors along the lines already advocated in the OECD Principles for internal control functions reporting to the audit committee or equivalent.

- The process of risk management and the results of risk assessments should be appropriately disclosed. Without revealing any trade secrets, the board should make sure that the firm communicates to the market material risk factors in a transparent and understandable fashion. Disclosure of risk factors should be focused on those identified as more relevant and/or should rank material risk factors in order of importance on the basis of a qualitative selection whose criteria should also be disclosed.
- With a few exceptions risk management is typically not covered or is insufficiently covered, by existing corporate governance standards or codes. Corporate governance standard-setters should be encouraged to include or improve references to risk management in order to raise awareness and improve implementation.

Issues of Governance Related to Board Practices

- It appears difficult, and perhaps impossible, to find a 'silver bullet' in the form of laws and regulations to improve board performance. This leaves the private sector with an important responsibility to improve board practices through, inter alia, implementing voluntary standards.
- The objective should be to facilitate the creation of competent boards that are capable of objective and independent judgement. While there is no inherent conflict between the independence and the competence, it is important to keep in mind that formal independence should sometimes be necessary, but never a sufficient, condition for board membership. A board evaluation process, conducted with the support of independent experts on a regular basis, should be used as a structural tool for monitoring board effectiveness and efficiency.
- The shareholders' role in nominating board members and in their appointment should be enhanced through instruments which takes into account the specific features of the ownership structure of a company.
- It should also be considered a good practice that the functions of the Chief Executive Officer and Chair of the Board of Directors in unitary boards are separated. When a dual board structure exists, the head of the management board should not become Chair of the supervisory board upon retirement. In both cases, some form of 'comply or explain' and associated transparency is necessary to preserve flexibility for companies in special situations.
- Board member liability and how their duties are specified and disclosed should remain on the policy agenda since it is not clear that effective arrangements are yet in place.
- It should be considered a good practice that boards develop specific policy for the identification of the best skill composition of the board, possibly indicating the professional qualities whose presence may favour an effective board. Especially in banks, some form of continuing training is required.
- In companies and industries where 'fit and proper person tests' are applied by regulators for public policy reasons, so that board membership is not solely a shareholder decision, the criteria could be extended to technical and professional competence of potential members, including general governance and risk management skills.
- The test for those particular companies might also consider the independence and objectivity of boards. To meet concerns about board independence, the test might also consider the time that board members have served under the same CEO or Chair.

Issues in Governance While Exercising Shareholder Rights

- The interests of some shareholders and those of management had been 'aligned' in the past period of a bull market but this was not sustainable and was associated with a great deal of short-term behaviour.
- While there are different types of shareholders, they have tended to be reactive rather than proactive and seldom challenge boards in sufficient number to make a difference.
- Companies need to do more and it is in their interests to support constructive engagement with their shareholders.
- The equity share of institutional investors continues to increase but their voting behaviour suggests that they can have important conflicts of interest. Many institutional investors are still not playing an active, informed role and when compelled to vote, the reaction often appears to be mechanical.
- Institutional investors (and others) should not be discouraged from acting together in the individual shareholders meetings, both through consultation before the meeting and the presentation of common proposals, provided that they do not intend to obtain the control of the company.
- Even though barriers to voting (e.g., share blocking) do not fully explain low voting participation, they are still significant, namely with regards to cross-borders voting. Measures should be taken, both by regulators and by all the institutions involved in the voting chain (issuers, custodians, etc.) to remove remaining obstacles and to encourage the use of flexible voting mechanisms such as electronic voting. As the importance of institutional shareholders increases, greater attention needs to be given to proxy advisors and to the potential for conflicts of interest. It is also claimed that there is a danger of 'one size fits all' voting advice so that a competitive market for advice needs to be encouraged.

Problems Faced by the Developing and Transition the Economies

Many developing, emerging and transition economies lack or are just now in the process of developing the most basic market institutions. Hence, corporate governance in these societies involves a much wider range of issues. Economic growth in these countries has turned out to be lower than expected. Privatisation does not seem to have brought about the anticipated improvements in corporate efficiency. The state and "para-state" institutions such as privatisation funds remain the largest shareholders of companies. Internal owners dominate in many companies, while the external owners do not have enough voting power to control the companies and thereby to ensure for themselves appropriate returns. The capital markets are just developing and do not facilitate the inflow of new capital as intended. Further, market transactions are often based on the abuse of inside information.

In the developed market economies, a system of corporate governance has been built gradually through centuries, and today it can be defined as a complex mosaic consisting of laws, regulations, politics, public institutions, professional associations and codes of ethics. However, in the transition economies, a lot of details of the mosaic are still missing. Trying to develop a system of good corporate governance in these countries is made difficult by problems such as complex corporate ownership structures, vague and confusing relationships between the state and the financial sectors, the weak legal and judicial systems, absent or under-developed institutions and scarce human resource capabilities.

Many developing, emerging and transition economies lack or are just now in the process of developing the most basic market institutions. Hence, corporate governance in these societies involves a much wider range of issues. Privatisation does not seem to have brought about the anticipated improvements in corporate efficiency. In the developed market economies, a system of corporate governance has been built gradually through centuries, and today it can be defined as a complex mosaic consisting of laws, regulations, politics, public institutions, professional associations and codes of ethics.

The need for corporate governance in the developing, the emerging and the transition economies extends far beyond resolving problems stemming from the separation of ownership and control, which is the core and substance behind the need for corporate governance. The developing and the emerging economies are constantly confronted with issues such as the lack of property rights, the abuse of minority shareholders, contract violations, asset stripping and self-dealing. To make matters worse, these acts often go unpunished. This is because many developing, emerging and transition economies lack the necessary political and economic institutions to enable democracy and markets function effectively. Without these institutions, corporate governance measures will have little impact. Hence, in the context of the developing, the emerging and the transition economies, instituting corporate governance entails establishing democratic, market based institutions as well as sound guidelines to make companies run internally.

For instance, even in some leading developing countries like India which have the benefit of democratic institutions and equity culture for well over five decades, there have been a series of scams involving huge sums of public funds denting seriously investors' confidence. The judiciary is so lethargic and bureaucratic that it takes more than a couple of decades to bring scamsters to book. Regulatory bodies are not alert, government appointees in Boards are lax, partisan politics and corruption in government and bureaucracy hardly play their roles in effectively stemming the damages caused by corporate misgovernance.

In other transition economies, the problem is still worse, as they lack democratic institutions and corporate culture apart from their having an overdose of bureaucratic management. In the process of establishing an equity culture, transparency in governance and building democratic institutions and regulatory bodies that function within them, much time is lost and more damage is done to a proper democratic corporate governance. Some of the problems faced by these economies are given below:

- Lower economic growth.
- Dominant public sector—the general perception is that corporate governance is meant for the private sector and the public sector does not fall within its purview.
- A Lack of effectiveness of privatisation.
- A Lack of awareness among shareholders.
- Greater government influence, and less autonomy to enterprises.
- Largest shareholders in most of the companies are the private funds.
- Internal owners dominate more than a company's external owners. Given their discretionary powers, company managers use the company resources to their own advantage. Investors, therefore, cannot get their returns from cash flow of the company from the projects.
- External owners do not have enough voting power.
- Concentration of ownership in the hands of a few individuals and family-owned corporations.
- A Lack of strong legal protection for investors in the developing countries that leads to the concentration of ownership which is used as a means to overcome the power of the management. This, in turn, leads to expropriation of minority interests.
- Capital markets are underdeveloped and do not facilitate the inflow of new capital. The foreign investors are wary of these markets and hence hesitate to invest in these countries.
- Market transactions are often based on internal information, and are often manipulative.
- Redrawing property rights and contract laws are slow in coming.

Some of the problems facing these economies are lower economic growth, dominant public sector, a lack of awareness among shareholders, greater government influence, and less autonomy to enterprises.

- Lack of well-regulated banking sector.
- Exit mechanisms, bankruptcy and foreclosure norms are absent.
- Sound securities market does not exist.
- Competitive markets have not developed.
- Corruption and mismanagement abound.
- Non-uniform guidelines—government formulated guidelines to ensure better governance are not uniformly applied to all companies. Structures of organisations, ownership and often inflexible and impractical rules stand in the way of applying these guidelines universally.

The Why and Wherefore of Corporate Governance

In most of the emerging economies, the lack of corporate governance enables insiders, whether they are company managers, company directors or public officials, ransack companies and deny public coffers their dues. They tend to enrich themselves at the expense of the shareholders, the creditors and other stakeholders such as the employees, the suppliers, the general public and public authorities.

Globalisation and financial market liberalisation have exposed companies to fierce competition and to considerable capital fluctuations. To expand and be internationally competitive, companies need a large quantum of capital that exceeds traditional funding sources. Failure to attract adequate levels of capital threatens the very existence of individual firms and can have dire consequences for entire economies. Before committing such large funds, investors especially institutional investors require evidence that companies are run according to sound business practices that minimise the possibilities for corruption and mismanagement.

For countries in transition, such as those of Russia and other Eastern European societies, that are forced to adopt capitalistic norms of governance in preference to the erstwhile socialistic system, the problem of good corporate governance development becomes more complicated due to the under-developed institutional infrastructure. The importance of a sound corporate governance for transition economies can be explained through its main influences: creation of the key institution which drives the successful economic transformation to a market-based economy, effective allocation of capital and development of financial markets, attracting foreign investment and making a contribution to the process of national development. Corporate governance requires coherent and strict legal regulations which imply an urgent mission for the makers of economic policies of countries in transition. Furthermore, it is important to provide for systems to recruit, train and reward professional managers who held to high standards of competency, ethics, and responsibility.

Corporate governance is directly related to financing and investments. For the countries in transition, the scarcity of domestic savings demands that capital should be directed towards the most profitable companies, which is possible only if the principles of corporate governance are given publicity, transparency and monitoring; in addition, due to the imperfection in market mechanisms (under-developed stock and bond markets and an ineffective banking system), corporate governance presents an additional mechanism for discipline and effective management control in corporations. International capital flows enable companies to tap sources of financing from a great number of investors. If countries want to take full advantage of global capital markets and if they want to attract long-term capital, they must follow clear standards of corporate governance at the international level. The degree to which corporations use basic principles for good corporate governance is a relevant factor for investment decisions as well. It is especially important when we talk about direct investments, which are of the greatest benefit to countries in transition because they bring not only capital, but

managerial skills, technology and know-how as well. Corporate governance is just as important for the public sector firms as for the private sector companies. Instituting corporate governance within public sector firms has recently begun to receive increased attention. This is particularly the case when countries are attempting to curb widespread corruption within the public sector, or when they are preparing the public enterprises for privatisation.

Defining Corporate Governance

In its narrowest sense, corporate governance can be viewed as a set of arrangements internal to the corporation that define the relationship between the owners and the managers of the corporation. Corporate governance "...is the relationship among various participants in determining the direction and performance of corporations. The primary participants are (1) the shareholders, (2) the management and (3) the board of directors."

The World Bank defines corporate governance from two different perspectives. From the standpoint of a corporation, the emphasis is put on the relations between the owners, management board and other stakeholders (employees, customers, suppliers, investors and communities). Another perspective in defining corporate governance is called "path dependence" where initial historical conditions matter in determining the corporate governance structures that are prevalent today. So, a nation's system of corporate governance can be seen as an institutional matrix that structures the relations among owners, Boards, and top managers, and determines the goals pursued by the corporation.[1]

The OECD'S (1999) original definition is: "Corporate governance specifies the distribution of rights and responsibilities among different participants in the corporation, such as the Board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance."[2]

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Corporate Governance Models

The countries with developed economies apply two different systems of corporate governance—the group-based system and the market-based one or as they are often referred to as the insider and outsider systems.

Insider System

In the concentrated ownership structures, ownership and/or control is concentrated in the hands of a small number of individuals, families, managers, directors, holding companies, banks and/or other non-financial corporations. Most countries, especially those governed by civil law, have concentrated ownership structures. Insiders exercise control over companies in several ways: own the majority of the company shares and voting rights; own some shares, but enjoy the majority of the voting rights.

Companies that are controlled by insiders enjoy certain advantages. Insiders have the power and the incentives to monitor management closely thereby minimising the potential for mismanagement and fraud. Moreover, because of their significant ownership and control rights, insiders tend to keep their investment in a firm for longer periods. As a result, insiders tend to support decisions that will enhance a firm's long-term performance as opposed to decisions designed to maximise short-term gains.

Developed countries apply two different systems of corporate governance—the insider and outsider systems. The insider system: ownership and/or control is concentrated in the hands of a small number of individuals, families, managers, directors, holding companies, banks and/or other non-financial corporations. Most countries, especially those governed by civil law, have concentrated ownership structures. In the outsider system owners rely on independent board members to monitor managerial behaviour and keep it in check. As a result, outsider systems are considered more accountable and less corrupt and they tend to foster liquid capital markets. Despite these advantages, dispersed ownership structures have certain weaknesses.

However, insider systems predispose a company to certain corporate governance failures. One is that dominant owners and/or vote holders can bully or collude with management to expropriate the firm's assets at the expense of minority shareholders. This is a significant risk when the minority shareholders do not enjoy legal rights. Similarly, when managers control a large number of shares or votes they may use their power to influence board decisions that may directly benefit them at the company's expense.

In short, insiders who wield their power irresponsibly waste resources and drain company productivity levels; they also foster investor reluctance and less liquid capital markets. Shallow capital markets, in turn, deprive companies of capital and prevent investors from diversifying their risks.

Outsider System

Dispersed ownership is the other type of ownership structure. In this scenario, there are a large number of owners each holding a small number of company shares. Small shareholders have little incentive to closely monitor a company's activities and try not to be involved in management decisions or policies. Hence, they are called outsiders, and dispersed ownership structures are referred to as outsider systems.

Common Law countries such as the UK and the US tend to have dispersed ownership structures. The outsider system or the Anglo–American, market-based model is characterised by the ideology of corporate individualism and private ownership, a well-developed and liquid capital market, with a large number of shareholders and a small concentration of investors. The corporate control is realised through the market and outside investors.

In contrast to the insider systems, the owners in the outsider systems rely on independent board members to monitor managerial behaviour and keep it in check. As a result, the outsider systems are considered more accountable and less corrupt and they tend to foster liquid capital markets. Despite these advantages, dispersed ownership structures also have certain weaknesses. Dispersed owners tend to be interested in short-term profit maximisation and they approve policies and strategies that will yield short-term gains, but may not necessarily promote long-term company performance. At times, this can lead to conflicts between the directors and the owners, and to frequent ownership changes because the shareholders may divest in the hopes of reaping higher profits elsewhere, both of which weaken company stability. Small-scale investors have less financial incentive to vigilantly monitor boardroom decisions and to hold directors accountable. As a result, directors supporting unsound decisions, instead of being removed, remain on the board, which is against the company's interest.

In the outsider model, the discussions about corporate governance are focussed on the responsibility of corporate managers, the lack of control and direct supervision from the owners' part, and the imperfection of existing control and compensation mechanisms.

It is evident that both the insider and the outsider systems have inherent risks. Failure to institute the appropriate mechanisms to reduce these risks jeopardises the well-being of entire economies. Corporate governance systems are designed to minimise these risks and to promote political and economic development. An effective corporate governance system relies on a combination of the internal and external controls. Internal controls are arrangements within a corporation that aim to minimise risk by defining the relationships between the managers, the shareholders, the boards of directors, and the stakeholders. In order to have meaningful effect of these measures, they must be buttressed by a variety of extra-firm institutions or external controls tailored to a country's environment.

Developing a Corporate Governance Framework

There are the following three different ways in which owners maintain control over the work of management:

1. The owners directly influence the corporate strategy and the selection of the top management team
2. The owners delegate their rights to the board, but ensure that compensation and other incentives are aligned with the share price maximisation.
3. The owners rely on the market mechanisms of corporate control, such as takeover, when due to a decreasing share price new owners take over a company and change management in order to rehabilitate the company and increase its market value.

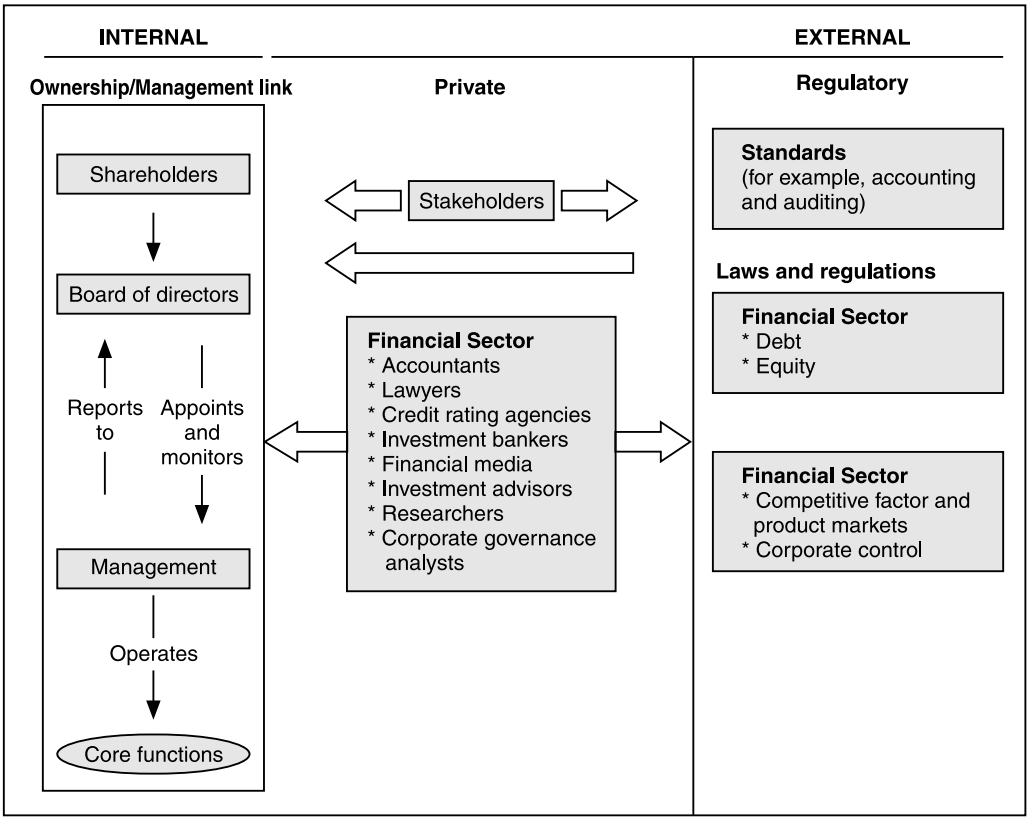
There are three different ways that owners maintain control over the work of management. The owners directly influence the corporate strategy and selection of the top management team, the owners delegate their rights to the board, but ensure that compensation and other incentives are aligned with share price maximization and the owners rely on the market mechanisms of corporate control, such as takeover, when due to a decreasing share price new owners take over a company and change management in order to rehabilitate the company and increase its market value.

In other words, the corporate governance mechanisms can be both internal and external.[3] There are two basic dilemmas connected with the corporate governance problem in transition economies. First, is it possible to have the identical framework that has evolved over centuries in the developed market economies for the emerging markets, or is it better to adapt the system of corporate governance to the specific circumstances of a transition economy?

The framework for the implementation of corporate governance in developed economies is explained by the World Bank, as shown in Figure 17.1.

Figure 17.1

Modern corporations are disciplined by internal and external factors



Source: World Bank, Corporate Governance: Framework for Implementation, Overview, 1999, www.worldbank.org., p.5.

It can be observed from the illustration of the framework that there are internal and external forces that interface and interact with one another and have an impact on the behaviours and activities of corporations. While the internal forces define the relationships between and among the key players of the corporation, the external forces help in effecting the discipline and conduct of beahviours.

In the developed market economies, especially of the West, as the illustration depicts, these forces are institutions and policies that ensure greater transparency by monitoring and effecting discipline among corporations. Examples of external forces include the legal framework for ensuring competition among corporates, the legal machinery to protect rights and privileges of shareholders, the system of accounting and auditing, a well-regulated financial system, the bankruptcy system and the market for corporate control. One could easily envisage the situation wherein the internal and the external forces combined together create a range of corporate governance systems, reflecting market structures, legal framework, rules and regulations, traditions, precedents and perceptions, cultural and social values.[4]

The second dilemma involves the question of the appropriateness of the mechanism used for corporate governance. The existing corporate governance literature is almost exclusively concerned with the external mechanisms—accounting transparency to improve the accuracy of stock market valuations, regulatory pursuit of fraud, the role of the shareholders' general meeting, "disciplinary" takeovers, legal requirements for the appointment of "external" directors. In these external mechanisms, the crucial role belongs to the well-developed stock market or to the monitoring role of the banks. Unfortunately, in the transition economies these mechanisms of market discipline hardly work because of the lack of such institutions as the stock markets and an efficient banking sector.

The Institutional Framework for Effective Corporate Governance

As we have seen earlier, the developing countries and the transition economies lack the required framework to put in place the best corporate governance practices. The following are the desiderata for such a framework:

Developing countries and transition economies lack the required framework to put in place best corporate governance practices. They need to develop property rights contract laws and a well-regulated banking sector.

1. **Property rights:** It is essential that property rights, laws and regulations establish simple and straightforward standards to specify clearly who owns what and how these rights can be combined or exchanged (for example, through commercial transactions), and standards for recording required information (such as the legal owners of property, whether the property has been used as loan collateral, etc.) in a timely and cost-efficient manner into an integrated, publicly accessible data base. Investors will be extremely reluctant to provide capital to firms without legally stipulated and enforced property rights.
   In this context, there are a few key types of legislation. The first is a legislation that gives corporations jurisdical personality by recognising their existence as legal "persons" independent of their owners, establishes corporate chartering requirements, and limits corporate owners' liability to the value of their equity in the corporation. The second is the legislation that permits the establishment of joint stock companies.
2. **Contract law:** Very few business transactions will occur without such legislation and regulations that legally guarantee and enforce the sanctity of contracts. It is essential that such institutions protect suppliers, creditors, employers, employees and so forth. Without such legislations that protect the sanctity of the system of contracts, industries, trade, business and commerce can not have an easy and uninterrupted supply of factors of production, raw materials, components, etc.

3. **A well-regulated banking sector:** A healthy banking system is an absolute prerequisite for a well-functioning stock market and corporate sector. The banking sector provides the necessary capital and liquidity for corporate transactions and growth. Good governance within the banking system is especially important in the developing countries where banks provide most of the finance. Moreover, financial market liberalisation has exposed banks to more fluctuations and to new credit risks. As evidenced by the Asian and Russian crises, poorly governed banking systems and massive capital flight can seriously damage national economies.

   The banking framework is based on three pillars: minimum capital requirements, supervisory review of an institution's internal assessment process and capital adequacy and effective use of disclosure to strengthen market discipline as a complement to supervisory efforts. The first, minimum capital requirements, provides banks and supervisors with a range of tools to accurately assess different types of risks so that a bank has an adequate amount of capital to cover these risks. Determining the accuracy of capital adequacy requirements, is useful only if such requirements are upheld. To this end, each bank has a set of policies and procedures to ensure adequate capital requirements, in particular, and a sound bank management, in general. Such measures include undertaking credit risks, monitoring and disciplining large borrowers effectively, and adhering to stringent auditing procedures. In the end, it is the results of these internal processes that count and these depend on two factors. The first is an effective corporate governance of borrowers, usually firms. Banks need accurate information about a firm's condition in order to assess risks appropriately. This demands that a company has well-documented and thoroughly audited books that are to be made available to banks.

   The second, the supervisory review process is designed to have effective monitoring mechanisms that ensure compliance. Based on a set of standards, supervisors review a bank's internal processes in order to determine the extent to which these measures assess the bank's capital adequacy needs relating it to a thorough evaluation of risks. The third, the new framework, bolsters the first two by strengthening disclosure requirements and thereby enhancing market discipline. The only way that market participants can evaluate the soundness of their dealings with banks is whether they can understand and have access to banks' risk profiles and capital adequacy positions in a timely manner. Regular disclosure of this information will discipline banks because market participants will flock to banks that have sound practices and are financially viable. Market participants will avoid banks that take excessive risks without adequate capital provisions, and possibly those that do not undertake enough risk in order to remain competitive. Disclosing banks' risk assessments can also improve corporate governance. Banks' company risk rankings provide important information about a corporation's financial viability. Shareholders can use this information to press managements changes or to discipline managements by shifting their capital elsewhere.

   Similarly, disclosing information about the banks' ownership structures and relationships with other firms or the public sector fosters good governance of banks and corporations, and helps prevent moral hazard and financial meltdowns. Many developing countries experienced financial crises that stemmed from the undisclosed transactions that were not conducted at arm's length. Examples include the frequent and substantial direct or connected lending by banks to firms in the bank's business group that were not creditworthy. When this happens on a large scale, the impact can be as great as any other economic shock. In short, links between the government, banks and corporations should be at least disclosed so that shareholders and board

members can respond accordingly, and, at best, served. Similarly, there is an increasing discussion about whether or not the developing countries should require that the commercial and the investment banking activities be separated.

4. **Exit mechanisms: bankruptcy and foreclosure:** Because not all corporate endeavours succeed, legislation that establishes orderly and equitable clearing and exit mechanisms is essential so that investments can be liquidated and reallocated into productive undertakings before they are squandered completely. What is herein necessary are laws and regulations that require financial and non-financial entities to adhere to rigorous disclosure standards concerning their debts and liabilities; and laws and procedures that allow for swift, efficient bankruptcy and foreclosure proceedings that are equitable to the creditors and other stakeholders alike. The lack of transparency regarding company and bank debts was a major factor behind the Asian and Russian financial crises. Moreover, the lack of adequate and/or enforced bankruptcy and foreclosure procedures facilitated widespread asset-stripping by insiders.
5. **Sound securities markets:** Efficient securities market discipline insiders by sending price signals rapidly and allowing investors to liquidate their investment quickly and inexpensively. This affects the value of a company's shares and a company's access to capital. A well-functioning securities market requires laws governing how corporate equity and debt securities are issued and traded, and stipulating the responsibilities and the liabilities of securities issuers and market intermediaries (brokers, accounting firms and investment advisers) that are based on transparency and fairness. In particular, laws and regulations governing pension funds and allowing for open-ended mutual funds are extremely important; Stock-Exchange listing requirements should be based on transparency and stringent disclosure standards—independent share registries would be useful in this regard, laws protecting minority shareholders' rights and a government body such as a Securities Commission that has independent and qualified regulators empowered to regulate corporate securities transactions and to enforce securities laws.
6. **Competitive markets:** The existence of competitive markets is an important external control on companies forcing them to be efficient and productive lest they lose market share or go under. The lack of competitive markets discourages entrepreneurship, fosters management entrenchment and corruption and lowers productivity. For this reason, it is crucial that laws and regulations establish a commercial environment that is fair, yet competitive. To this end, governments can do the following:
   - Remove barriers to entry.
   - Enact competition and anti-trust laws.
   - Eliminate protectionist barriers including the protection of monopolies.
   - Eliminate preferential treatment schemes such as subsidies, quotas, tax exemptions, etc.
   - Establish fair trade priorities.
   - Remove restrictions on foreign direct investment and foreign exchange.
   - Reduce the cost of setting-up and running a formal business.
7. **Transparent and fair privatisation procedures:** Having transparent, straightforward and fair rules and procedures stipulating how and when enterprises can be privatised is, therefore, essential. Ill-designed privatisation schemes can devastate an economy and negatively influence the business environment. This has been proved time and again in many transition economies and the emerging markets.
8. **Transparent and fair taxation regimes:** Taxation systems should be reformed so that they are fair, simple and straightforward. In this regard, multi-step, complex procedures on fiscal reporting that allow officials to exercise considerable

Emerging economies have to put in place transparent and fair privatisation procedures, Transparent and fair taxation regimes, an independent, well-functioning judicial system, strengthened administrative and enforcement capacity of government agencies and establish routine mechanisms of participation.

discretion and therefore engage in corruption should be eliminated. Tax laws and regulations should also require adequate and timely disclosure of financial information, and should be enforced, consistently, timely and effectively.

9. **An independent, well-functioning judicial system:** One of the most important institutions of a democratic, market-based economy is an independent, well-functioning judicial system that enforces laws consistently, efficiently and fairly, thereby maintaining the rule of law. The judiciary should be alert, efficient and proactive and should be able to dispense justice fairly and speedily.
10. **Anti-corruption strategies:** One of the major factors that promotes, corporate misgovernance is corruption which is the by-product of controls, bureaucratisation and excessive governance. The State should implement effective anti-corruption measures by specifying and streamlining legal and regulatory codes and clarifying laws on conflict of interest. This will lead to a better corporate governance.
11. **Reform government agencies:** Government agencies that are excessively bureaucratic and inefficient need to be reformed. This can be accomplished by streamlining and simplifying agencies' internal operating procedures and by regularly evaluating agencies' performance according to clear, well-defined standards. Measures to improve poorly performing agencies need to be implemented promptly and comprehensively. For example, when exported and imported goods are held up for lengthy periods of time in government-owned ports by the customs authorities, entrepreneurs' costs increase and the competitiveness of these goods decreases; moreover, the temptation to ask for and pay bribes to speed up the process increases.
12. **Strengthen administrative and enforcement capacity of government agencies:** Governments in these economies should strengthen and maintain their agencies' administrative and enforcement capacity by cultivating a staff of well-qualified civil servants, hiring and promoting staff based on verifiable professional standards (through standardised tests), offering civil servants vocational training based on the latest technology, paying adequate salaries to attract well-qualified professionals and to deter bribe-taking, and offering tenure based on performance. The capacity of government agencies can also be strengthened by providing sufficient financial and technical resources to administer laws expeditiously.
13. **Establish routine mechanisms of participation:** Establishing the necessary institutional framework for corporate governance to take root requires reforming many existing laws and regulations and creating new ones. In order to ensure that the new framework creates a level playing field, citizens need to have ample opportunity to participate in grafting it. To ensure this, establishing routine mechanisms to participate in the policymaking process on a daily basis are required.
14. **An investigative and well-informed media:** A well informed and committed media plays a very significant role in ensuring corporate governance. The role of the Fourth Estate (Media) in ensuring corporate democracy cannot be overstressed, and can be considered as important as its role in ensuring that political democracy functions as well as it is intended to be. Many a scam in the corporate world would not have come to the limelight but for the bold and upright investigation of journalists. At the same time, journalists and the media they represent also have the responsibility to bring to light and commend the good deeds the corporates do just as they condemn their misdeeds.
15. **Strengthening reputational agents:** Reputational agents are individuals and/or groups that reduce the information gap between the insiders and the outsiders by seeking and providing information to the outsiders about the performance of the insiders and enterprises and by setting high professional standards and then applying peer pressure and, at times, sanctions to

uphold them. Reputational agents can also "refer to private sector agents, self-regulating bodies, the media and civic society that reduce information assymmetry, improve the monitoring of firms, and shed light on opportunistic behaviour". For this reason, it is important to provide the necessary training and environment in which such agents can thrive. Examples of reputational agents include the following:

- Self-regulation bodies such as accounting and auditing professionals
- The media
- Investment bankers and corporate governance analysts
- Lawyers
- Academicians, economists and corporate analysts
- Credit rating agencies
- Consumer activists
- Environmentalists
- Activist investors and shareholders such as institutional investors and venture capitalists
- Non-government Organisations (NGOs)

Each of these individuals or groups has a particular type of expertise, and the resources and responsibilities to undertake intensive monitoring to bridge the information gaps between the insiders and the outsiders.

Sound Stakeholder Relationships are Good for Business

A common misconception is that achieving profits and looking after stakeholders' interests are diametrically opposite goals. Operating fairly, responsibly, transparently and accountably towards both the shareholders and other stakeholders does more than improving a company's reputation and attract investment; it gives the corporation a competitive advantage. Firms rely on the stakeholders to provide a series of essential inputs such as labour, components, spare parts and other supplies on a predictable basis. Interruptions in the supply of these goods and other services will harm the company's ability to operate, sell its products and thus survive—let alone make profits. Hence, cultivating and maintaining productive relationships with the stakeholders is in a company's best, long-term interest.

A company's treatment of other stakeholders such as suppliers is just as important to the company's long-term performance. A firm that breaks a contract with a supplier or pays unfair prices not only hurts the supplier, but damages its own reputation as a reliable and honest business partner. Other suppliers will be reluctant to conduct business with this company thereby jeopardising the supply of crucial inputs. Moreover, firms that switch suppliers solely based on cost considerations may wind up with an inferior final product that could jettison their overall sales levels and reputation.

In short, firms that treat the stakeholders fairly and include them in long-term strategy-planning sessions, minimise the risk that these stakeholders will use their power to extort resources from the company by charging exorbitant fees for specialised inputs—whether it be parts of technical assistance—or by failing to uphold contracts. The stakeholders will quickly realise that their fate hinges partly on the firm's performance and *vice versa*.

Healthy relationships between firms and stakeholders can also boost a company's market share. Employees (whether company staff, suppliers or vendors) that are well-paid and enjoy stable jobs or contracts will have the money and the incentive to buy the firm's products thereby increasing the company's value and profits.

There are other ways through which companies can increase profits while offering stakeholders, benefits. A firm that provides infrastructure, education and

training programme gives the community useful resources. Local citizens and policymakers will, in turn, have an incentive to return the favour by providing the company with a hospitable business climate in terms of laws and regulations. This can greatly reduce a firm's operating costs thereby enhancing competitiveness and increasing profits.

Corporate Governance Challenges in Developing, Emerging and Transition Economies

Establishing any one of institutions enumerated above is a necessary and challenging undertaking without which democratic markets and corporate governance cannot take root. Success requires that the private and the public sectors work together to establish the necessary legal and regulatory framework and a climate of trust through ethical behaviour.

While the set of institutions described above is designed to be comprehensive, each region is in a different stage of establishing a democratic, market-based framework and a corporate governance system. Hence, each nation has its own particular set of challenges. Some of the general challenges confronting the developing, the emerging and the transition economies include the following:

- Establishing a rule-based (as opposed to a relationship-based) system of governance.
- Combating vested interests.
- Dismantling pyramid ownership structures that allow insiders to control and, at times, siphon off, assets from publicly owned firms based on very little direct equity ownership and the few consequences.
- Severing links such as cross shareholdings between banks and corporations.
- Establishing property right systems that clearly and easily identify true owners even if the State is the owner (When the State is the owner, it is important to indicate which State branch or department enjoys ownership and the accompanying rights and responsibilities.)
- De-politicising decision-making and establishing firewalls between the government and the management in corporatised companies where the State is a dominant or majority shareholder.
- Protecting and enforcing minority shareholders' rights.
- Preventing asset stripping after mass privatisation.
- Finding active owners and skilled managers amid diffuse ownership structures.
- Educating and enlightening investors of their rights and duties.
- Encouraging good corporate governance practices and creating benchmarks through co-operation with trade associations.
- Establishing regulatory bodies that help reduce fissures through arbitrations and conciliations between competing and conflicting parties.
- Promoting good governance within family-owned and concentrated ownership structures.
- Cultivating technical and professional know-how.

Corporate Governance Is Not Only a Private Sector Affair

In many developing, emerging, and transition economies the public sector companies contribute more to the nation's gross national product, employment, income, and capital use than the private sector firms. Moreover, the public sector companies often shape public policies. As a result, instituting sound corporate

In many emerging, economies public sector companies contribute more to the nation's gross national product, employment, income, and capital use than private sector firms apart from shaping public policies. As a result, instituting sound corporate governance practices within public sector companies is essential to economic development, growth and reform.

governance practices within public sector companies is essential to economic development, growth and reform. To begin with, public companies need to be corporatised before they can be privatised. The corporatisation process can, at times, be lengthy. Even after corporatisation, it takes time before the new company benefits from the active owners and the skilled managers. In the meantime, a good management of the company will ensure that the company's resources are managed efficiently and fairly thereby increasing the company's productivity and value. There are other scenarios calling for governance practices within the public sector. Public companies, for example, may gain control of previously privately owned firms through joint ventures. In addition, some public economic entities may never be privatised because they are considered vital to the national security or politically sensitive. Obviously, these companies would benefit from sound corporate governance practices. This can be enhanced through granting of financial and managerial autonomy which will reduce political interference, nepotism, corruption and other such evils.

Successful Strategies—One Size Does Not Fit All

Many international organisations are funding corporate governance initiatives that aim to put in place the developed country models of corporate governance. More often than not, this fails to instill or improve corporate governance because these models are not designed for local realities and challenges. As a result, indigenous groups are then faced with the task of adapting the international model to the local conditions. In India, for instance, attempts by international organisations such as the World Bank, the International Monetary Fund and the WTO to promote transparency, accountability and such healthy practices have not been taken kindly by a vast section of political spectrum. The critics complain that these west-based organisations try to transplant systems and procedures that are workable in the West, but are unsuitable in the developing economies that have different cultures, work ethics, employer–employee relations and so on.

The countries in transition face problem of corporate governance in a paradoxical situation. Their corporate sector consists of "instant corporations" formed as the result of mass privatisation, without the simultaneous development of legal and institutional structures necessary to operate in a competitive market economy. The business environment is without the set of elements needed for making competitive relationships, which provides an advantage to old, large, dominant companies and discourages entrepreneurship and the appearance of new companies. The role of the State in the transition economies is ambiguous. On the one hand, the role of the State in post-socialism should be limited. On the other hand, strong State power is needed to carry through the political programmmes required by economic transformation.

Current Corporate Governance Settings in Transition Economies

In the emerging economies, the term "corporate governance" is new, yet it has caught on rapidly. A set of formal legal frameworks, often modeled after the Anglo–American system, frequently exists. Nearly all firms have shareholders, boards, and "professional" managers, which are the components of modem corporate governance. However, the similarities in governance between the emerging and the developed economies are often more in form than in substance.

The countries in transition are facing the problem of corporate governance in a specific way. Their corporate sector consists of "instant corporations" formed as a result of mass privatisation, without the simultaneous development of legal and institutional structures necessary to operate in a competitive market economy. Under the circumstances of diffused ownership, it enables insiders to strip assets and leave little value for minority shareholders.[5]

The business environment is without the set of elements needed for making competitive relationships, which, provides an advantage to the old, large, dominant companies and discourages entrepreneurship and the appearance of new companies. Unstable macroeconomic conditions create a situation of great uncertainty and shorten the time horizon in business. Under unpredictable economic circumstances, managers see their positions as temporary and uncertain which leads to maximising their own profit, instead of maximising the company's profit.

The role of the State in the transition economies is ambiguous. On the one hand, the role of the State in post-socialism should be limited. On the other hand, strong State power is needed to carry through the political programmmes required by economic transformation. Weak governments have proved to be incapable of economic transformation. In reality, the State still has a great role in both the industrial and the financial sectors. The State authorities and the company managers are tightly related, so that the line between the "controllers" and the "controlled" is unclear. In practice, informal constraints, such as relational ties and family and government contacts play a greater role, leading to different outcomes.

The State gives subsidies to companies directly or indirectly while on the other hand, companies enable State representatives to have a certain amount of control over the process of making decisions and cash flow. Behaving in such a way, managers are constantly searching for new subsidies, instead of looking for existing or potential strategic partners.

The creation of networks of linked enterprises, rather than of autonomous independent firms is a relationship characteristic of transition economies. Transactions between privatised enterprises become linked to each other, to banks and to the State through complex structures of cross-shareholding and corporate interlocks. Relationships between the enterprises and the banks are especially crucial in view of the shortage of capital and credit, and continued to be influenced by personal and institutional connections. Where credit is not available from banks, barter relationships amongst organisations known to and trusted by each other provide an alternative means of financing.

In transition economies, the most important firms, such as public sector companies that contribute more to the nation's gross national product, employment, income and capital use than to the private sector firms, are controlled by the State as it was in India, prior to 1991. Moreover, public sector companies often shape public policies. From a governance perspective, State-owned firms are controlled by bureaucrats with control-rights but with no formal ownership. Although all the citizens of a country own the firms, in practice control-rights rest with the powerful ministries. As a result, citizens subsidise State firms and end up as "minority shareholders" with practically no voice.

The missing element in the context of corporate governance development in transition economies is the lack of institutions associated with successful market economies. In the market economies there is a standard set of institutions that have been successful as the tools used to control corporations. Institutions are the "rule of the game" in a society. They are the rules that society established to reduce the uncertainty of human interactions. The institutional framework has three components: formal rules, informal rules and enforcement mechanisms. While both the formal legal environment and the informal institutional constraints affect corporate governance, institutional theory states that when the formal institutions are weak, informal constraints play a larger role in shaping firm-behaviour.

Corporate Governance in Different Countries

Corporate Governance in UK

Britain has a long corporate history of about four centuries. But its corporate governance history is not as old as its corporate history. The country's legal system, based on common law and political democracy exists in the UK. A well-developed capital market with diverse shareholding pattern including individuals, financial institutions and institutional investors also exist in the UK. The major business form is public corporations as compared to family owned business in many other European countries. The country's corporate governance is based on agency theory with the Anglo American model of corporate governance. Strong emphasis is given

to transparency, fiduciary responsibility and protection of minority interest, full disclosure and Board's responsibility with regards to compliance aspects. The UK follows 'Comply or explain' principle, i.e., the company has to fully comply the corporate governance codes, if not, explain the reason why it is not possible to comply with certain provisions.

UK Corporate Governance

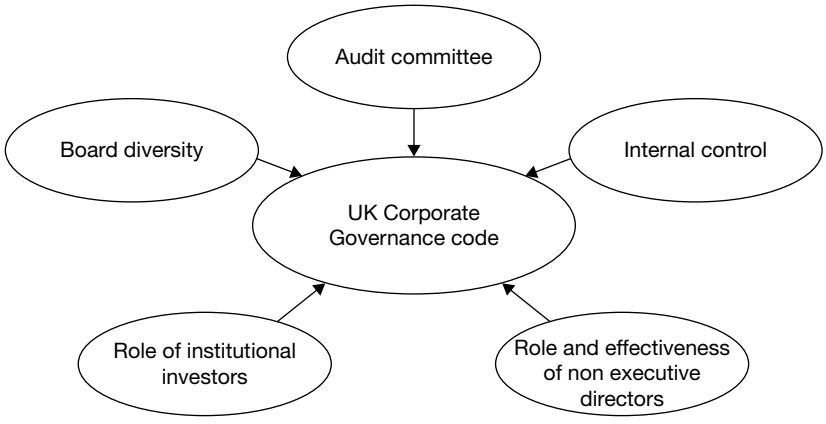
The UK CG code is based on the Cadbury Committee (1992) report dealing with board composition and functioning of board committees, the Greenbury Committee (1995) dealing with strengthening accountability and enhancing performance of directors, the Hampel Committee (1998) dealing with board relationship with stakeholders, the Turnbell Committee (1997) dealing with sound system of internal control, etc.

Combining the recommendations of these committees' reports the first comprehensive code of corporate governance was published in 1998 by the Financial Reporting Council of UK. The code specified several issues such as 1) internal control, 2) role of institutional investors, 3) role and effectiveness of non-executive directors, 4) audit committee and 5) board diversity. It was followed by the introduction of Stewardship code to address the issue of institutional investors.

Comply or explain is the main principle followed in the UK.

Financial crisis and the resultant corporate failures are the main reasons for the development of strict code of governance around the world. In the UK also the corporate collapse and financial frauds of late 1980s and early 1990s led to the development of a strong corporate governance code. Post corporate crisis and frauds forced the UK government to appoint several committees to study various aspects of corporate governance to prevent the corporate crisis. The most important among them are Cadbury Committee (1992) dealing with board composition and functioning of board committees, the Greenbury Committee (1995) dealing with strengthening accountability and enhancing performance of directors, the Hampel Committee (1998) dealing with board relationship with stakeholders , the Turnbell Committee (1997) dealing with sound system of internal control, etc. Combining the recommendations of these committees' reports the first comprehensive code of corporate governance was published in 1998 by the Financial Reporting Council of UK. The Code specified several issues such as (1) internal control, (2) role of institutional investors, (3) role and effectiveness of non-executive directors, (4) audit committee and (5) board diversity. It was followed by the introduction of Stewardship Code to address the issue of institutional investors.

UK Corporate Governance Code



The UK company law has also a strong influence on the corporate governance system. Since the influence of 'outsiders' in corporate shareholding pattern is very high as in the case of the USA the influence of US, Sarbanes-Oxley Act has also a strong influence in the corporate governance system of the UK. Based on all these reports and codes, in 2010 a comprehensive corporate governance code was introduced called 'Combined code' adopting the principle of 'Comply or explain'. In addition to the five aspects covered in the earlier code, the following aspects were introduced in the new code:

1. Risk management.
2. Performance related pay to board of directors.
3. All directors must come under re-election every year as a way to increase accountability.
4. New principle introduced on the compensation and selection of BOD on merit and ensuring gender diversity in board.

This code was again modified in 2012 by issuing another code namely the UK corporate governance code 2012. Two modifications were incorporated from the earlier code, namely (1) work of nomination-committee described and (2) ensured a balance of skills, experience, independence and knowledge of the company on the board diversity including gender diversity.

Corporate Governance in Russia

Ever since the Soviet revolution and the establishment of communist government in Russia, the country's corporate ownership was also reached in the hands of the State. Several decades of State governance ruined the country. Nepotism, favouritism and inefficient poor governance were the hall-marks of the governance system. Bureaucracy dominated the administration of Soviet Union. The disintegration of the East with the Soviet Union and the collapse of communist government in Russia created a new wave of privatisation and globalisation of business and industry through the system of 'Voucher Auction'. During the early 1990s most of the big companies with a worker strength of above 1000 and not less than 50 million rubbles book value of assets were brought under the privatization plan and around 15,000 companies satisfying the above conditions were privatized during 1993–94 period.

Most of the shares of these companies were acquired by managers and workers of the companies and some financial and non-financial firms in Russia and some retail investors. After privatization also, all the fragmented share holdings of workers were acquired by the managers. All these contributed to a high degree of 'insider' ownership in Russian corporate structure. This has become a threat to outside ownership particularly overseas investors.

Russian Corporate Governance Code

Essentially Russian code is based on OECD corporate governance principle, but has also taken from other international codes. The OECD principles emphasize six principles such as ensuring an effective corporate governance framework. Emphasis on the right of shareholders as key stakeholders. Equitable treatment of all shareholders. Role of other stakeholders in corporate governance. Disclosure and transparency and Board of Directors responsibility.

The Russian code envisages dual board system consisting of the board of directors and the executive board headed by the CEO. The director board is elected or nominated from shareholders. It is estimated that 25 per cent of the directors with not less than three must be independent directors, Board committees are an integral part of Russian CG.

The main characteristics of corporate structure in Russia are as follows:

(a) Corporate share holding pattern is highly concentrated in the hands of insiders consisting of managers and workers. Approximately 47 per cent of the shares are held by these two groups and $2 per cent shares are held by financial and non-financial institutions and retail investors. The State holds only 7 per cent of the shares. Over the years outsiders share is showing an increasing trend. Hence, in Russian corporate governance the conflict between insiders and outsiders is a major issue.
(b) Russia in common with other developing economies is moving towards market economic system from the State controlled economic system.
(c) Minority interests are not adequately looked after in the Russian corporate governance as also the foreign investor's interest.
(d) Like in most European countries Russia also follows civil law system.

Salient Features of Corporate Governance of Russia

1. The present corporate governance of Russia is based on the corporate governance code issued by the federal commission in 2001.
2. Essentially Russian code is based on OECD corporate governance principle, but has also taken from other international codes. The OECD principles emphasise six principles such as:
   (a) Ensuring an effective corporate governance framework.
   (b) Emphasis on the right of shareholders as key stakeholders.
   (c) Equitable treatment of all shareholders.
   (d) Role of other stakeholders in corporate governance.
   (e) Disclosure and transparency and
   (f) Director Board's responsibility.
3. The Russian code envisages dual board system consisting of the Board of directors and the Executive Board headed by the CEO. The director board is elected or nominated from shareholders. It is stated that 25 per cent of the directors with not less than three must be independent directors. The key function of the board of directors includes strategic aspects ensuring efficient control over management, resolving corporate conflict and ensuring effective work of executive body. The executive board or management board headed by the CEO looks after the day to day operations of the company and compliance of financial and business plans of the company. There is no clear mention about the size of the management board and its selection. But it specifies that a transparent process must be followed in the selection of the CEO and the members of the management board.
4. The code explicitly envisages the board committees such as strategic planning committee, audit committee, HR and remuneration committee, and corporate conflict resolution committee. The code also prefers audit committee with independent directors only.
5. The code insists on the appointment of a company secretary which is new to the corporate governance of Russia. He has to act as a liaison officer between the company and the shareholders by providing all required information to shareholders. Any response to the shareholders must be based on the law and the company can serve as an intermediary, if there is a conflict between shareholders themselves.

6. The code ensures the effective supervision of operations of the company including the risk management by the BOD through audit committee preferably consisting of independent directors only.
7. Dividend payment is always a problem in Russia. Hence, the code always specifies that the profit figure as shown in the company's accounts must be used in deciding dividend. It also specified that the declared dividend must be paid in cash only with a set deadline which cannot exceed 60 days after announcement. If this clause is violated, the CEO is personally responsible for the delay and has to compensate.
8. The code also specifies that the company's information policy should make available to shareholders.

Chinese Corporate Governance

China, being a communist country, follows the communist economic system in its economic administration of the country. Vital economic resources are owned and controlled by the State. Economic plans and priorities are determined by the government not on basis of market requirements but on the basis of the political line of the party. Since 1990 China underwent changes in different aspects of the economic system including corporate structure and capital market. Sincere efforts were made to modernize existing stock exchanges, started new stock exchanges and improved the regulatory frame work of capital market operations with the aim of raising capital from the domestic and foreign investors to provide listed companies with new funds. During the period, business slowly moved from the status of State-controlled enterprises to joint stock companies and then to companies listed in stock exchanges. The Chinese government aimed to modernize its industry and other sectors and to expand other sectors and to move towards a socialist market economy several measures have been initiated like improving the shareholders rights, protect minority shareholders rights, insulate the company boards from inappropriate influence and ensure transparency and disclosure in its corporate governance system.

But these measures had very little impact on the overall industrialization of China. Most of the old State-owned units were harvesting gains with outdated technology, employing too many workers with low wages and running business in non-professional and non-commercial business lines. These state enterprises were subject to the influence at different levels of party leaders. It was also under the high influence of corruption and lack of transparency and disclosure. But these units were earning handsome profits because of liberal funding by the State owned Chinese banks.

Major Characteristics of Chinese Corporate Bodies

The major characteristics of Chinese business are as follows:

(a) Main business form is State-owned companies and joint stock companies.
(b) State is the main owner of these corporate bodies.
(c) Like other countries of the region like Japan and Korea, the legal system of China is based on civil law.
(d) The country follows communist economic system and the communist party's influence at all levels is very high in all economic institutions.
(e) Capital market is slowly getting developed.
(f) The power of bureaucracy is very high in China.

Essentially Based on OECD Principles
Shareholders including minority shareholders are to be treated – Dual board system with BOD and supervisory board—visualize board committees-transparency and disclosure-protection of stakeholders interest also-emphasis on CSR.

Main Features of China's Corporate Governance

The corporate governance development of China involves a number of regulatory bodies such as China Secretary Regulatory Commission, Ministry of Finance, The State Economic and Trade Commission and Central Bank of China. In 2001, China introduced a comprehensive code of governance with the following features.

(a) The code is essentially based on the OECD principles of corporate governance to protect the investor's interests and rights, basic behavioural rules and moral standards for directors, supervisors, managers and other members of the listed companies.

(b) Regarding shareholders, the code states that the company should ensure that all shareholders are to be treated fairly especially minority shareholders. They should be given equal rights, any infringement should be redressed through legal actions.

(c) Controlling shareholders should not act in a way that is detrimental to the listed company's or shareholders' legal rights.

(d) The code envisages dual board system with the BOD and the supervisory board. The BOD consists of executive directors and independent directors on election or nomination basis. At least one third of the directors must be independent directors. The BOD members must be suitably qualified with appropriate skills and knowledge. They should faithfully, honestly and diligently perform their duties for the best interest of all shareholders.

(e) The supervisory board must consist of individuals with professional knowledge in the area of law, accounting, etc., the supervisory board is also accountable to shareholders and their duty includes supervising corporate finance, monitoring directors' and managers' performance, protecting the shareholders' and company's legal rights and interests.

(f) The code also visualizes various board committees such as corporate strategy committee, Remuneration and appraisal committee, Audit committee and Nomination committee through which the directors discharge their functions. Majority of the committee members must be independent directors and also chaired by an independent director.

(g) The code also emphasises the protection of stakeholders' interest along with the protection of shareholders' interest. The company also gives attention to CSR activities.

(h) Regarding disclosure and transparency aspects the code emphasises on timely and accurate disclosure of mandatory and non-mandatory information to all the shareholders. It should also disclose the corporate governance system followed by the company.

Australian Corporate Governance

Australia, being an old British colony and at present a member of the British Commonwealth follows the economic system similar to Anglo US economic system prevailing in the UK and the USA. As a country in the Asia-Pacific region

strong in financial terms contributed significantly in developing economies of the region through APEC. Many countries of the region have recovered from their crisis because of the help of Australia. Being a British common wealth country its corporate governance system seems to have developed along the line of the Anglo US model having features that are typical to the UK unitary board structure.

A close examination of the corporate characteristics shows that on one side it is an insider the dominated corporate structure while on the other side it is an outsider-dominated structure. Dignam and Galanis summarises the various features of Australia that might lead to a doubt as to which corporate governance system it has or whether it is moving from one system to other. These features include political system which is socialist in nature which is usually associated with insider-system. The ownership of listed companies shows a dispersed pattern on one side, but the presence of a significant non institutional investors and block shareholders. The former is typically the characteristic of insider-system while the latter is the characteristic of an outsider-system. Public corporations are the main form of business in Australia and corporate or family investors are the predominant shareholders. Capital market is also well developed in the country.

Australian CG Code

The Australian CG code says that, 'good corporate governance structure encourages companies to create value and provide accountability and control system commensurate with risks involved and good corporate governance practices and increasingly important in determining cost of capital in a global capital market. Australian companies must be equipped to compete globally and maintain and promote investor confidence both in Australia and overseas'.

The code covers a wide range of issues such as (1) board structure and composition, (2) appointment of executive directors, (3) remuneration of directors, (4) risk management, (5) financial reporting and auditing, (6) issue of conflict of interest and (7) the role of company secretary in corporate governance.

The corporate governance institutions are relatively new in Australia and only in 1991, the first corporate governance code was developed on the basis of the Bosch Report on corporate Practices and Conduct. It covers a wide range of issues such as (1) board structure and composition, (2) appointment of executive directors, (3) remuneration of directors, (4) risk management, (5) financial reporting and auditing, (6) issue of conflict of interest, and (7) the role of company secretary in corporate governance.

In 2003, Australian corporate governance council issued a more comprehensive code of corporate governance and best practices which is now widely followed in Australia.

The Code says that, 'good corporate governance structure encourages companies to create value and provide accountability and control system commensurate with risks involved and good CG practices and increasingly important in determining cost of capital in a global capital market. Australian companies must be equipped to compete globally and maintain and promote investor confidence both in Australia and overseas'. To achieve this aim the following core principles are identified and listed as the essential corporate governance principles.

1. **The composition of board of directors:** The board of directors must consist of executive directors and non-executive directors and independent directors. Majority of the board must be independent directors and the Chairman should be from the independent director.

2. The role of Chairperson and the CEO should not be exercised by same individual.
3. There should be a nomination committee to nominate directors. All these details must be included in the report of corporate governance in the annual report. The system envisages unitary board only.
4. Promote ethical and responsible decision making: The Company should clarify the standard of ethical behaviour required from company directors and key executives, encourage the observance of standard and publish its policy as regards board and employees training.

The US Corporate Governance

The US economy is one of the largest economies in the world with a strong presence of corporate form of business. More than half of the top fifty companies in the world are US companies. The country follows a market driven economic system since Independence with a strong presence of financial market including capital market for mobilizing capital for the industrial development of the country. Regarding share holding pattern, a diverse shareholder base including institutional investors exists in the US. Since the government control over the economy is minimum, the country has a strong self-regulatory system in various fields including corporate governance. The GDP in the United States is worth 18,569.10 billion US dollors in 2016. The GDP value of US represents 29.95% of the world economy. Since a well-developed capital market exists, a large part of savings are flowing to capital market. Over the years Delaware has built up a body of corporate case law called Delaware corporate law in the US and that has become the norm in corporate America. This approach has been very company-friendly and a majority of the US companies listed in NYSE are registered in Delaware in order to take advantage of more flexible non prescriptive approach. This approach gives emphasis on board of directors, the authority to pursue corporate strategy and objectives whilst at the same time operating within the concept of fiduciary duty.

US Corporate Governance

US Code of Corporate Governance is based on Sarbanes-Oxley Act (20002), New York Stock Exchange Corporate Governance Rule (2003), Commission on Public Trust and Private Enterprises (2003), New York Stock Exchange Commission on Corporate Governance (2010), Delaware Corporate Law and Employees Retirement Income Security Act (1874).

Sarbanes Oxley Act focus on issues (1) related to disclosure, (2) auditor's independence and (3) establishment of a new regulatory body called Public Company Accounting Oversight Board ensuring quality and integrity of auditors of US listed companies and (4) prohibition of non-auditing services for statutory auditors.

Despite all the above, the country did not have a definitive corporate governance code in the same way that many countries of the world. Its corporate governance approach is almost similar to the UK corporate governance code. US corporate governance is based on shareholders principles and the Anglo Saxon model of corporate governance with unitary board system is followed. Several State and federal regulations exist in the US for governing corporate form of business. Companies have a choice to adopt a particular regulation. A Large number of corporate frauds and failures like Enron, World Com, AIG, etc., took place during the last two decades forced the US administration to introduce several comprehensive legislations for corporate governance called Sarbanes-Oxley Act (20002), New York Stock Exchange Corporate Governance Rule (2003), Commission on Public

Trust and Private Enterprises (2003), New York Stock Exchange Commission on Corporate Governance (2010). These laws along with the Delaware Corporate Law and Employees Retirement Income Security Act (1874) constitute the legal framework of US corporate governance.

Sarbanes Oxley Act

As stated earlier this Act is the net result of the frauds and financial scandals resulting in the failure of Enron, WorldCom, Global Crossing, AIG Insurance, etc., during late 1990s and early 2000s. Immediately after this crisis the US Congress with the aim of winning investor confidence introduced an Accounting Industry Reforms Act in 2002 which is popularly known as Sarbanes Oxley Act. Four major aspects covered by the act are (1) related to disclosure, (2) auditor's independence and (3) establishment of a new regulatory body called Public Company Accounting Oversight Board ensuring quality and integrity of auditors of the US listed companies and (4) prohibition of non-auditing services for statutory auditors.

As per the act the CEO and CFO must certify the quarterly and annual reports filed in Form 10Q, 10K and 20F fully compliant with the applicable securities law and present a fair picture of the financial situation of the company. A penalty of $1 million USD fine or an imprisonment of up to ten years or both is imposed for the failure of this.

Regarding auditor's independence the act prohibits the statutory auditor undertaking nine non-audit services such as book keeping and accounting service, financial information system decision and implementation service, etc., while acting as statutory auditor of the company. The Act also strengthened the audit committee of BOD by insisting that all the members of this committee must be independent directors with at least one member having expertise in financial management. The Act further insists that only auditors registered with PCAOB are eligible to be appointed as statutory auditor. Auditor's rotation after every 5 years is also introduced in the Act.

New York Stock Exchange Commission on Corporate Governance (2010)

The NYSEC issued a corporate governance rule in 2003 which focused on strengthening the corporate governance standards for listed companies and fair disclosure to enable the directors, officers and employees to operate more efficiently. For improving this, in 2009 the NYSE appointed a commission to examine the core governance principles acceptable to all market participants. The commission submitted the report in 2010 with the following principles of corporate governance. These principles are as follows:

1. The fundamental objectives of the board should be to build long term sustainable growth in shareholders' value.
2. The key aspect of the successful governance is creating an environment of performance and integrity which is the responsibility of management.
3. Shareholders rights and responsibilities are to be exercised through voting.
4. Transparency policy and disclosure are the essence of corporate governance.
5. A proper balance must be made between the independent and the non-independent directors appointed to ensure proper mix of expertise, diversity and knowledge.
6. Good corporate governance must be integrated with the company's business strategy.

7. Market based governance solutions must be made in every issue in addition to legislation based decision.
8. The influence of proxy firms must be observed and regulated.

German Corporate Governance

German political system, economic system, corporate history, form, structure, shareholding pattern, etc., are explained in the first chapter while explaining the German corporate history. Here a brief account of the German corporate governance is given. In a nutshell, the public or private company limited by share is the main corporate form and with regards to shareholding pattern it is insider dominated.

German Corporate Governance

The major aspects of the code are shareholders and general body meetings – Coordination between supervisory board and management board – Functioning of management board – Functioning of supervisory board – Transparency – Reporting and auditing of annual financial statement.

Germany follows duel board system and its basis is stakeholders theory – Employees representation in supervisory board is an essential aspect of German CG.

The theoretical base of German corporate governance is stakeholder's theory. Germany follows dual board system with a supervisory board consisting of representatives of various stakeholders elected or nominated and management board consisting of few people elected/nominated from the supervisory board. Shareholders' representatives in the supervisory board are elected by the general body meeting. The main task of supervisory board is to supervise the activities of management board and give direction with regards to administration and management. Strategic policy directions of the firm are also taken by this board and implementation is the task of management board. Employee's representation is one of the unique features of the German corporate governance. Germany follows Gromne code 2002 for its corporate governance. The major aspects of the code are as follows:

1. Shareholders and general body meetings
2. Coordination between supervisory board and management board
3. Functioning of management board
4. Functioning of supervisory board
5. Transparency
6. Reporting and auditing of annual financial statement

Japanese Corporate Governance

Japanese corporate history, structure, economic and political systems have already explained in chapter one. Here, its corporate governance is briefly explained. Japan's corporate governance is based on three pillars such as obligation, family and consensus. Japanese feeling of obligation or company or country running the business is the first pillar of corporate governance. Strong feeling of being part of the family running the company is the second pillar. Japanese culture emphasis on consensus or agreement rather than disagreement is the third pillar.

Japanese corporate governance is based on the concept that, 'a good company maximize the profits of its shareholders by efficiently creating value and in the process contributes the creation of a more prosperous society by enriching the lives of its employees and improving the welfare of other stakeholders'.

The code gives equal emphasis to shareholders principle and stakeholder principle and follows German model of corporate governance with duel board, functioning of board of directors, board committee, independent directors, incentive based compensation, disclosure and investor relations.

(a) Role of other stakeholders in corporate governance.
(b) Disclosure and transparency.
(c) Board of Directors responsibility.
    1. The Russian code envisages dual board system consisting of Board of Directors and Executive Board headed by CEO. The director board is elected or nominated from shareholders. It is figured that 25 per cent of the directors with not less than three must be independent directors. The key function of the board of directors includes strategic aspects ensuring efficient control over management, resolving corporate conflict and ensuring effective work of executive body. The executive board or management board headed by CEO looks after the day to day operations of the company and compliance of financial and business plans of the company. There is no clear mention about the size of the management board and its selection. But it specifies that a transparent process must be followed in the selection of CEO and members of the management board.
    2. The code explicitly envisages the board committees such as strategic planning committee, audit committee, HR and remuneration committee, and corporate conflict resolution committee. The code also prefers audit committee with independent directors only.
    3. The code insists on the appointment of a company secretary which is new to the corporate governance of Russia.

Corporate Governance in South Africa

In South Africa, Ministry of Finance is the apex Broad Regulatory Structure. It oversees the statutory regulations of all fraud intermediaries and advisors in South Africa. The ministry has the overall responsibility to develop, implement and supervise the corporate and financial governance superstructure in South Africa. It carries out its functions through four major statutory bodies.

1. Financial Services Board (FSB)
2. South African Reserve Bank (SARB)
3. Registrar of Companies
4. South African Department of Trade and Industry

FSB has the regulatory powers over all non-bank financial institutions, as well as act in as advisory capacity to the Ministry of Finance (Example: Financial Services Board Act 1990), FSB is also assisted by Insider Trading Directorate, the Advisory on Financial Market as well as the Advisory Committees on long and short term financial instruments. In contrast the Appeal Board serves as the official adjudicator of all conflict emanating from whole financial system; the FSB, the Advisory Committees and the South African Reserve Bank (SARB).

The FSB's functions are further delegated to the subordinated statutory bodies namely

(i) The Financial Markets
(ii) Unit Trusts
(iii) Insurers and Financial Advisors Board

The Financial Market Board is responsible for the supervision and issuance of licences for the operations of securities markets, such as stock, bond and financial futures market. The Board has supervisory powers over the JSE ltd, the Board Exchange of South Africa (BESA) and the South African Futures Exchange (SAFEX).

Corporate Governance Structure Imposed on Corporations by King I

The governance structure imposed by King Report 1994 are divided into six major parts such as:

1. **Board of Directors:** King I recommended that every South African Company should be headed by an effective Board consistent with the Cadbury report. It advocated Anglo American style of Unitary Board of executive and non-executive directors who are primarily responsible for directing and controlling the corporates. They are also jointly accountable to shareholders.
2. **Risk Management, Internal Audit and Control:** King Committee placed emphasis on the need for companies to have a well-resourced internal audit and control units. It pointed out that internal auditing are complementary to , but different from, that of the outside auditors. As such, it encouraged companies to establish internal audit function to undertake regular monitoring of key controls and procedures.
3. **Accounting and Auditing:** King I suggested that South African firm's should prepare their financial reports in line with Generally Accepted Accounting Practices as recommended by the JSE's Listing rules and the South African Accounting Standards Board. In this regard, it placed four major responsibilities on directors.
   (a) It mandated directors to prepare financial statements for every financial year which give true and fair view of the state of affairs of the company.
   (b) Directors must maintain adequate accounting record.
   (c) They must confirm that suitable accounting policies and standards have been consistently appeared in preparing the financial reports and also in applying accounting standards, substance should always take precedence over form.
   (d) Directors must express their opinion as to whether the business will continue to operate as a 'going concern' for a foreseeable future. The board is expected to fully state the fact and assurances used in the assessment of the going concern, status of the company at the end of a financial year.
4. **Integrated sustainability reporting/non-financial information:** The explicit requirement for firm to engage in stakeholders reporting is what distinguishes from Cadbury or Anglo American Corporate Governance Codes.
5. **Compliance and Enforcement:** King also supported the principle of self-regulation or voluntary compliance. The responsibility of putting codes into practice laid directly with board of directors of listed firm, but indirectly with auditors and shareholders. Corporate board has the responsibility of putting codes into practice laid directly with board of directors of listed firm but mainly with auditors and shareholders.

Corporate Governance in New Zealand

New Zealand being a colony of UK is highly influenced by its legal structure. The companies in New Zealand are relatively stable and therefore no major collapse of the corporations reported from the country. The major enactments in New Zealand are as listed below.

(i) New Zealand Companies Act 1993
(ii) Securities Act 1978
(iii) Securities Market Act 1988
(iv) Takeovers Act 1993
(v) Takeovers Code and Financial Reporting Act 1993

Corporate Governance in Indonesia

In Indonesia since 1990s several states owned enterprises have been equalized and converted into partially privatised companies through public offering or through strategic alliance. Banking, electricity, mining, oil and natural gas, telecommunications, railways, shipbuilding sectors are still largely dominated by state owned enterprises where the state retains more than 51 per cent shares and exercises its control via the GMS and the Commissioners appointed by the State to the company's Board of Commissioners.

Concentrated ownership: Many private companies in Indonesia start out as a small private companies owned either by a single controlling shareholder, members of family or a small group of shareholders. This concentrated ownership structure often entails a lack of proper documents (such as the company charter or financial regulations) and a lack of supervisory activities and proper book keeping. This impedes the ability of outsiders to become shareholders and leaves room for minority shareholder abuses. Such insider dominance and weak protection of external shareholders/investors has resulted in failed deals and the underdevelopment of the capital markets in Indonesia.

Legal and Regulatory framework: The legal and regulatory framework in Indonesia has some unique characteristics resulting from Indonesia's history and the development of Indonesia's economy. Indonesia first regulates the Limited Liability Company on 1848 in Chapter 3 of Indonesia Commercial Code. On the other hand, the foreign investment in Indonesia first introduced through the 1967 Foreign Investment Law. The first comprehensive piece of legislation for domestic companies was approved in 1968 with the Domestic Investment Law. In 1995, Indonesia established the Indonesia company law 1995. In 2007 there are significant changes in legal and regulatory framework for companies and investment in Indonesia where the government issued Investment Law and ICL. Indonesia's legal and regulatory framework for corporate governance has improved dramatically but actual implementation and adherence by Indonesian companies to corporate governance practices is still in its improving stages.

Institutional framework: There are numerous institutions that make up the institutional framework for corporate governance in Indonesia. The following institutions have at least one core activity focusing on corporate governance.

- Corruption Court
- Supreme Court
- District Court
- High Court of Indonesia
- Military Court of Indonesia
- Religious Court of Indonesia

- Indonesian National Board of Arbitration
- People Representatives
- The Government of Indonesia
- Ministry of Law and Human Rights
- Ministry of Finance
- Indonesian Financial Supervisory Authority
- BAPPENAS
- Indonesia Stock Exchange
- National Police
- Corruption Eradication Commission
- Security Depository
- Central Bank of Indonesia
- Chamber of Commerce and Industries
- National Committee on Governance
- Indonesian Advocates Association
- Indonesian Institute on Corporate Directorship
- Indonesian Transparency Society
- Forum for Corporate Governance in Indonesia
- Global Corporate Governance Forum
- International Finance Corporation
- Organisation for Economic Cooperation and Development
- The World Bank

Corporate Governance in Israel

Israeli corporate governance landscape is characterized by ownership concentration and family control of a significant number of listed companies. Nearly 64 per cent of Israeli listed companies are controlled by family or individual Interests. Institutional investors accounted for 18 per cent of market capitalization, foreign investors for 17 per cent while government ownership accounted for only 1 per cent of market capitalization. The role of the state in capital market has been on the decline, the role of institutional bodies has grown. IDB holding Corporation Ltd (IDBH) is one of the largest and most influential holding corporations in Israel. Approximately, 72 per cent of investment made by IDB Development Corporation Ltd is in Communications, Insurance and Financial Services, real estate, technology, industry, commerce and services. IDB Holdings in turn is controlled (49.5% shares of ownership) by Dankner Family Group. The principal pieces of legislation bearing on corporate governance in Israel are the Company law (1999) and Securities Law (1968). Both the Companies and the securities laws contain a number of important corporate governance provisions. In addition, sectoral legislation has been introduced to regulate the operations of financial sector participants including banks (the Banking Licensing Law 1981), mutual funds (joint investment trust law, 1994), Provident funds (Provident Funds, 2002) and pension funds (Pension Counseling and Pension Market Law 2005). In general, the mandate for the design and enforcement of corporate legislation is shared between the Ministry of Finance, the Ministry of Justice and the Israel Securities Authority.

In the absence of a formal national corporate governance code, the Companies Law incorporates a large number of corporate governance related provisions. It applies to all Israeli companies and to a limited extent to foreign companies, whereas the Securities Law applies to any entity offering securities to the public, whether or not listed on Tel Aviv Stock Exchange. The Companies Law is structured to allow autonomy of choice in solving corporate governance issues and enables

civil enforcement by shareholders, directors and creditors. Moreover, given the risks arising from concentrated ownership and large company groups, the legislators were also intent to enshrine the key provisions in Companies Law, thus making compliance compulsory. From a corporate governance point of view a crucial aspect of the Companies law is addressing what is seen as the key agency problem in Israel; the relationship between majority and minority shareholders.

Core Features of Israeli Corporate Governance

- Ensuring a consistent regulatory framework that provides for the existence and effective enforcement of shareholder rights and the equitable treatment of shareholders, including minority and foreign shareholders.
- Requiring timely and reliable disclosure of corporate information in accordance with internationally recognised standards of accounting, auditing and non-financial reporting.
- Establishing effective separation of the government's role as an owner of state owned companies and the government's role as regulator, particularly with regard to market regulation.
- Ensuring a level playing field in markets where state owned enterprises and private sector companies compete in order to avoid market distortions.
- Recognising stakeholder rights as established by law or through mutual agreements and the duties, rights and responsibilities of corporate boards of directors.[7]

CONCLUSION

The question is whether it is possible to reproduce all at once from the institutions of developed market economies in transition economies. The standard institutional portfolio has evolved gradually in different circumstances. Merely transplanting these institutions is not possible because there are new conditions and many cultural differences. On the other hand, to develop entirely new institutions would be an unpredictable adventure. The transition economies cannot afford the luxury of searching for third system between socialism and capitalism. Instead, they have to find a way to accept the existing institutional portfolio and to make it work in the specific cultural, historical and economic environment. Each region is in a different stage of establishing a democratic, market-based economy and a corporate governance system. Hence, each nation has its own particular set of challenges and it has to solve its problems in a way it successfully addresses these and establish the most suitable system of government practices ideal to its genius and people.

KEYWORDS

- Aggressive business Strategy
- Anti-corruption strategies
- Bankruptcy and foreclosure
- Competition
- Competitive markets
- Contract law
- Corporate governance and developed countries
- Effective corporate governance
- Emerging economies
- Enforcement capacity
- Exit mechanisms
- Fair taxation regimes
- Financial Reporting
- Governance challenges
- Governance models
- Governance settings
- Governance framework
- Government agencies
- Independent directors
- Insider system
- Outsider system
- Participation
- Property rights
- Reputational agents
- Risk Management
- Routine mechanisms
- Sound securities markets
- Special Purpose Vehicle
- Stakeholder relationships
- Successful strategies
- The institutional framework
- Transition economies
- Transparent and fair privatisation procedures
- Well-functioning judicial system
- Well-informed media
- Well-regulated banking sector
- Whistle blowing
- Why and wherefore

DISCUSSION QUESTIONS

1. What are the important characteristics of developing countries? Explain their features in the context of countries like India.
2. Define corporate governance. Justify the why and therefore of corporate governance in the context of low income countries.
3. Discuss the different models of corporate governance. What are the different ways in which an appropriate corporate governance framework can be developed for countries like ours?
4. How can a state/society create an institutional framework to ensure corporate governance in the administration of companies involved in business?
5. What are the challenges and opportunities involved in ensuring corporate governance in transition economies?
6. According to some cynics, corporate governance is a myth. What is your take on this?
7. What are the problems faced by developed economies in corporate governance?
8. How competitions become a governance issue leading to corporate failure?
9. What do you mean by aggressive business strategy? How aggressive business strategies lead to corporate failure?
10. How investor's pressure and personal motive lead to corporate failure?
11. What do you mean by special purpose vehicle? Explain with example the creation of SPV and its role in defeating corporations and it's functioning?
12. What do you mean by complex accounting procedure? State the circumstances under which the companies fail due to poor reporting.
13. State the duties and responsibilities of independent directors. Explain how the passive role of independent director leads to corporate failure.
14. Explain how the ethics and value system affect the business performance. State your answer with suitable examples.
15. State the issues of governance related to remuneration process in developed countries.
16. State the issues of governance related to effective implementation of risk management in developed countries.
17. State the issues of governance related to Board practices in developed countries.
18. State the issues in governance while exercising shareholder rights in developed countries.

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18



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Corporate Governance in the Public Sector and the Family Owned Companies: The Indian Scenario

CHAPTER OUTLINE

- Introduction
- Corporate Governance in the Public Sector Companies
- The Public Sector Governance in India
- Forms of CPSUs
- Generation of Income
- Strong Industrial Base
- Public Sector Governance
- Compliance of the Guidelines
- Family Run Business and Corporate Governance

Corporate Governance in the Public Sector Companies

The corporate governance system of any country is influenced by several factors like the existing legal system in the country, the economic philosophy followed, the political set up, the role of corporate model in the development process, the corporate structure and the ownership pattern, the impact of business corporations on the society, the level of capital market development, etc. For example, in countries like the USA and the UK where market-driven economic system is followed, the private sector dominates the economy and the public sector has only a very limited role to play. Such countries follow a different type of corporate governance. But in countries like India where mixed economic system is followed, the coexistence of public and private sector is common; the corporate governance framework is slightly different. In China and Russia where the socialist economic policy is followed the public sector dominates in the development process, the corporate governance set up is tuned accordingly. Similarly, in countries which follow corporate model of development, it plays a significant role in the society; hence governance system must be designed to suit that requirement. Corporate ownership pattern is another important factor determining the corporate governance system. In countries like the USA, the UK, Australia, where outsider domination exists in the shareholding pattern the shareholder's principle with one ties board system exists while in countries like Japan, Korea, Germany where insider-dominated ownership structure exists, stakeholder's principles based dual board system is prevailing. The level of capital market development in different countries is yet another factor influencing the governance because it influences the ability of the company to raise finance.

In India three types of companies dominate the corporate scenario viz. Public sector companies, family owned private companies and others. In this PSUs play a dominant role with approximately 28% of market capitalization of BSE. Family-owned private corporate sector share around 50%.

In India three types of companies dominate the corporate scenario namely the public sector companies, popularly known as PSUs, both central government owned and state governments owned, family owned private corporate sector companies and others. Public sector companies are owned and managed by the State for the welfare of the general public. Ownership rests with the State and governance system is designed and implemented by it. In India, of the three hundred and odd CPSUs 47 are listed companies in addition to 28 public sector listed banks and six state level listed PSUs. The overall market capitalization of these CPSUs is approximately 28 per cent of the total market capitalization of BSE of 1.64 Trillion USD in the year 2016. These PSUs play a significant role in the overall industrialization of the country particularly in laying the foundation of the country's industrial base. The Second major category is the family-owned private corporate sector. Some of them are listed while a good number unlisted. Approximately fifty business families own almost half of the corporate entity in terms of market capitalization. A Substantial share of this equity never comes to the market for trading. The governance system of these family owned companies are also slightly different because the major shareholders are fully represented in the board of directors and hence the major agency problem do not exist. The rest of the companies that come under other categories are represented approximately about 20 to 25 per cent of the market capitalization where standard corporate governance principles are applied. Hence, in this chapter some of the governance issues of PSUs and family-owned business are discussed.

Public Sector Governance in India

Origin of the Public Sector in India

India was predominantly an agrarian economy at the time of Independence with a weak industrial base, a low level of savings, inadequate investments and poor basic infrastructure facilities. The country was also facing problems like

inequalities in income and low levels of employment, regional imbalances in economic development and a lack of trained manpower. Since Independence, we have followed a mixed economic system and under this, both the public sector and the private sector are indispensable partners for the overall economic growth of the country. The private sector enterprises are primarily driven by profit motive, not by welfare purposes or public interest. Therefore, private business owners are not interested in setting up their businesses and investing in those areas of the economy which are very closely related to public interest, wherein massive capital investment is required, but profit obtained by such investment is either meagre or can be achieved after a long period. The Government directly takes part in the business activities in those sectors by setting up their own undertakings.

On account of this type of socio-economic set up, the country drew up a roadmap for the development based on Public Sector as an instrument for industrialization for achieving self-reliant economic growth. This guiding factor led to the passage of Industrial Policy Resolution of 1948 and followed by Industrial Policy Resolution of 1956. It envisaged the development of core sectors through the public investments with the aim of correcting the regional imbalances, developing entrepreneurship and creating employment. Industrial Policy Resolution of 1948 laid emphasis on the expansion of production, both agricultural and industrial and in particular on the production of capital equipment and goods satisfying the basic needs of the people and of commodities, the export of which would increase earnings of foreign exchange. During the early stage of Independence, capital was scarce and the base of entrepreneurship was also not strong enough. Hence, the 1956 Industrial Policy Resolution gave primacy to the role of the State which was directly responsible for industrial development. Consequently, when planning process was initiated taking into account the needs of the country, several new public sector undertakings were started by the government in basic sectors like iron and steel, coal, heavy electricals, defence production, fertilizers and chemicals, machine tools transport infrastructure, etc. Many companies functioning in the private sector like petroleum, banking and insurance companies were also nationalized by the government. In the words of the then Prime Minister Jawaharlal Nehru public sector is the 'temple of modern India'. The main objectives of public sector at that time were:

Since Independence, India followed mixed economic system with coexistence of both public sector and private sector in the industrialization of the country. The realization of profit motive of private sector during the pre independence period forced the government of the independent India to give high priority for the public sector. It also aimed to generate financial resources for the country's development, redistribution of income and wealth, balanced regional development, employment creation, export promotion and import substitution.

- To generate financial resources for the country's development.
- To promote redistribution of income and wealth.
- To make public sector a major employment creator.
- To ensure balanced regional development.
- To encourage small scale industries.
- To accelerate export and import substitution.

Growth of Public Sector

There were only five central public sector undertakings in India with an investment of ₹29 crore in 1951 which increased to 47 undertakings with an investment of ₹948 crore by 1961 and 84 undertakings with an investment of ₹3897 by 1971. Also during 1980's we gave higher importance to the industrial development of the country through the public sector. By 1981 the number of central PSUs increased to 179 with an investment of ₹18150 crore and by 1991 this increased to 240 undertakings with an investment of ₹99329 crore and further 260 undertakings with an investment of ₹3.24 lakh crore by 2001. By 2015 the number of Central PSUs has increased to 320 with an investment of ₹117 lakh crore.

Forms of CPSUs

These PSUs operate in India in four forms, firstly, the Departmental Undertakings, such as, Railways, postal services, Broadcasting (Doordarshan and All India Radio), etc., which are under control of some ministry of the Government and financed and controlled by the Government Departments; secondly, the Statutory Public Corporations created by the Parliament or the State Legislature by passing an Act which defines the powers, functions, management, organisational and administrative structures of such corporations, such as the Food Corporation of India, Life Insurance Corporation of India, etc., thirdly 'Boards' constituted by special acts of the Parliament and fourthly, the Government companies. A company is deemed to be a Government company or PSU if the Government holds 51 per cent or more of its paid up capital. For example, the Hindustan Machine Tools Limited, the Steel Authority of India Limited, etc.

Public sector had played an important role in the industrialization of the country during the first forty years of independence. It contributed significantly in income and employment generation, capital formation, export promotion and import substitution, growth of ancillary industries, etc., the public sector has been organized in four different modes namely Departmental Undertakings, Statutory Public corporations, Statutory Boards, and Government companies. The number of CPSUs has increased from five with an investment of ₹ 29 crore in 1951 to 320 units by 2015 with an investment of ₹ 117 lakh crores.

Contribution of Public Sector in Indian Economy

Over the years, the Indian public sector has contributed significantly in achieving its goals. Now PSUs account for 20 per cent of the countries tax revenue' both direct and indirect put together and act as a strong engine for balancing regional development. It also contributes 22 per cent of the total industrial sector GDP and 10 per cent of gross domestic savings. In capital formation public sector contributes 25 per cent. The specific contribution of public sector in the national economy can be looked at from different angles as follows.

Generation of Income

Public sector in India has been playing a definite positive role in generating income in the economy. The share of public sector in net domestic product (NDP) at current prices increased from 7.5 per cent in 1950–51 to 21.7 per cent in 2003–04. Again the share of only the public sector enterprises (excluding public administration and defence) in NDP also increased from 3.5 per cent in 1950–51 to 11.12 per cent in 2005–06.

Capital Formation

The Public sector has been playing an important role in the gross domestic capital formation of the country. The share of public sector in gross domestic capital formation increased from 3.5 per cent during the First Plan to 9.2 per cent during the Eighth Plan. The comparative share of public sector in the gross capital formation of the country also recorded a change from 33.67 per cent during the First Plan to 50 per cent during the Sixth Plan and then declined to 21.9 per cent in 2005–06 and 18 per cent by 2011–12 and further 16 per cent by 2015–16. But the public sector has not been playing a significant role in mobilization of savings. The share of this sector in gross domestic savings was 16 per cent in 1980–81 to 7.7 per cent by 1990–91 and around 10 per cent by now.

Employment

The public sector is playing an important role in generating employment in the country in two ways namely, government administration, defence and other government services and employment by public sector enterprises of both central

and state enterprises. In 1971, the public sector offered employment opportunity to about 11 million persons but in 2003 this number rose to 18.6 million persons which was a 69 per cent increase. Since then, there has been a considerable decline in the employment generation in the public sector. Now it accounts for 12 million employments. The maximum number of employment is derived from transport, communication and banking followed by the manufacturing sector.

Infrastructure

Without the development of infrastructural facilities, the economic development is impossible. Public sector investment in infrastructure sectors like power, transport and communication, basic and key industries, sea port and airport, heavy industries, steel, coal, etc., has paved way for an overall development of the country. Private sector investments are also dependent on these infrastructural facilities developed by the public sector of the country.

Strong Industrial Base

There is no denying the fact that rapid industrialization during the first three decades after Independence was mainly due to the public sector. The government reserved certain industries namely railways, nuclear weapons, arms and ammunitions for the public sectors as it was difficult to trust the private sector in view of national security. Industries like iron and steel, petroleum, etc., have also been developed by the public sector. Thus, by building a strong industrial base the public sector has opened the path for rapid industrialization in the country.

Export Promotion and Import Substitution

Public sector enterprises have contributed a lot in the promotion of India's exports, resulting in the foreign exchange earnings. Public sector enterprises like the Hindustan Machine Tools, the State Trading Corporation, etc., are playing a vital role in this regard. In 2000, public sector exports stood at ₹18,147 crores. On the other hand, some public sector enterprises have paved way for import substitution. Import substitution means replacement of an imported product by indigenous material and know-how. The Bharat Heavy Electrical Ltd., the Bharat Electronics Ltd., the Indian Oil Corporation, etc., are playing a lead role in saving our valuable foreign exchange. The contribution of the public sector rose from ₹35 crore in 1965–66 to ₹5800 crores in 1984–85 and to ₹35,000 crores in 2002–03. By 2014–15 it has increased to 3,40,000 crores. PSUs like the Hindustan Steel Limited, the HMT, the Bharat Electronics Limited, the State Trading Corporation of India and metals and the Mineral Trading Corporation of India have played a significant role in this. Some PSUs have also shown incredible records in achieving import substitution and thereby saving precious foreign exchange reserve. In this aspect the contribution of the Indian Oil Corporation, the BHEL, the ONGC, the Hindustan antibiotics limited, etc., are worth mentioning.

Growth of Ancillary Industries

Public sector enterprises have helped the growth of ancillary industries in numerous ways. They are as follows:

1. They take responsibility for providing managerial and technical guidance on production process and the equipment selection, etc.

2. Public Sector enterprises give long-term contracts to small ancillary industries.
3. Public enterprises guide in tapping the sources of financing and procedure for obtaining them.
4. Public enterprises have made efforts to purchase items from the ancillary units.

Problems of PSUs

Despite the significant role of the PSUs in the economic development of the country in several ways such as entrepreneurship, contribution to capital formation gross value addition and foreign exchange earnings, the performance of many of our PSUs are far from satisfactory. A Large number of CPSUs is running at a loss. Instead of contributing to the exchequer they are grabbing the poor man's tax money for their day to day activities. There are several reasons for this poor state of affairs such as underutilization of capacity, accountability and control problems, a lack of professionalism, problem of autonomy, lack of clarity of vision-mission and objectives, poor infrastructure linkages, political interference and corruption, low employee productivity, poor capital base, the absence of modern technology, heavy social cost, high government interference, operational and managerial inefficiencies, poor financial management and capital structure, time and cost overrun problems.

Over in the years of poor functioning of PSUs, they have more a big become liability than an asset for the nation building. Instead of contributing to the exchequer they drained the tax payer's money for its routine activities. As a part of economic reforms Government started restructuring and reviving the Public Sector in three different ways namely, strengthening and make globally competitive those PSUs which are performing well, reviving those PSUs which can be revived and disinvest fully or partially of those PSUs which cannot be revived.

To overcome these problems and to make the public sector more efficient and discharge its role, several initiatives were undertaken since 1990. The economic liberalization, privatization and globalization initiative started all over the world since the downfall of the Soviet Union and foreign exchange crisis created its impact also in India in 1991. The Government has initiated a three way approach to address this issues namely, (1) strengthening those PSUs which have been performing well now by giving more autonomy, both financial and administrative, professionalization of management, etc., to make it globally competitive, (2) revival of those undertaking which can be revived by giving additional capital, new technology, marketing support, etc., and (3) disinvestment of selected PSUs which cannot be revived under PSU mode.

Miniratna, Navaratna and Maharatna Companies

As a part of providing more autonomy to the well performing PSUs for its further improvement and make it globally competitive the government has classified well performing companies as Navaratna companies, Maharatna companies and Miniratna companies. The criteria followed for classification to Navaratna companies are as follows:

1. It should be a Miniratna Category-I and Schedule A PSU.
2. It must have obtained 'excellent' or 'very good' rating under the memorandum of understanding system in three of the last five years and have composite score of 60 or above in the six selected performance parameters, namely
   - Net profit to net worth.
   - Manpower cost to total cost of production/services.
   - Profit before depreciation, interest and taxes to capital employed.
   - Profit before interest and taxes to turnover.
   - Earnings per share and Inter-sectoral performance.

As on June 2016, there are 17 Navaratna CPSEs whose names are

- Bharat Electronics Limited
- Bharat Petroleum Corporation Limited

- Container Corporation of India Limited
- Engineers India Limited
- Hindustan Aeronautics Limited
- Hindustan Petroleum Corporation Limited
- Mahanagar Telephone Nigam Limited
- National Aluminium Company Limited
- National Buildings Construction Corporation Limited
- NMDC Limited
- Neyveli Lignite Corporation Limited
- Oil India Limited
- Power Finance Corporation Limited
- Power Grid Corporation of India Limited
- Rashtriya Ispat Nigam Limited
- Rural Electrification Corporation Limited
- Shipping Corporation of India Limited

Similarly, some companies have been classified as Maharatna companies based on the following criteria:

1. It should be a Navaratna Company.
2. Listed on the stock exchange.
3. It should have an average annual turnover of 25,000 crores for the last 3 years.
4. It should have an average annual net worth of 15,000 crores for the last 3 years.
5. It should have an average annual net profit after tax of more than 5000 crores for the last 3 years.
6. It should have a significant Global presence.

As on June 2016, there are 7 Maharatna CPSUs.

1. Bharat Heavy Electricals Limited.
2. Coal India Limited.
3. GAIL (India) Limited.
4. Indian Oil Corporation Limited.
5. NTPC Limited.
6. Oil & Natural Gas Corporation Limited.
7. Steel Authority of India Limited.

A third category was also created namely Miniratna companies. The criteria for classification of PSUs as Miniratna are as follows:

The CPSEs which have made profits in the last three years continuously and have a positive net worth are eligible to be considered for grant of Miniratna status.

Disinvestment Policy

As a part of economic liberalization policy initiated since 1991, the government has initiated several programs to improve the economic fundamentals of the economy of reducing fiscal deficit, at the same time by finding out money for developmental and welfare measures. One of such measures is the disinvestment policy to divest poorly performing public sector enterprises of the country. In the words of Dr C. Rangarajan the former governor of the RBI, 'There is a compelling need to expand the activities of the State in areas such as education, health and medicine. It is therefore legitimate that a part of the additional resources needed

for supporting these activities comes out of the sale of shares of public enterprises built up earlier by the Government out of its resources'. Disinvestment is a sophisticated term used for the sales of the equity, fully or partly of public sector companies. In other words, it means the dilution of the stake of the Government in a public enterprise. This can be done in two ways. When the Government sells a part of its equity of a public enterprise less than 50 per cent of its total stock, it is called merely disinvestment; and in this case, the control and management of the business enterprise remains in the hands of government. On the other hand, when disinvestment or sale of its equity capital by the government exceeds 50 per cent so that the majority ownership and therefore control and management of the enterprise is transferred to private enterprise, it results in privatization. Therefore, in many disinvestment programmes government retains 51 per cent or more of the total equity capital of the public enterprises so that control and management remains in its hands. Through disinvestment government aimed two things namely finding out resources for strengthening the efficient public sector undertakings by providing additional financial resources for modernization, technological upgradation, research and development, etc., and to finance budgetary deficit.

Disinvestment refers to sale of equity fully or partially of PSUs. This is done in two ways namely, selling less than 50% of the government stakes to private sector and retaining the management and control, or selling more than 50% of the government stake and their by transferring the control and management to the transferees'.

Objectives of Disinvestment

The main objectives set for disinvestment in India are as follows:

- To meet the budgetary needs.
- To reduce fiscal deficit.
- To find out resources for development and welfare activities.
- To find out funds for technological upgradation and modernization of good and efficient public sector to make it globally competitive.
- To reduce the financial burden of the State.
- To diversify the ownership of PSUs for enhancing efficiency of individual enterprises.
- To improve public finance.
- To encourage wide-ownership of the public sector.

Approaches to Disinvestment

The Government has developed three approaches for disinvestment namely, minority disinvestment, majority disinvestment and complete disinvestment. In minority disinvestment, less that 50 per cent of the equity of the State enterprises are sold to private parties, thereby retaining control and management of the enterprise with the State itself. Disinvestment of shares of IOC, MRL, VSNL, IBP and BPCL are the examples of this kind. In the second approach more than 50 per cent of the equity shares of the State enterprises are sold to private investors thereby transferring the control and management to private investors. Examples are Modern foods, BALCO, CMC, HTL, IJMC, etc. In the third approach the whole equity shares of the state enterprise is sold to private parties. For example, selling of the 18 ITDC hotels.

Targets and Achievements

Upto 2014–15 the government fixed a target of raising ₹3.44 lakh crore from the disinvestment but the actual achievement was only ₹1.55 lakh crore just below half of the target fixed. Details of targets and achievements are given in the table below.

Disinvestment Targets and Achievements from 1991–92 to 2017–18

Year	*Target in (₹ crore)*	*Achievement (₹ In crores)*
1991–92	2500	3038
1995–96	7000	168
2001–02	12000	5632
2005–06	No target	1570
2010–11	40000	22276
2014–15	58425	21
2017–18	70000	NA
Total up to 2014–15	344225	155348

Compiled from the Department of Disinvestment, Government of India

Public Sector Governance

OECD Guidelines on Corporate Governance of State Owned Enterprises

Organization of Economic Cooperation for Development had made two attempts to develop guidelines for the corporate governance of State owned enterprises in OECD countries. The first was in 2005 when it adopted detailed guidelines as an internationally agreed standard on how governments should exercise ownership of State-owned enterprises. With the changes in the government policies and ownership pattern in different parts of the world and the experience in growing number of countries they are being modified and updated. In 2014, a new draft, if new guidelines was prepared by OECD and circulated among the user countries and on the basis of the feedback received a new set of guidelines was introduced which has been implemented with effect from 2015. The guidelines are intended to provide general advice that will assist governments in improving the performance of SOEs. The decision to apply the guidelines to the governance of particular SOEs should be made on a pragmatic basis. Guidelines should be considered as an integrated instrument and several recommendations are intended to be implemented in unison with others and might, if applied in separation, have little or no effect on good governance. It is a set of non-binding best practices to which the OECD members and associate countries have expressed their commitment. They provide guidance that is generally relevant to any corporate asset in the public sector ownership. However, none of its size fits all and not every aspect of the recommendations is applicable in every context. This section reviews some of the questions and trade-offs that the owners of enterprises need to address in order to decide on the applicability of the guideline. It applies to enterprises that are effectively controlled by the State, either by holding a majority of the voting shares or otherwise exercising an equivalent degree of control. The guidelines contain seven major principles of corporate governance of State owned enterprises as follows:

The OECD principles of public sector corporate governance focused on seven principles such as state ownership, exercise the owner's role in most transparent manner, ensure level playing field for PSUs in market along with private sector, equitable treatment of state and non state investors, ensure responsibility to shareholders, ensure high quality accounting and auditing practices and ensure the board responsibility.

1. **State's ownership:** This principle states that general public is the real owners of State enterprises. Since they are not able to exercise the ownership rights individually, they entrust this task to the State to carry it on behalf of the people. Therefore the State, while exercising the power of governance, carefully

evaluates and discloses the public policy objectives that motivate the State ownership. The government should also develop an ownership policy. The policy should inter alia define the overall rationales for State ownership, the State's role in the corporate governance of SOEs and how the government will implement its ownership policy. The ownership policy should be subject to appropriate procedures of political accountability and disclosure to the general public and should be subject to regular review. Also the government should define the rationales for owning individual SOEs and subject these to recurrent review. Any public policy objectives that individual SOEs, or groups of SOEs are required to achieve should be clearly mandated by the relevant authorities and disclosed.

2. **The State should exercise the role of owner in the most transparent and effective manner:** Transparency and accountability are the corner-stone of good corporate governance. Hence, the State as the informed, active owner, must ensure that the governance of the enterprise is carried out in the most transparent and professional manner with due accountability. As the owner, the State can fix objectives, targets, including financial and risk management target but never interfere in the day to day activities of the undertakings. Full autonomy must be given to the board to achieve the objectives and entrusted responsibility. The operational practices must be based on common accepted norms, but should be given the opportunity to carry out the task of board of directors by simplifying the legal systems. Similarly, as the owner, the State should be accountable to the people through the representative bodies like the Parliament or the state legislatives as the case may be. Board remuneration is always a grey area in corporate governance. Hence adequate care must be taken by the State as the owner, to ensure full disclosure of the director's remunerations and a disclosure policy must be formulated and implemented in all State owned enterprises.
3. **State should provide a level playing field to the PSUs in the market along with the private sector:** The guidelines suggest that as the owner, the State has an important role to provide a regulatory framework ensuring the PSUs to compete with their counter parts in the non-government sector in equal footings to avoid market distortions. There must be a clear division between the State's ownership function and other functions that may influence the PSUs with regards to market requirements. In this aspect, PSUs should neither be given undue advantage in the form of tax exemption, subsidies, etc., nor disadvantageous position like social security measures, price control, etc., as a part of public policy as compared to non-governmental organisations. In PSUs financing also the State must ensure that PSUs are able to raise capital like non-governmental organisations. In public procurements also PSUs as a bidder or procurer there should not be any discrimination between PSUs and other entities. Further, any additional cost involved to PSUs as part of any activity carried out by it as public policy must be adequately compensated. For example, any subsidy given by the PSUs to any section of society must be adequately compensated by the State.
4. **Equitable treatment to State and non-State investors in the rights and access to corporate information in case of listed and non-listed PSU's:** These guidelines suggest that if the State is not the sole owner of the entity in all such aspects, the entity should follow the general OECD principles of corporate governance ensuring equal treatment to all classes of owners. Whenever the State enterprises are put into any disadvantageous position in any aspect as part of State's public policy, it should be clearly informed to non-State owners.

5. **Ensure responsibility towards stakeholders:** The State as owners should fully recognise State enterprises responsibility established by law and mutual agreements towards stakeholders' rights and report their relation with all stakeholders. The State should also make clear its policy in respect of responsible business. All public policy objectives pursued by the entity involving additional cost or any other disadvantages must be reported to all stakeholders. The entity should also develop, implement and communicate the progress of internal code of ethics, based on national laws and international commitments. With regards to the government expectations about responsible business, the entity should publically disclose it.
6. **The PSUs must ensure high quality of accounting and auditing and high standard in transparency and disclosure:** In this aspect, the guidelines suggest that the government control mechanism is not sufficient for State enterprises. Instead the State, as the owner, has to maintain efficient internal audit system and independent external audit system with international standards. The audit systems must also be monitored by the board and the audit committee or an equivalent mechanism. Regarding the disclosures the guidelines suggest that the State enterprises must disclose all material, financial and non-financial information of the company in line with high quality international standards of corporate disclosure. It should also publish annually an aggregate report of the entity through web-based communications to facilitate access by the general public who are the real owners.
7. **Board responsibility in state enterprises:** The Board of directors constitutes the most important element in corporate governance of PUSs. They should have the necessary authority, competence and objectivity to carry out their functions. While acting they should show utmost integrity and be held accountable for their activities. Like non-governmental enterprises, the PSU board must have independent people in addition to the departmental representatives of optimum numbers. Their nomination and selection must be based on competence and the selection criteria should be clearly specified in the legislation governing the entity. The independent directors should be free from any material interest or relationship with the company. There should not be any conflict of interest between the board members and the owners. If employee's representatives are on the board, the mechanism should be developed to guarantee that the representation is exercised efficiently contributing to the enhancement of the broad objectives. For easy governance, a sufficient number of board committees is to be constituted, which are composed of independent directors and qualified members in respect of audit, risk management and director's remuneration.

Department of Public Enterprises Corporate Governance Guidelines to Public Sector Companies in India

Keeping in view the importance of Corporate Governance Principles in ensuring transparency and enhancing the trust of stakeholders, improving the operational and financial performance the government had, in 2007, approved the Guidelines on Corporate Governance for Central Public Sector Enterprises (CPSEs) These guidelines were formulated by the Department of Public Enterprises (DPE) keeping in view the relevant laws, instructions and procedures.

Since the issue of these guidelines in June, 2007, the CPSEs were given the opportunity to implement them on an experimental basis from the financial year 2008–09. It was felt that while the principles of Corporate Governance apply equally to both the public and the private sector, there was a continued need to adopt and apply the good corporate governance practices in respect of CPSEs where huge

The Department of Public enterprises have given a detailed guideline for corporate governance of CPSUs in India. The guideline divide the CPSUs into two namely listed CPSUs and un listed CPSUs All listed CPSUs have to follow the SEBI guidelines relating to clause 49 of listing rules plus the additional provisions of the guideline issued by the DPE. While non listed CPSUs must follow the guideline issued by the DPE. The guidelines are divided into five broad headings such as Board of Directors, Audit Committee, Remuneration Committee, Subsidiary Companies, and Disclosure Requirements

public funds had been invested. Thus, it was decided after due inter-ministerial consultations, the introduction of Guidelines on Corporate Governance for all CPSEs on mandatory basis was made by the Government of India in March 2010.

These guidelines have now been made mandatory and are applicable to all CPSEs. The guidelines cover issues like composition of Board of CPSEs, Audit Committee, Remuneration Committee, Subsidiary companies, Disclosures, Code of conduct and ethics, risk management and reporting. The guidelines have been modified and improved keeping in view the experience gained during the experimental phase of one year by including additional provisions relating to monitoring the compliance of guidelines by the CPSEs and formation of remuneration committee. Since, the concept of corporate governance is dynamic in nature, it has also been provided that suitable modifications in these guidelines would be carried out to bring them in line with prevailing laws, regulations, Acts, etc., from time to time.

Applicability of the Guidelines

For the purpose of evolving guidelines on corporate governance, PSEs have been categorized into two groups, namely, (i) those listed on the Stock Exchanges; (ii) those not listed on the Stock Exchanges.

CPSEs Listed on Stock Exchanges

In so far as listed CPSEs are concerned, they have to follow the SEBI Guidelines on Corporate Governance. In addition, they shall follow those provisions in the guidelines which do not exist in the SEBI Guidelines and also do not contradict any of the provisions of the SEBI Guidelines.

Non-listed CPSEs

Each CPSE should strive to institutionalize good Corporate Governance practices broadly in conformity with the SEBI Guidelines. The listing of the non-listed CPSEs on the stock exchanges may also be considered within a reasonable time frame to be set by the administrative ministry concerned in consultation with the CPSEs concerned. The non-listed CPSEs shall follow the Guidelines on Corporate Governance given in the subsequent chapters, which are mandatory. The guidelines for Corporate Governance for the listed and the unlisted CPSEs are being dealt under the following headings.

- Board of Directors
- Audit Committee
- Remuneration Committee
- Subsidiary Companies and
- Disclosures

Board of Directors

The Board of Directors is considered a crucial part of the corporate governance. The Board's primary role is to monitor management on behalf of the shareholders. The primary responsibility of governing a company (whether a private or a government company) its Board of Directors. The Board should function as follows:

1. The Board should meet regularly, keep its control over the company and monitor the executive management of the company.

2. The Board of Directors should steer discussions properly in the meetings with regard to the affairs of the company.
3. The Board of Directors has responsibilities in the matter of employment and the dismissal of the CEO.
4. The Board of Directors should provide guidance and supervise on the selection, evaluation, etc., of the senior management of the company.
5. The Board should monitor the performance of the company in the fulfilment of its business objectives, plans and strategies. The Board also oversees to ascertain the proper management of the company.
6. The Board also ensures compliance with the applicable laws, rules and regulations, etc.

The Board of Directors of a CPSE shall have an optimum combination of functional, nominal and independent directors. The functional directors are full-time operational directors responsible for the day to day functioning of the enterprise. Each Board shall have an adequate number of functional directors on it. The government directors are appointed by the administrative ministries and are officers dealing with the concerned enterprise. The non-official directors are to be drawn from the public, technocrats, management experts and consultants and professional managers in industry and trade with a high degree of proven ability. The details of the guidelines are given below.

Composition of Board

The Board of Directors of the company shall have an optimum combination of Functional, Nominee and Independent Directors. The number of Functional Directors (including CMD/MD) should not exceed 50 per cent of the actual strength of the Board. The number of Nominee Directors appointed by Government/ other CPSEs shall be restricted to a maximum of two. In case of a CPSE listed on the Stock Exchanges and whose Board of Directors is headed by an Executive Chairman, the number of Independent Directors shall be at least 50 per cent of Board Members and in case of all other CPSEs (i.e., listed on Stock Exchange but without an Executive Chairman, or not listed CPSEs), at least one-third of the Board Members should be Independent directors.

Part-time Directors' Compensation and Disclosures

All fees/compensation, if any, paid to part-time Directors, including independent directors, shall be fixed by the Board of Directors subject to the provisions in the DPE guidelines and the Companies Act.

Number of Board Meetings

The Board shall meet at least once in every three months and at least four such meetings shall be held every year. Further, the time gap between any two meetings should not be more than three months. A director shall not be a member in more than 10 committees or act as the Chairman of more than five committees across all companies in which he/she is beholding his/her position as a director.

Compliance of Laws to be Reviewed

The Board shall periodically review compliance reports of all laws applicable to the company, prepared by the company as well as steps taken by the company to rectify instances of non-compliances.

Code of Conduct and Functional Role Clarity

The Board shall lay down a code of conduct for all the board members and the senior management of the company. The code of conduct shall be circulated and also posted on the website of the company. All board members and senior management personnel shall affirm compliance with the code on an annual basis. The Annual Report of the company shall contain a declaration to this effect signed by its Chief Executive. Guidelines and policies evolved by the Central government with respect to the structure, composition, selection, appointment and service conditions of the Boards of Directors and senior management personnel shall be strictly followed. There shall be no extravagance in expenditure on the part of Board members and senior management personnel. The CPSE executives shall be accountable for their performance in conformity with the established norms of conduct. While formulating the code of conduct the following shall be taken in to account:

1. Act in the best interests of and fulfil their fiduciary obligations to the Company.
2. Act honestly, fairly, ethically and with integrity.
3. Conduct themselves in a professional, courteous and respectful manner and not take improper advantage of the position of Director.
4. Act in a socially responsible manner, within the applicable laws, rules, and regulations, customs and traditions of the countries in which the company operates.
5. Comply with the communication and other policies of the enterprise.
6. Act in good faith, responsibly, with due care, competence, and diligence.
7. Not to use the company's property or position for personal gain.
8. Not to use any information or opportunity received by them in their capacity as directors in a manner that would be detrimental to the company's interest.
9. Act in a manner to enhance and maintain the reputation of the enterprise.
10. Disclose any personal interest that they may have regarding any matters that may come before the Board and abstain from discussion, voting or otherwise influencing a decision on any matter in which the concerned director has or may have such an interest.
11. Abstain from discussion, voting or otherwise, influencing a decision on any matter in which they may have a conflict or potential conflict of interest.
12. Respect the confidentiality of information relating to the affairs of the company acquired in the course of their service as directors for their personal advantage or advantage of any other entity.
13. Not to use the confidential information obtained in the course of their service as directors for their own benefit or advantage of any other entity.
14. Help create and maintain a culture of high ethical standards and commitment to compliance.
15. Keep the Board informed in an appropriate and timely manner any information in the knowledge of the member which is related to the decision-making or is otherwise critical for the company.
16. Treat other members of the Board and other persons connected with the company with respect, dignity, fairness and courtesy.

The CPSE Board of Directors is also entrusted with some moral imperatives. The Board has to ensure that the social responsibilities, needs, etc., are satisfied by the products of efforts involved in the company. It is to be ensured that the safety standards prescribed for health, environmental and social security standards,

human wellbeing, etc., are maintained. In this regard, all Board members are expected to act in accordance with highest standards of personal and professional integrity, honesty and ethical conduct while conducting the business of the public enterprise. Values like equality, tolerance, respect for others, non-discrimination by race, religion, sex, caste, age, etc., to be maintained by Board members. Further, confidentiality about the affairs of the company should always be kept.

Risk Management

An enterprise risk-management helps management in achieving CPSE's performance and profitability targets. It helps to ensure effective reporting and compliance with laws and regulations and helps avoid damage to the entity's reputation and associated consequences. Considering the significance of risk management in the scheme of corporate management strategies, its oversight should be one of the main responsibilities of the Board/Management. The Board should ensure the integration and alignment of the risk management system with the corporate and operational objectives and also that risk management is undertaken as a part of normal business practice, and not as a separate task at certain times.

Training of Directors

The company concerned shall undertake training program for its new Board members (Functional, Government, Nominee and Independent) in the business model of the company including the risk profile of the business of company, the responsibility of respective Directors and the manner in which such responsibilities are to be discharged. They shall also be imparted training in Corporate Governance, model code of business ethics and conduct applicable for the respective directors.

Audit Committee

Qualified and Independent Audit Committee

A qualified and independent Audit Committee shall be set up, giving the terms of reference. The Audit Committee shall have minimum three Directors as members. Two-thirds of the members of audit committee shall be independent Directors. The Chairman of the Audit Committee shall be an Independent Director. All members of Audit Committee shall have knowledge of financial matters of Company and at least one member shall have good knowledge of accounting and the related financial management expertise.

The Chairman of the Audit Committee shall be present at the Annual General Meeting to answer shareholder queries; in case, the Chairman is unable to attend due to unavoidable reasons, he may nominate any member of the Audit Committee. The Company Secretary shall act as the Secretary to the Audit Committee.

Role of Audit Committee

The role of the Audit Committee shall include the following:

1. Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.
2. Recommending to the board the fixation of audit fees.
3. Approval of payment to statutory auditors for any other services rendered by the statutory auditors.

4. Reviewing, with the management, the annual financial statements before submission to the Board for approval, with particular reference to:
   (a) Matters required for inclusion in the Directors Responsibility Statement to be included in the Board's report in terms of clause (2AA) of section 217 of the Companies Act.
   (b) Changes, if any, in accounting policies and practices and reasons for the same.
   (c) Major accounting entries involving estimates based on the exercise of judgment by the management.
   (d) Significant adjustments made in the financial statements arising out of audit findings.
   (e) Compliance with legal requirements relating to financial statements.
   (f) Disclosure of any related party transactions.
   (g) Qualifications in the draft audit report.
5. Reviewing with the management the quarterly financial statements before submission to the Board for approval.
6. Reviewing with the management, the performance of internal auditors and the adequacy of the internal control systems.
7. Reviewing the adequacy of internal audit function, if any, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure, coverage and frequency of internal audit.
8. Discussion with internal auditors and/or auditors on any significant findings and follow up there on.
9. Reviewing the findings of any internal investigations by the internal auditors/ auditors/agencies into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the Board.
10. Discussion with statutory auditors before the audit commences, on the nature and scope of audit as well as post-audit discussion to ascertain any area of concern.
11. To look into the reasons for substantial defaults in the payment to the depositors, debenture holders, shareholders (in case of non-payment of declared dividends) and creditors.
12. To review the functioning of the Whistleblower Mechanism.
13. To review the follow-up action on the audit observations of the C&AG audit.
14. To review the follow-up action taken on the recommendations of Committee on Public Undertakings (COPU) of the Parliament.
15. Provide an open avenue of communication between the independent auditor, internal auditor and the Board of Directors.
16. Review all related-party transactions in the company. For this purpose, the Audit Committee may designate a member who shall be responsible for reviewing related-party transactions.
17. Review with the independent auditor the coordination of audit efforts to assure completeness of coverage, reduction of redundant efforts and the effective use of all audit resources.
18. Consider and review the following with the independent auditor and the management: The adequacy of internal controls including computerized information system controls and security: Related findings and recommendations of the independent auditor and the internal auditor, together with the management responses.

19. Consider and review the following with the management, the internal auditor and the independent auditor.
    (a) Significant findings during the year, including the status of the previous audit recommendations.
    (b) Any difficulties encountered during the audit work including any restrictions on the scope of activities or access to required information.

Powers of Audit Committee

Commensurate with its role, the Audit Committee should be invested by the Board of Directors with sufficient powers, which should include the following:

(i) To investigate any activity within its terms of reference.
(ii) To seek information on and from any employee.
(iii) To obtain outside legal or other professional advice, subject to the approval of the Board of Directors.
(iv) To secure attendance of outsiders with relevant expertise, if it considers necessary.
(v) To protect the whistleblowers.

Meeting of Audit Committee

The Audit Committee should meet at least four times in a year and not more than four months shall elapse between two meetings. The quorum shall be either two members or one third of the members of the Audit Committee whichever is greater, but a minimum of two independent members must be present.

Remuneration Committee

Each CPSE shall constitute a Remuneration Committee comprising at least three Directors, all of whom should be part-time Directors (i.e., Nominee Directors or Independent Directors). The Committee should be headed by an Independent Director. CPSE will not be eligible for Performance Related Pay unless the Independent Directors are on its Board. Remuneration Committee will decide the annual bonus/variable pay pool and policy for its distribution across the executives and non-unionized supervisors, within the prescribed limits.

Subsidiary Companies

1. At least one Independent Director on the Board of Directors of the holding company shall be a Director on the Board of Directors of its subsidiary company.
2. The Audit Committee of the holding company shall also review the financial statements of its subsidiary company.
3. The minutes of the Board meetings of the subsidiary company shall be placed at the Board meeting of the holding company. The management should periodically bring to the attention of the Board of Directors of the holding company, a statement of all significant transactions and arrangements entered into by its subsidiary company.

For the purpose of these guidelines, only those subsidiaries turnover or net worth of which is not less than 20 per cent of the turnover or net worth respectively of the holding company in the immediate preceding accounting year may be treated as subsidiary companies.

Disclosure

Transaction Disclosure

1. A statement in summary form of transactions with related-parties in the normal and ordinary course of business shall be placed periodically before the Audit Committee.
2. Details of material individual transactions with related-parties, which are not in the normal and ordinary course of business, shall be placed before the Audit Committee.
3. Details of material individual transactions with related-parties or others, which are not on an arm's length basis should be placed before the Audit Committee, together with the Management' s justification for the same.

Accounting Standard Disclosure

Where in the preparation of financial statements, a treatment different from that prescribed in an Accounting Standard has been followed, the fact shall be disclosed in the financial statements, together with the management's explanation in the Corporate Governance report as to why it believes such an alternative treatment is more representative of the true and fair view of the underlying business transaction.

The Companies Act, as well as many other statutes, requires that financial statements of an enterprise should give a true and fair view of its financial position and working results. That requirement is implicit, even in the absence of a specific detailed provision to this effect. However, what constitutes a true and fair view has not been defined either in the Companies Act, 1956 or in any other statute. The Accounting Standards as well as other transactions of the Institute of Chartered Accountants of India on accounting matters seek to prescribe the accounting principles and the methods of applying these principles in preparation and presentation of financial statements so that they give a true and fair view.

Consolidated financial statements shall present financial information about the parent company, its subsidiaries, its associates and joint ventures as an economic entity to show the economic resources controlled by the group, the obligation of the group and the results the group achieved with its resources, which is not determinable from individual financial statements of parent, subsidiaries, associates and joint ventures. All CPSEs shall prepare consolidated financial statements as per Accounting Standards, namely, AS21, AS23 and AS27 issued by the Institute of Chartered Accountants of India (ICAI) in relation to the Consolidation of Financial Statements.

Many CPSEs provide groups of products and services or operate in the geographical areas that are subject to differing rates of profitability, opportunities for growth, future prospects and risks which may not be determinable from the aggregated data. Reporting of segment information is widely regarded as necessary for meeting the needs of users of financial statements. Hence, all CPSEs are required to publish segment-wise profit and loss as per Accounting Standard 17 'Segment Reporting' issued by the ICAI.

Risk Management Disclosure

The company shall lay down procedures to inform Board members about the risk assessment and minimization procedures. These procedures shall be periodically reviewed to ensure that the executive management controls risk through means of a properly defined framework. Procedure will be laid down for the internal risk management also.

The Board should implement policies and procedures which should include:

(a) Staff responsibilities in relation to fraud prevention and identification.
(b) Responsibility of fraud investigation, once a fraud has been identified.
(c) Process of reporting on fraud-related matters to management.
(d) Reporting and recording processes to be followed to record allegations of fraud.
(e) Requirements of training to be conducted on fraud prevention and identification.

Disclosure of Remuneration to Directors

All pecuniary relationship or transactions of the part-time Directors with regard to the company shall be disclosed in the Annual Report.

Further the following disclosures on the remuneration of Directors shall be made in the section on the Corporate Governance of the Annual Report.

(a) All elements of remuneration package of all the directors, i.e., salary, benefits, bonuses, stock options, pension, etc.
(b) Details of fixed component and performance-linked incentives, along with the performance criteria.
(c) Service contracts, notice period, severance fees.
(d) Stock option details, if any, and whether issued at a discount as well as the period over which accrued and over which exercisable.

Disclosure of Management Analysis

As part of the Directors' Report or, as an addition thereto, a Management Discussion and Analysis Report should form part of the Annual Report. This Management Discussion and Analysis should include discussion on the following matters within the limits set by the company's competitive position:

(i) Industry structure and developments.
(ii) Strength and weakness.
(iii) Opportunities and threats.
(iv) Segment-wise or product-wise performance.
(v) Outlook.
(vi) Risks and concerns.
(vii) Internal control systems and their adequacy.
(viii) Discussion on financial performance with respect to operational performance.
(ix) Material developments in Human Resources, Industrial Relations front, including the number of people employed.
(x) Environmental Protection and Conservation, Technological conservation, Renewable energy developments, Foreign Exchange conservation.
(xi) Corporate's Social responsibility.

Senior managers shall make disclosures to the board relating to all material financial and commercial transactions, where they have personal interest that may have a potential conflict with the interest of the company (Example: dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives, etc.)

Compliance of the Guidelines

The Ministry of Corporate Affairs, the SEBI and the Department of Public Enterprises are the three bodies under the Government of India to implement all corporate governance initiatives in CPSUs in India. Conventional wisdom suggests that the Government of India undertakings, as a model entrepreneur and investor is supposed to implement the guidelines in its letter and spirit. But unfortunately, the results are disturbing. Majority of the CPSUs have not implemented then in full. A survey conducted by an independent agency Stakeholders Empowerment Service (SES) among top 27 companies which includes 13 PSUs among the top 100 companies listed in the BSE and account for 14 per cent of the market capitalization, reveals that LIC Housing Finance Company is the only company complied the guidelines in full. It is stated that 25 per cent of the companies do not meet the criteria for independent directors, 50 per cent failed to constitute CSR complaint committee, 25 per cent do not have a woman director and 80 per cent have not complied with compliant audit committee and nomination and remuneration committee. Many of the listed PSUs are falling behind in complying with minimum requirements envisaged in Clause 49 which is statutory in nature. In the words of M. Damodaran, Former Chairman of the SEBI, 'While the issue of non-compliance is important, it is equally important to determine where accountability lies. While a PSU might be technically correct in taking the position that it is the concerned administrative ministry that is responsible for the appointment of Independent Directors, it would be necessary to consider the levying of penalties on the non-compliant PSUs so that the latter appropriately pressurise the concerned administrative ministries to make timely appointments of independent directors'.

World Bank Initiative of Improving Corporate Governance of India's CPSU

In 2010 the World Bank made an initiative for improving the performance if CPSU's in India and published a report making several suggestions. Some of the most important ones are as follows:

First, corporate governance reforms are and should be seen as part and parcel of the broader CPSE reform program rather than as a stand-alone or substitute reform. Reforms aimed at improving governance and increasing the CPSE autonomy such as board appointment and empowerment, separation of ownership from policy functions can facilitate broader policy reforms aimed at increasing market discipline through exposure to competition, tightening of budget constraints, listing of the CPSEs on the stock exchange and bringing in private sector participation. Market discipline in turn puts pressure on the CPSE to adopt further governance reforms and ensure transparency and accountability. It also helps maximize and sustain the gains from an improved governance.

Secondly, the GOI should target corporate governance efforts at Navaratnas, Miniratnas and other profitable companies. In tandem with other policy reforms, this would help achieve even higher levels of performance of some of India's most important companies. It would allow companies to graduate to higher categories, giving them greater delegation of powers and more autonomy while requiring higher levels of transparency and accountability. It would also help to facilitate listing of such companies on the capital markets. For consistently loss-making or unviable companies, the focus should be on restructuring through freeing up land for more productive use elsewhere in the economy, implementation of VRS and retraining programs and closure or liquidation.

Third, expanding and deepening corporate governance reforms requires action on several fronts. These are as follows:

1. **Strengthening the State's ownership role:** How the State organises and exercises its ownership rights is central to improving the CPSE governance. The main challenge lies in making a complex and control oriented ownership framework more effective in striking the right balance between the CPSE autonomy and accountability. This can be achieved by: (i) reforming ownership arrangements with a view to focusing the role of administrative ministries on policy-making and limiting their day-to-day role in commercial decision-making, giving boards greater decision-making powers in practice, and considering moving to a more centralized ownership model in the longer-term; (ii) improving the ways in which the GOI exercises its key ownership functions, in particular enhancing the transparency in the board appointment process and improving performance monitoring; (iii) enhancing the role and the capacity of the Department of Public Enterprises as a nodal agency to make it a more active promoter of the governance agenda and (iv) improving the Corporate Governance Guidelines so that they become a more effective governance tool.
2. **Professionalising CPSE boards:** While boards have come a long way in becoming more professional over the years, there is still substantial room for improvement. Particularly in the case of Navaratnas, Miniratnas and other profit-making companies, boards could be made more effective by bringing in independent directors from the private sector, empowering boards with greater decision-making authority while ensuring fair and responsible behaviour through integrity and accountability mechanisms, strengthening audit committees, introducing performance-based board evaluation and remuneration practices and making board development and leadership programs mandatory.
3. **Imposing market discipline:** The legal and regulatory framework for State-owned enterprises should ensure a level-playing field in markets where State-owned enterprises and private sector companies compete in order to avoid market distortions. The framework should build on and be fully compatible with the OECD Principles of Corporate Governance. In India mostly administered pricing mechanism is followed for many products like fertilizers, drugs, food, Kerosene, etc. This should be changed and market-driven pricing mechanism should be introduced in the CPSUs.
4. **Make human resource policies more market-based:** The CPSE employee status remains ambiguous. Even though there are court rulings that the CPSU employees does not enjoy the status of civil servants, for all practical purposes, however, the CPSE employees are treated as public sector employees and as such enjoy a number of rights and benefits, including job security and social benefits. This once made and still makes the CPSE employment highly desirable, but the rapid growth of the private sector has created new opportunities for skilled workers and managers. Attracting and retaining talent in the CPSEs could become a major challenge.

Uday Kotak Committee 2017 Recommendations on PSUs' Governance

Uday Kotak committee on CG after identifying the unique characteristics of PSU's such as multiplicity of objectives, structural issues relating to single entity acting as regulator and owner recommended for ensuring transparency in commercial and welfare objectives, independence of PSU's decision making process, and creation of a separate entity for the management of PSU's.

The Uday Kotak Committee on corporate governance 2017 also emphasized the need for a mechanism for the Good governance of PSUs in India.

The Committee identified the unique features of PUSs and the problems faced by them such as a multiplicity of objectives to be achieved (business objectives and welfare objectives), different from private sector because of the government ownership, structural issues like single entity (Government) acting as owner and

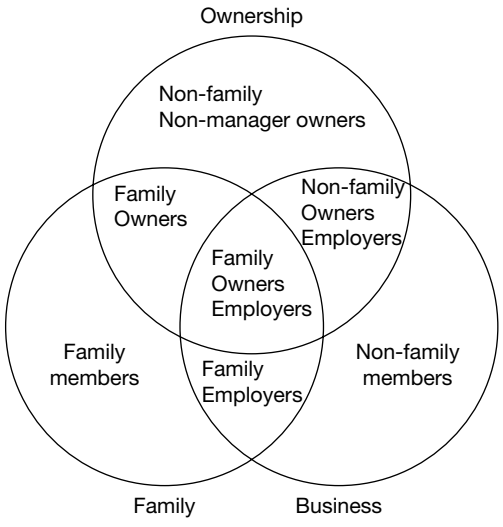
regulator and lengthy decision making time in PSUs because of multiple level accountability. The Committee also made some recommendations like the need for establishing transparency in commercial and welfare objectives, ensuring independence of PSUs at least for decision making purpose from the crutches of the concerned ministry, consolidation of the government stake in the different PSUs and creation of a separate entity for management of different PSUs such as strategy formulation, performance evaluation, consolidations, mergers, etc.

Family-Run Business and Corporate Governance

Introduction

Family-owned business refers to a business entity whose voting rights are in the hands of a family which pass the rights of their descendents. It occupies a dominant position all over the world. The globalization process and international movement of capital across the globe has made significant changes in this structure. In India also about two third of business entities are owned and controlled by a few business families. This model has its own strengths such as higher commitment, innovations, quick decision-making etc., and weaknesses such as informality, complexity, resistance to changed, lack of discipline etc.

Family-run business dominates in most of the developed and the developing economies of the world. In the US, family-run business constitutes 80 to 90 per cent of the total business enterprises and provides 50 per cent of the total employment. In India family controlled businesses are 85 to 90 per cent of the total enterprises and provide 50 per cent of the employment. The situation in most of the countries is not much different. The globalisation and the fast changing technology pose a great threat to the survival of such businesses. A well knit corporate governance mechanism implemented within the family run business will ensure longevity and survival chances of such businesses. The economic and social importance of family-run business is widely accepted among the world community. Internationally these firms are considered to be more influential and dominating. The member of family-run business to total enterprises is estimated to range from 75 per cent in the United Kingdom to more than 90 per cent in South Asia, Latin America and the Far and the Middle East. It is widely seen that family-run businesses have a very short lifespan beyond their founder's age and that some 95 per cent of family businesses do not survive beyond the founder life span. This is the great challenge such an organisation is facing throughout the world. Family-owned business is the oldest and the most common model of economic organisation. The world's richest people are from the members of family-owned business. In some countries, many of the largest publicly listed firms are family owned. The three circle model is generally accepted as the standard model for family businesses and includes family business and ownership as the three main components.



Source: Taguiri and Davis "Bivalent Attributes of the Family Firm" Harvested Business School.

Definition and Characteristics—Strengths and Weaknesses

Definition

According to IFC, a family business refers to a company where the voting majority is in the hands of the controlling family; including the founder(s) who intends to pass the business on to their descendants. A family business is a commercial establishment where decision-making is taken by multiple generations of the family related by blood or marriage. Leadership and ownership is difficult to segregate. Multigenerational presence is essential to term an organisation as family business. Owner-manager enterprises are not termed as family businesses because of the fact that they lack the multi-generational dimension and family influence that create unique dynamics and relationships of family business. Following are the characteristics of family owned business.

- **Commitment:** The family as the business owner shows the highest dedication in seeing its business grow prosper and get passed on to the next generations. As a result, many family members identify with the company and are usually willing to work harder and reinvest a part of their profits in the business to allow it to grow in the long term.
- **Knowledge continuity:** Families in business make it a priority to pass their accumulated knowledge, experience, and skills to the next generations. Many family members get immersed in their family business from a very young age. This increases their level of commitment and provides them with the necessary tools to run their family business.
- **Reliability and pride:** Because family businesses have their name and reputation associated with their products and/or services, they strive to increase the quality of their output and to maintain a good relationship with their partners (customers, suppliers, employees, community, etc.).
- **Sustainability:** The most often cited characteristic of family businesses is that many of them fail to be sustainable in the long term. Indeed about two-thirds to three-quarters of family businesses either collapse or are sold by the founder(s) during his their own tenure. Only 5 to 15 per cent continue to the third generation of the descendants of the founder(s). This high rate of failure among family businesses is attributed to a multitude of reasons. Some of these reasons are the same ones that could make any other business fail such as poor management, insufficient cash to fund growth, inadequate control of costs, industry and other macro conditions.

Strength of Family-Owned Business

- **Entrepreneurial:** Family-owned business is found to be highly informal and therefore it is flexible and innovative. Hence, in the family-owned enterprises entrepreneurship is very high.
- **Multiple roles:** A single person at the helm of affairs is often played in multiple roles having dual relationship. Therefore quick decision making is possible.
- **Committed employees:** Employees are very committed, loyal, shared values and belief system. Family spirit, strong sense of mission/vision.
- **Innovative:** Employees are well spirited and loyal engaged in deeper ties with the family. They can foster creativity, rich interplay of roles and goals.

Weaknesses of Family Owned Business

- **Complexity:** Family businesses are usually more complex in terms of governance than their counterparts due to the addition of a new variable such as the family. Adding the family emotions and issues to the business increases the complexity of issues that these businesses have to deal with. Unlike in other types of businesses, family members play different roles within their business, which can sometimes lead to a non-alignment of incentives among all family members.
- **Informality:** Because most families run their businesses themselves (at least during the first and the second generations), there is usually very little interest in setting clearly articulated business practices and procedures. As the family and its business grow larger, this situation can lead to many inefficiencies and internal conflicts that could threaten the continuity of the business.
- **Lack of discipline:** Many family businesses do not pay sufficient attention to key strategic areas such as the CEO and other key management positions, succession planning, family member employment in the company and attracting and retaining skilled outside managers. Delaying or ignoring such important strategic decisions could lead to business failure in any family business in what is to be done resulting in confusion.
- **Lack of clarity:** Many family-run businesses lack clarity in what is to be done resulting in confusion. In some cases they are totally indecisive, resistant to change, and they lack management development with no organisational chart defining specifically about the role and responsibility of each member in the family work for the organisation.
- **Autocratic:** Sometimes the leadership is as conservative and rigid as a reflection of autocratic tendency of the family. They resist changing the structure and the system arresting the smooth flow of the organisation.
- **Family problems:** Can't keep family issues out of business. Inability to balance family's and business's need for liquidity, lack of objectivity, inward looking, emotionally charged decision making, can't separate work and family rivalries.
- **Resistance to change:** Family-run business in most of the cases is tradition bound. History of family affects business decisions, trust affected by earlier disappointments.
- **Succession:** In most of the family-run business the administration finds it difficult to find a suitable successor.
- **Governance:** May sacrifice growth for control, do not have to answer to stockholders. Often no outside board of directors, high premium on privacy.

Stages of Growth in a Family Business

There are three stages in the growth of family business namely Founder's stage, Sibling partnership and Cousin Confederation.

Several models have been developed to describe and analyse the different stages that family businesses go through during their existence. Generally the three stage model of business growth is noted: (i) the Founder(s) Stage; (ii) the Sibling Partnership Stage; and (iii) the Cousin Confederation Stage. Although this model allows for a good analysis of the three basic steps of evolution of the family business, it does not mandate that all family-owned companies will necessarily go through all the three stages of development. For example, some companies will disappear during the early stages of their life-cycle because of bankruptcy or getting acquired by another firm. The evolution of ownership and management within most family businesses goes through the following stages:

1. **Stage 1:** The Founder(s) (Controlling Owner(s))
   This is the initial step of the family business' existence. The business is entirely owned and managed by the founder(s). Most founders might seek advice from a

small number of outside advisors and/or business associates but they will make the majority of the key decisions themselves. This stage is usually characterized by a strong commitment of the founder(s) to the success of their company and a relatively simple governance structure. Overall, this stage contains limited corporate governance issues compared to the next two stages since both the control and ownership of the company are still in the hands of the same person(s): the founder(s). Perhaps the most important issue that will need to be addressed during the life of the founder(s) is the succession planning. For the family business to survive onto its next stage, the founder(s) should make the necessary efforts to plan for their succession and start grooming the next leader(s) of the company.

2. **Stage 2:** The Sibling Partnership
   This is the stage where the management and the ownership have been transferred to the children of the founder(s). As more family members are now involved in the company, governance issues tend to become relatively more complex than those observed during the initial stage of the business' existence. Some of the common challenges of the sibling-partnership stage are maintaining siblings' harmony, formalising business processes and procedures, establishing efficient communication channels between family members and ensuring succession planning for key management positions.
3. **Stage 3:** The Cousin Confederation (Cousin Consortium or Family Dynasty)
   At this stage, the business' governance becomes much more complex as more family members are directly or indirectly involved in the business, including children of the siblings, cousins and in-laws. Since many of these members belong to the different generations and the different branches of the family, they might have diverse ideas on how the company should be run and how the overall strategy should be set. In addition, any conflicts that existed among the siblings in the previous stage would most likely be carried to the cousin generation as well. As a consequence, this stage involves most family-governance issues. Some of the most common issues that family businesses face at this stage are family member employment, family shareholding rights; shareholding liquidity, dividend policy, family member role in the business, family conflict resolution and family vision and mission.

Dominant Shareholder Issues

- Leadership transition
- Succession
- Estate planning
- Maintaining teamwork and harmony
- Sustaining family ownership
- Allocation of corporate capital: dividends, debt, and profit levels
- Shareholder liquidity
- Family conflict resolution
- Family participation and role
- Family vision and mission
- Family linkage with the business

Major issues in the family-run business are leadership transition, succession issues, estate planning, team work and harmony, maintaining family relationship, distribution of profit and dividend, family vision and mission, family participation in business, family linkage with business, and related party transactions.

The following table summarizes the key family governance issues faced by family businesses during their development cycle.

Each stage presents different challenges and issues that, if properly managed can ensure the continuity of the family business. Most family-owned companies are successful during their infancy stage thanks to the tremendous efforts made by the founder(s) as they are implicated in all aspects of the business. In the longer

term though, it becomes necessary to set up the right governance structures and mechanisms that will allow for efficient communication channels and a clear definition of the roles and expectations of every person involved in the family business.

Governance Issues Faced by Family Run Business

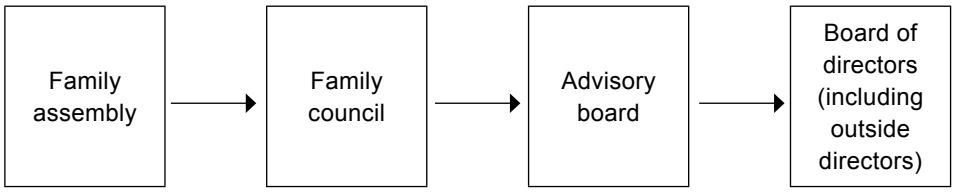
Ownership Stage	*Dominant shareholder issues*
Stage 1: The Founder(s)	• Leadership transition • Succession • Estate planning
Stage 2: The Sibling Partnership	• Maintaining teamwork and harmony • Sustaining family ownership • Succession
Stage 3: The Cousin Confederation	• Allocation of corporate capital: dividends, debt, and profit levels • Shareholder liquidity • Family conflict resolution • Family participation and role • Family vision and mission • Family linkage with the business

Each stage presents different challenges and issues that, if properly managed, can ensure the continuity of the family business. Most family-owned companies are successful during their infancy stage, thanks to the tremendous efforts made by the founder(s) as they are implicated in all aspects of the business. In the longer term though, it becomes necessary to set up the right governance structures and mechanisms that will allow for efficient communication channels and a clear definition of the roles and expectations of every person involved in the family business

Family-owned Business and Governance

In family-owned business the managers may act solely for the family, and not for the shareholders. It is, therefore, a problem of agency where the interest of the managers is to protect the interest of the family members and therefore, the separation of ownership and control in its letter and spirit is not implemented properly. The directors are appointed, in some cases, act as rubberstamps and no discourse takes place in its meetings. Ultimately, the terms dictated by the family members run the business. The generational changes in the family business have little or no impact on the business because the families are interlocked with marriages. The problems of legal heir in certain cases are not addressed properly. The cultural bondage of the family unites them often. When a business reaches a stage where the family relationship worsens due to sharing of huge properties at their disposal, consequently the performance of the company worsens day after day the top administration realises the need and necessity of bringing professional leadership to the company.

Possible stages in a family firm's governance



Family-Owned Business in India

Prior to the industrial revolution and emergence of multinational corporations the industrial scenario of the world was that of family-owned business. In the Indian context, there were a lot of issues regarding succession of family businesses. Family business in India had been in practice since long, of course, with its changing nature and structure over the period. India enjoys a rich and glorious history of family-owned business. The origin of family business in India could be traced back to the bazaar system in the ancient times. Initially family business in India started in the form of trading and money-lending, involving the hustle and bustle of the bazaar. It was also confined to certain communities, notably the Jains and Marwaris especially in the northern India. Its industry form is relatively of recent origin, going back largely to the British rule and the First World War. Cowasji Davar set up the first cotton mill or say the first manufacturing enterprise in Bombay in 1854. Subsequently some trading communities started textile mills in Mumbai and Ahmedabad during the last half of the 19th Century. The trading communities emerged as Agarwals and Guptas in the North, the Chettiars in the South, the Parsees and Gujarati Jains and Banias, Muslim Khojas and Memons in the West, and Marwaris all over India. Nowadays, Agarwals are mostly referred to as Marwaris.

Initially, family businessmen were engaged in small-size business requiring small investments managed by them only. But, once they entered the manufacturing sector, they felt the need for more and heavy investments, not manageable by themselves. At the same time, they also knew that once they allowed someone to join business, their control over management of the business would weaken which they, however, did not want. In such a case, family businesses inducted their family members or relatives or friends in the business by allotting them blocks of shares while making sure that the majority control and, in turn, the management of the business remained with the promoting family itself. It was how corporate management was born embedded by a combination of joint stock principle and family control over business. Because stock markets were yet to gain sufficient momentum, on the one hand, and the joint family system was also intact, on the other, business families were holding control over their business empires built up through ingenious device, popularly known as the 'managing agency system'. The managing agency system continued till 1970 as an instrument of maintaining family control over the business enterprise. As such, all critical decisions about the business were taken by the promoting families, euphemistically termed managing agents. This system of corporate management got so rooted in due course of time that hardly any industrial firm remained out of its orbit. In other words, this indicates that all businesses were controlled and managed by a few families in the country.

Some of the leading family run businesses in India are detailed below.

1. **The Tata Group:** Established in 1868 by Jamshedji Tata as trading company, the Tata Group has become the global face of Indian business. It has 32 listed companies with market capitalisation of more than ₹ 6 trillion. The number of people employed in various Tata companies is nearly 5 lakh. Its major companies include the Tata Motors, the TCS, the Tata power, the Titan Industries and the Taj Hotels. The group has a strong tradition of philanthropy.
2. **The Murugappa Group:** The foundation of Murugappa group was laid by Dewan Bahadur A. M. M. Murugappa Chettiar in 1900. It started as a money lending and banking service in Burma. Currently the fourth generation of the family is managing the business which has 28 companies and is headquartered in Chennai. They employ 32000 people and the total business is worth ₹ 225 billion. They are into the sectors as diverse as general insurance, fertilisers, manufacturing bicycles, steel tubes and abrasives.

3. **The Dabur Group:** Dabur has come a long way since its foundation by Dr. S. K. Burman in 1884. It is currently the largest manufacturer of Ayurvedic medicines in India. Dabur offers 260 medicines for the treatment of a range of ailments. It employs around 3000 people. The have several non-family members serving. On the board of the company and also in the CEO position.
4. **The Birla Group:** The Birla business group was founded by Seth Shiv Narayan Birla in 1857. Currently, they have presence in 33 countries and provide employment to 1,36,000 people. They are the third largest Indian company in private sector with a net revenue of USD 40 billion. They have a very wide range of business interest in such as mining, cements, textiles, telecommunications, financial services, chemicals, power generation, IT and BPO services.
5. **The Wadia Group:** Wadia group was established when Sir Lovji Wadia got a contract to manufacture ships and docks for the East India Company in 1736. Currently they have 5 listed companies in Bombay Dyeing, Britania Industries, Bombay Realty, Go Air and National Peroxide. The current chairman is Nusli Wadia. They have presence in aviation, healthcare, real estate, auto components, chemicals, engineering, plantations and retail.
6. **The Godrej Group:** Ardeshir Godrej founded the Godrej Group in 1897 to manufacture locks. They are present in industries such as furniture, industrial engineering, real estate, agribusiness, construction, information technology and FMCG. It is currently managed by the 4th generation of the family. The group generates a revenue of US$ 3.5 billion. They employ 26,000 people. The present chairman of the group is Adi Godrej.
7. **The Kirloskar Group:** The Kirloskar Group was set up in 1888 as Kirloskar Brothers Limited. The group came to prominence and achieved high success under the leadership of Laxamanrao Kirloskar. They are into engineering and manufacturing of pumps, engines, valves and compressors. They are also into the construction business. They have more than 18,000 employees and US$ 2.5 billion revenue. The current chairman of the group is Sanjay Kirloskar.
8. **The Modi Group:** Rai Bahadur Gujarmal Modi established in 1933. They have a diversified business portfolio such as tea and beverages, restaurants, education, entertainment, consumer products, healthcare, food and hospitality. They have US$ 2.8 billion revenue and offer employment to 28,000 people. They are headquartered in New Delhi. The current chairman is Krishan Kumar.
9. **The Mahindra Group:** Brother's J. C Mahindra and K. C Mahindra along with Malik Ghulam Muhammad started a business in 1945 to trade steel. Later the company was known as Mahindra and Mahindra. Currently they have US$ 15.9 billion revenue employing 1,55,000 people. They are into automobiles, aerospace, agribusiness and information technology. The major subsidiaries of the group are Mahindra & Mahindra, Mahindra Satyam, Tech Mahindra and Mahindra Aerospace.
10. **The Raymond Group:** In 1925 the Raymond mill was set up in Thane to produce woollen blankets. Raymond is currently one of the leading fashion retailers and fabric manufacturers of India with a revenue of US$ 210 million. They produce fabrics, designer-wear, denim, toiletries and engineering files and tools. They are also into air charter services. The major brands of the Raymond group are Raymond, Park Avenue, Parx and Raymond Apparel.
11. **The Reliance Industries:** Founded by Dhirubhai Ambani in 1966 as Reliance Commercial Corporation, Reliance industries is the largest private sector conglomerate company in India. The company was divided between the

founder's two sons, Mukesh Ambani and Anil Ambani in 2006. In September 2008, Reliance Industries was the only Indian firm that featured in the Forbes's list of "World's 100 most respected companies". In 2010, the company occupied the 13th position in the Platts Top 250 Global Energy Company Rankings. The company's petrochemicals, refining, oil and gas related operations are the core of its business. Other segments of the company include textiles, retail business, telecommunications and special economic zones development. Reliance retail has moved into the fresh food market as Reliance Fresh.

12. **Bharti Airtel:** Bharti Airtel popularly known as Airtel was founded by Sunil Mittal in 1995. It is an Indian telecommunications company that operates in 20 countries across the South Asia, Africa and the Channel Islands. It operates a GSM network in many countries, providing 2G or 3G services depending upon the company of operation. Airtel is the fifth largest telecom operator in the world. The company has its headquarters in New Delhi. Its main products are fixed-line and mobile telephony, broadband and fixed-line internet services, digital television, IPTV and network services.
13. **Wipro:** Headquartered in Bangalore, Wipro technologies is a global information technology company which was founded by M. H. Hasham Premji in 1945. After M. H. Hasham Premi's death, his son Azim Premji had to leave Stanford University to take care of the company which he struggled to convert it into Wipro technologies. Recently Rishad Premji son of Azim Premji is promoted as Vice President of Wipro. Wipro provides outsourced research and development, infrastructure outsourcing, business process outsourcing and business consulting services.
14. **Jindal Group:** Jindal Group was founded in 1952 by O. P. Jindal. After O. P. Jindal's death in 2005 in a helicopter crash much of his assets were transferred to Savitri Jindal, the wife of Late O. P. Jindal. She was ranked among the 19th richest Indian person by Forbes. Naveen Jindal is the Managing Director of Jindal Steel and Power limited. The company manufactures and sells sponge iron, mild steel slabs, ferro chrome, iron ore, mild steel, structural, hot rolled plates and coils and coal based sponge iron plant. Jindal steel and power limited is also engaged in power generation. Jindal group has manufacturing outfits across India, the US and Indonesia.

Issues of Corporate Governance in Family-Owned Business in India

The major concern of corporate governance of family-run business in India is the concentration of ownership in multiple organisations under the same management. Therefore, the related-party transactions between these organisations are a matter of concern for the other prime stakeholders of the company. High profile related party transactions have damaged the long term interest of the shareholders resulting in tarnished image of the company. The new Companies Act enacted in the year 2013 has provisions regarding the related-party transactions that still require further provisions to bring transparency, disclosure and accountability in controlling shareholders. Therefore, OECD has brought out suggestions to strengthen governance in family owned business.

Related Party Transactions

According to the OECD Principles of Corporate Governance (2004), the related-parties can include entities that control or being under the common control with the company, there are significant shareholders including members of their families and key management personnel. Transactions involving the major shareholders

(or their close family, relations, etc.), either directly or indirectly are potentially the most difficult type of transactions to identify.

The various types of RPTs that are commonly observed are:

- Financial assistance through provisions of loans, guarantees and collateral.
- Asset sales and purchases between related-parties.
- The sale, purchase or supply of any goods, materials or services in the ordinary course of business.
- Bailouts

The OECD Principle on Protection of Minority Interest and Related-Party Transactions

Principle III.A.2 (minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly and should have effective means of redress). While laws and regulations are in place, effective means of redress is lacking.

Principle III.C (members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation). This is implemented by laws and regulations even though the enforcement might remain problematic.

Principle V.A.5 (disclosure should include, but not be limited to material information on related-party transactions). It is broadly implemented through the listing agreement and accounting standards although disclosure about the company group might need to be better developed.

Principle VI.D.6 (the board should fulfil certain key functions, including monitoring and managing potential conflicts of interest of management, board members and shareholders, including the misuse of corporate assets and the abuse in related-party transactions) is broadly implemented by Sections 299 and 300 of the company law although they might need to be tightened to cover conflicts of interest with controlling shareholders and company groups.

Legal Framework Governing Related-Party Transactions and Minority Interest in India

Existing law does not prohibit RPTs in India. Instead, the law puts into place a system of checks and balances, such as requirements for approval from the board of directors/shareholders, timely disclosures and prior statutory approvals, to ensure that the transactions are conducted within appropriate boundaries. RPTs are required to be managed transparently, so as not to impose a heavy burden on a company's resources, affect the optimum allocation of resources, distort competition or siphon off public resources.

The Indian Companies Act

The Companies Act 2013 contains the definition of related-party, as follows:

'Related-party', with reference to a company, means

(i) A director or his relative.

(ii) A key managerial personnel or his relative.

(iii) A firm, in which a director, manager or his relative is a partner.

(iv) A private company in which a director or manager is a member or director.

(v) A public company in which a director or manager is a director or holds along with his relatives, more than two per cent of its paid-up share capital.

(vi) Anybody corporate whose Board of Directors, managing director or manager is accustomed to act in accordance with the advice, directions or instructions of a director or manager.

(vii) Any person on whose advice, directions or instructions a director or manager is accustomed to act provided that nothing in sub-clauses (vi) and (vii) shall apply to the advice, directions or instructions given in a professional capacity.

(viii) Any company which is:
  (a) A holding, subsidiary or an associate company of such a company.
  (b) A subsidiary of a holding company to which it is also a subsidiary.

(ix) Such other person as may be prescribed.

The Companies Act 1956 imposes certain conditions when a company is entering into any transaction in which directors have an interest.

- Section 297 of the Companies Act requires board approval for entering into any contract or arrangement with the related parties. This section covers only transactions relating to sale, purchase or supply of any goods, materials and services or for the underwriting of the subscription of any shares in, or debentures of the company.
- Further, there is a requirement to obtain prior central government approval if the company has paid up capital of more than 1 crore rupees.
- At the same time, Section 297(2) provides exemption to obtaining approvals if:
  - The purchase/sale is for cash and at prevailing market prices.
  - The contract relates to goods, materials and services regularly traded or doing business, provided the value of the contract is less than ₹ 5000.
  - In the case of banking or insurance company, the exemption applies to any transaction in the company's ordinary course of business.
- Section 299 imposes a duty on directors to disclose their interest in other concerns to the board of directors before entering into any contract with the related parties. Section 299 is broader than Section 297, since it covers any contract or arrangement with entities in which a director is concerned or interested.
- Section 300 disallows the director to participate in voting when the board resolution is passed relating to any business in which he/she is interested. The main intention behind this section is to prevent personal gain by the interested director. The Companies Auditor's Report Order (CARO) requires the auditor to comment on certain related-party transactions and on the reasonableness of those transactions in the audit opinion.

Accounting Standards

To enhance disclosure of related-party transactions, the Institute of Chartered Accountants of India (ICAI) introduced Accounting Standard 18-Related-Party Disclosures, which requires companies to disclose RPTs in their financial statements. Under Accounting Standard 18-Related Party Disclosures (AS 18), 'the parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions'. A related-party

transaction means 'a transfer of resources or obligations between related parties, regardless of whether or not a price is charged'. The following are examples of related parties pursuant to AS-18:

- Holding companies, subsidiaries and fellow subsidiaries.
- Associates and joint ventures.
- Individuals (including their relatives) having voting power giving them control or significant influence.
- Key management personnel (KMP), including their relatives.
- Enterprises where individuals, their relatives or KMP have the ability to control or exercise significant influence. Currently, this definition of a related-party is used to identify the transactions for making disclosures in the Annual Report. The definition is also referred to in determining related-party transactions for the purpose of compliance with the listing agreement. The section of the Annual Report on managerial remuneration, loans/advances due from directors and subsidiaries and the auditor's report (which may certify/qualify certain transactions) may provide important supplementary information on transactions with related-parties. In its commitment to converge Indian Generally Accepted Accounting Principles (GAAP) with the International Financial Reporting Standards (IFRS), ICAI has published Indian Accounting Standards 24 on Related-Party Disclosures, which substantially reflects the standards set forth in the International Accounting Standard (IAS) 24. IAS 24, which deals with related-party transactions, has a wider definition and coverage of related party transactions. The definition of related party under IAS 24 is 'A related party is a person or entity that is related to the entity that is preparing its financial statements'.

The term 'related' has further been defined to include persons having the ability to exercise control/joint control or significant influence over the reporting entity. Further, the members of the family and entities under common control are covered under this definition. The IAS 24 definition of related parties includes the KMP of the parent company within the related party framework. Furthermore, this definition covers co-ventures or co-associates and requires extended disclosures for compensation of KMP under different categories. IAS 24 also mandates disclosure of the amount of related party transactions; in comparison, Indian AS 18 requires the disclosure the volume of transactions either as an amount or as a proportion. India also announced a roadmap to converge with IFRS and has published converged Accounting Standards (Ind AS). Ind AS 24 corresponds to IAS 24 and deals with the related-party transactions. While Ind AS 24 has a similar definition of related parties as IAS 24, it is much more comprehensive and seeks to address some of the present concerns in its wider scope and more specific disclosure requirements.

The Income Tax Act 1961

A disclosure that a related-party transaction was made during the year serves little purpose, unless one takes into account the terms of the transaction and the tax implications. Section 40 A (2) of the Income Tax Act disallows the expenditure incurred in respect of specified persons (related parties) if the tax assessing officer considers the expenditure excessive and unreasonable. Auditing and Assurance Standard 23 imposes duty on the auditor to identify and disclose RPTs in the financial statements.

Equity Listing Agreement

As per Clause 49 of the Equity Listing Agreement, the audit committee (a committee on which two-thirds of the directors and the chair are independent) should review the RPTs, the whistleblower mechanism and the internal control, among other areas (Clause 49). Further:

(a) The audit committee shall periodically consider a statement in summary form of transactions with related parties in the ordinary course of business.
(b) The audit committee shall evaluate details of material individual transactions with related parties that are not in the normal course of business.
(c) The Audit Committee shall review details of material individual transactions with related-parties or others that are not on an arm's length basis, along with management's justification for those transactions. Senior management shall make disclosures to the board relating to all material financial and commercial transactions, where they have a personal interest or that may pose a potential conflict with the interests of the company at large (for example, dealing in company shares and commercial dealings with bodies under common management) (Clause 49). SEBI has taken certain steps to prevent abusive RPTs, such as a requirement that listed companies provide a fairness opinion of any independent merchant bankers employed by the company to their shareholders on schemes involving mergers with unlisted companies and comprehensive disclosures regarding related party transactions in the offer documents for public and rights issues.

SEBI Circular

Further, to encourage minority shareholders and institutional investors to participate in the voting process of the listed companies, the SEBI has issued circulars dated on 5 October 2011 and 15 March 2010 requiring listed companies to disclose the voting patterns to the stock exchanges and asset management companies of mutual funds to disclose their voting policies and their exercise of voting rights on their websites and in Annual Reports. The Ministry of Corporate Affairs' and SEBI's initiatives on e-voting will also facilitate dispersed minority shareholders' exercise of their voting rights in general meetings.

Fiduciary Responsibility of Controlling Shareholders

Controlling shareholders, better known as promoters in India, who manage the company owe a fiduciary responsibility to the minority shareholders and to the company as a whole. There have been cases where controlling shareholders have used the company for their personal interest while sacrificing the overall interest of the company and of its shareholders mostly by abusing RPTs. Current laws/regulations do not explicitly set forth the fiduciary responsibilities of the controlling shareholders.

Uday Kodak Report on Corporate Governance 2017

The new report on corporate governance released on 5 October 2017 states that 'governance practices even in some of the most reputed publicly listed Indian companies have come under question on a number of dimensions. These include evaluation of company boards, board diversity, reliability of disclosures (especially

those relating to financial statements), role of independent directors, protection of minority shareholder interests, managerial compensation and related-party transactions'. The observations of the Committee on shaping the governance to protect the shareholder interests are:

(i) Strengthening the core safeguarding committees of the board, audit, risk and technology (including cyber security), enhancing their scope and periodicity.

(ii) Enhancing monitoring of group entities and subsidiaries to ensure that the shareholders get a holistic and transparent view of performance.

(iii) A majority of Indian listed entities continue to be promoter–driven entities with a significant shareholding being held by the promoter/promoter group. Therefore, the protection of the interests of minority shareholders, especially those of the retail shareholders assumes even greater importance. In this context, clarifying conditions for sharing of information and creating checks and balances on the related-party transactions are crucial for good governance. It is also important to ensure that compensation practices, especially with respect to promoter-directors, do not exacerbate potential agency problems.

(iv) Enhancing disclosure norms significantly in order to provide greater transparency to investors and thereby reducing a possible asymmetric information, in areas such as credit rating, securities holdings and performance. Financial and performance disclosures alone tend to yield little insight into the company's value drivers or future potential. These disclosures rarely connect recent performance to long-term strategy and progress on value creation. Companies that articulate a long-term strategy effectively tend to attract investors who are more willing to look beyond short-term under-performance.

(v) Recognising that stakeholders rely significantly on auditors, strengthening the audit function will provide them greater comfort.

(vi) Evaluating structural solutions for the PSEs.

(vii) Strengthening the enforcement mechanism by leveraging data, technology and creating greater enforcement capacity within the SEBI. This has the potential to have a multiplier effect on governance of listed entities.

CONCLUSION

Indian corporate sector is still dominated by family-owned business. Majority of them are not listed. Therefore, a difference lies in perfect corporate governance and good corporate governance. This is because in some closely held unlisted companies in India the stakeholders are better protected than in the listed companies. But their size is relative small. In this context, Indian corporate governance practices need to be refined further to bring transparency, accountability and safety of stakeholders.

KEYWORDS

- Ancillary industries
- Closely held company
- Disinvestment
- Family owned business
- Family trust
- Maharatna
- Market capitalization
- Media
- Miniratna
- Minority interest, Companies Act 2013.
- Navaratna
- Non state ownership
- Public sector undertakings
- State enterprises
- State ownership
- Three circle model
- Uday Kodak Committee Report 2017

DISCUSSION QUESTIONS

1. Define the major characteristics of a public sector company.
2. What are the contributions of public sector in India?
3. Define disinvestment. Explain the disinvestment policy of the Government of India.
4. Discuss the major principles of the OECD guidelines of public sector corporate governance.
5. What are the different types of PSUs in India? How are they organised?
6. Explain the guidelines issued by the Department of Public Enterprises on corporate governance of state enterprises.
7. Distinguish between public policy and public sector governance. How does public policy affect the public sector governance?
8. Discuss the contribution of World Bank initiatives in the public sector corporate governance.
9. Define family-owned business. State its important characteristics.
10. State the strengths and the weaknesses of family-owned business.
11. What are the stages of growth of family-owned business?
12. What do you mean by three circle model of family-owned business? Explain.
13. What do you mean by related party transactions? State its features.
14. What are the legal provisions relating to related-party transactions?
15. State the observations of the Uday Kodak report on related-party transactions.

SUGGESTED READINGS

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Golden Case Studies

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Case Study 1

Infosys Technologies: The Best Among Indian Corporates

(This case is based on reports in the print and electronic media. The case is meant for academic discussion only. The author has no intention to tarnish the reputations of corporates or executives involved.)

Humble Beginning and Spectacular Growth of Infosys

Infosys Technologies is India's most popular and best managed IT company with its global headquarters at Bangalore. It was founded in 1981 by Narayana Murthy and six of his colleagues in Bombay in a single room of Murthy's house with a paltry sum of Rs. 10,000 as capital. It has, today, a global presence of 32 sales offices in 16 countries, 33 global software development centres and one business continuity centre. It employed 35,229 people as on 31 December 2004.

Vision and Message of Infosys

The *vision* of Infosys is "to be a globally respected corporation that provides best-of-breed business solutions, leveraging technology, delivered by best-in-class people". Its *mission* is "to achieve our objectives in an environment of fairness, honesty and courtesy towards our clients, employees vendors and society at large". Infosys has set standards in every business activity—best campus, best working environment, best employer, most transparent dealings, highest quality standards—as well as the highest ethical standards, never seeking any deviant benefits from the government.

The most telling message that Infosys gives out to any discerning observer is its motto: *Powered by Intellect and Driven by Values.* These two phrases put together stand for everything that Infosys is and wants to be. It is a combination of the business acumen and the deep commitment to ethical values.

Powered by Intellect: Infosys plans to take a lead in leveraging the global delivery model (GDM), pioneered and perfected by it, to help clients derive maximum strategic advantage. In the next growth phase, Infosys would focus on customer-centricity, meeting shareholder expectations and building a multicultural workforce—a seamlessly integrated team of talented, global professionals.

Driven by values: Infosys is an ethical organisation whose value system ensures fairness, honesty, transparency and courtesy to all its constituents and society at large.

Infosys Technologies strives to be the best company both commercially and ethically not only in India but also globally. To realise this objective, the company has developed C-Life Principle of core values that it puts into practice in all aspects of its business activities.

- **Customer delight:** A commitment to surpassing customer expectations.
- **Leadership by example:** A commitment to set standards in the business and transactions, and be an exemplar for the industry and their own teams.
- **Integrity and transparency:** A commitment to be ethical, sincere and open in their dealings.
- **Fairness:** A commitment to be objective and transaction-oriented, thereby earning trust and respect.
- **Pursuit of excellence:** A commitment to strive relentlessly, to constantly improve themselves, their teams, services and products so as to become the best.

Infosys also has developed a strong management system to guarantee at all times to all its stakeholders a set of procedures that would serve them. For example, there was a much publicised sexual harassment case against one of its top managers in the USA that was settled out of court. But this unsavoury situation has led the company to review and improve its staff training to create an awareness of such problems and to introduce a code of conduct for employees with a view to guiding them follow a certain work ethics in their places of work.

Even while Infosys is committed to long-term shareholder value, its business activities are anchored in three pillars of corporate behaviour, namely, Business Ethics, Corporate Governance and Corporate Social Responsibility. The Infosys fraternity recognises, understands and appreciates these principles. As a result, Infosys demonstrates an exceptional work ethic.

India's Most Admired Company

Infosys Technologies is widely known for its best practices in terms of business ethics and corporate governance. In 2000, the company was conferred the National Award for Excellence in Corporate Governance by the Government of India. The Business World—IMRB Survey ranked Infosys number one among the most respected companies in India, in 2001. It was voted as India's best managed company for 6 years in a row, between 1996 and 2001 by the Asia Money Poll. In the year 2000, in the survey of Far Eastern Economic Review, Infosys was selected as one of Asia's leading corporations and was ranked first as "The Company that Others Try to Emulate". The company was voted "India's Most Admired Company" in Economic Times in 2000. In 2003, Infosys Technologies co-founder and chairman, N. R. Narayana Murthy, won the Ernst & Young World Entrepreneur of the Year award; judges of the award praised his "intellectually, philosophically, ethically and spiritually-driven entrepreneurship" and his company's "outstanding financial performance and global impact in a dynamic and volatile industry". Infosys Technologies has won the prestigious "Global Most-Admired Knowledge Enterprises (MAKE)" Award, for 2004. Infosys won the award for the second time in a row, and remains the only Indian company to have ever been named a prestigious global most-admired knowledge enterprise.

Infosys Technologies made a winning sweep in the *Business World* "Most Respected Companies' Award" 2004. The company remained "India's most respected company" since 2001; it topped the special categories of "most ethical and most globally competitive" companies and the "Most Respected Company in the IT Sector" category, topping all 19 parameters of the survey. The latest *Business Today*—AT Kearney study conducted in March 2005 placed Infosys Technologies as "India's Best Managed Company". Such encomiums have been pouring in for Infosys, year after year.

Infosys Technologies featured among the world's most respected companies, having climbed in the "respect" ranking from last year. It was also recognised in a number of other categories including corporate governance, creation of shareholder value, corporate social responsibility and innovation.

A People-centric Company

Infosys excels in people management. While its employee strength has skyrocketed to over 35,000 from around 5000 at the turn of the century, the intense focus on people and their skills has only increased over the years. Infosys' focus on people is a natural corollary of its growing business, with customers identifying this as a quality that often distinguishes it from other competitors in the IT services sector. As Infosys seeks to transform itself into a global enterprise, it has learnt that its employees have to be the best, not just in India, but in the globe. While its selection is already stringent (in 2003–04, it recruited 10,000 people from over a million applicants), training will help keep its nose ahead of the increasing competition.

Business Description

The company's services include business consulting, custom software development, maintenance and re-engineering services, systems integration, IT infrastructure management and business process outsourcing. Infosys is today the second largest publicly traded software services exporter providing specialist IT services to around 350 corporations such as GE, Airbus, Cisco and Nortel, predominently in the US. It was the first Indian company to be listed on the NASDAQ exchange in 1999, when their stock value soared.

Financials of Infosys—Next $1-b Revenue Seen in 18 Months

Infosys' net profits rose by 53 per cent to Rs. 513 crore, while revenue grew by 47 per cent to Rs. 1,987.32 crore for the quarter-ended 31 March 2005, over corresponding last year. Sequentially, the growth in net profits and revenues was at 3.25 per cent and 5.96 per cent, respectively. Onsite volumes grew by 4.6 per cent while off-shore volumes rose by 6.6 per cent during the March quarter, as compared to double digit-volume growth the company used to post in the last few quarters. The lower growth during the year was attributed to the high cost incurred by the company in complying with the tenets on corporate governance prescribed by The Sarbanes—Oxley Act, the Anti-Money Laundering Act and the Patriots Act in the US wherefrom most of Infosys

business comes. The company has forecast a substantial revenue growth in the current fiscal (2005–06) enabling it to cross the $2 billion mark by March 2006.

While it took 23 years for Infosys to go past the $1 billion revenue mark, it may take less than 18 months for it to cross the next billion. The scorching pace at which Infosys is growing gives an indication of the company getting several of its initiatives right. "We are beginning to see the results of various initiatives taken over the last few years," Mr. Nandan Nilekani, the CEO and Managing Director of the company, observed in April 2005. He said the company's clients increasingly see it as a strategic long-term partner which can offer a wide range of services and contribute to their business goals. The company also hopes to reap large benefits from its current investments. Infosys is expected to invest Rs. 950–1100 crore mainly in technology infra-structure expansion of seat capacity and China Operations.

Business Strategy of Infosys

As Infosys scorches its way ahead with around 50 per cent growth rates, there are a handful of hurdles it will have to clear to stay on course. The most obvious one is the strong appreciation of the rupee, but there are other, far more significant challenges, such as the shrinking pool of skilled manpower and the creation of a complete solutions provider with global reach and scale; yet another challenge is the increasing cost of adherence to global best practices that would tell upon profit margins in an extremely competitive environment as has been demonstrated in 2004–05 financials of many software services companies. Their profit margins were highly reduced consequent on their complying with Sarbanes–Oxley Act on corporate governance, the Anti-Money Laundering Act and the Patriots Act in the US.

Like its peers in the upper reaches of India's IT service industry, Infosys faces the challenges of, all at once, inducting and orienting a large number of employees, ensuring that the Infosys way, a process-driven way of working, does not change, and distilling knowledge from all the projects it has completed or from the work in progress. The company, which currently has around 36,000 employees on its rolls, has addressed these challenges through what it terms "PRIDE" (Process Repository @ Infosys for Driving Excellence), an online resource that segues into the company's fancied knowledge management system termed Kshop (Knowledge Shop) at one end, and the actual development environment at another. As a result of this, "Infosys will reap the benefit of an army of employees that works the same way, gains in process efficiency and productivity, and higher quality".

Rapid Wealth and Value Creation Through Diversified Business

Building a $1-billion company has not been achieved by just being good to employees. While it was initially just a plain IT services company, Infosys has stepped up its offerings over the past few years at both ends of the spectrum and is increasingly managing to string its various pieces together. Thus, Infosys Consulting, which the company started off in April 2004 with a $20-million investment, will become a 500-employee unit by 2007 and Progeon, its business process management subsidiary, already boasts of over 3400 employees.

The company's extended capabilities are reflected in growing engagements with customers across industries. In many cases, Infosys began with conventional IT maintenance work in 2000, but rapidly stepped up its partnership to encompass many other areas such as business process consulting, software process consulting, application development and support, enterprise architecture services, and technical training as in the case of Hannaford Brothers, a European retailer. The creation of a US-based consulting company is a major step forward in Infosys' long-term strategy of presenting itself as a global service provider. Infosys' $20-million investment in this subsidiary is designed to send a clear signal to the marketplace that it is being totally different from its Indian competitors, and intends to compete for business consulting services with the traditional consultancies.

Infosys relies on its much-touted Global Delivery Model (GDM), which is based on much more than cheap manpower, to push its case as a preferred vendor. Yet, it is apparent that the competition, especially companies like IBM, having recently discovered GDM are pushing ahead with their new-found wisdom. The key to GDM is the focus on getting the best talent, wherever it is

located, and using that to address the customer's needs.

One of Infosys' key strengths has been its ability to add new business offering and mould itself to suit changing market requirements. It has added services such as independent software testing and enterprise applications to its offerings. It has also reorganised itself along verticals or industrial compared to the geography-specific orientation it conformed to earlier. And most of the company's growth has been organic, barring the odd buy like its acquisition of Expert Information Systems, which it morphed into Infosys Australia.

Infosys is also looking to diversify its risk and explore emerging markets for its range of services. The American market may offer the largest and deeper IT market to companies; yet, the potential in other countries can not be ignored. The contribution from the US has in fact dipped to just over 65 per cent for the third quarter ended 31 December 2004, compared to over 73 per cent in the corresponding period in the previous fiscal.

Infosys' Key to Success

Infosys survived the global downturn in IT spending during the years of recession between 2001 and 2004, managing to actually grow by focussing on providing services to companies that desired to update their existing systems, undertaking more work for current clients, launching an aggressive marketing campaign overseas, adding new clients and cutting costs wherever possible.

Infosys' attributes its success to investing heavily in its employees leading the market by focussing on cutting edge technology, and applying strict ethical business practices. Infosys' success in the highly competitive IT industry lies in:

- Giving employees a world-class environment to work and learn.
- Giving employees a high quality of life and wealth creation opportunities.
- Looking at potential employees' ability to learn and assimilate technical knowledge and skills.
- Replacing obsolete technology regularly to remain at the cutting edge.
- Emphasising constantly on quality by benchmarking against the best processes in the world.
- Diversifying income sources to minimise risk of revenue, i.e. setting limit to contributions from one client, one technology, one industry.
- Complying with accounting standards of advanced countries and ensuring strictest adherence to corporate governance.

Business Ethics at Infosys

Infosys Technologies has unveiled a *code of ethics* for its finance professionals and a *whistleblower's policy* to encourage and protect employees willing to share information on frauds, but who choose to remain anonymous. Though the Indian law has not imposed it on companies as yet, the Infosys chose to apply this code because it believes it should raise the bar for compliance.

The code of ethics for its finance professionals states, "We consider honest conduct to be conduct that is free from fraud or deception and marked with integrity. We consider ethical conduct to be conduct conforming to accepted professional standards of conduct. Ethical conduct includes the ethical handling of actual or apparent conflicts of interest between personal and professional relationships. By expecting the highest standards of honesty and ethical conduct, we expect our officers to stay far from the line differentiating honesty from dishonesty and ethical conduct from unethical conduct".

The Code of Business Conduct and Ethics helps the company ensure compliance with legal requirements and the company's standards of business conduct. The code deals with aspects of employees' responsibilities to the company and its stockholders, which includes General Standards of Conduct (covering workplace free of harassment, drug and alcohol abuse, safety in workplace, dress code and other personal standards, expense claims and applicable laws.

The Whistleblower's policy encourages employees to report questionable accounting matters, any reporting of fraudulent financial information to shareholders, the government or the financial markets or any conduct that results in a violation of law by Infosys to the management even if it is on an anonymous basis. It sets out norms for receiving, retaining and treating complaints and procedures for confidential, anonymous submission by employees of complaints with regard to accounting frauds leading to results in a violation of laws or mismanagement of company resources.

In terms of ethical behaviour, Infosys has an unwavering commitment to best global practices and has been driven by its vision to became a global player. It was one of the first Indian public companies to adopt voluntarily the stringent US GAAP long time back while many other organisations are only toying with the idea of implementing it in their companies. To quote Nandan M. Nilekani, Infosys' CEO and Managing Director: "Infosys as a company has always believed in commitment to values, ethical conduct of business and making a clear distinction between personal and corporate funds. When we founded the company, we took a decision that we keep this line very clear."

The culture of ethical behaviour in the organisation emanates from the top and percolates down to the managerial and employees' level, for the foundations of such systems are made to rest on ethical value system. The founders of the company took only salaries and dividends and had no other benefits from the company unlike founders of other companies. In following these principles of observation and preservation of ethical standards in his company, N. R. Narayana Murthy "has known the way, shown the way, and gone the way". In order to create an ethical working environment, the initiative must be supported by, or better still, come from, the top management and leaders in the organisation. The steps in doing the same include the following:

- Making the decision to commit to ethics.
- Recognising that they are the role models by definition, by action, and by values.
- Assuming responsibility for instilling ethical behaviour.
- Articulating their values.
- Train the staff.
- Encouraging open communication.
- Being consistent in their approach.

It is only by doing all of the above on a continuous basis, that they can ensure the permeation of their ideals throughout the organisational layers, and deep-rooted understanding and following of these ideals by employees. Narayana Murthy and the other leaders at Infosys have taken this to heart and make it a point to express the company's ideals at every opportunity, to fellow-Infoscions as well as to the society in general. Explains Nilekani, "When a company has a strong value system, focusses on honesty, transparency and fairness to all stakeholders, the key thing is we have to set the example and be a role model in the way we conduct ourselves. We cannot have a system where we preach corporate governance but in our actions we don't demonstrate it. Then people will not believe us. I think once we practise that in every aspect of activity, then automatically people get ingrained in that".

The Phaneesh Murthy Case

For a company so revered by the entire Indian and foreign business community for having set the highest ethical standards, it seemed to be only a matter of time before someone tried to pull it down. But to their credit, the company honourably resolved the issue and came back much stronger and surer of its values than ever before. Infosys became entangled in a scandal, between October 1999 and December 2000, that dented its reputation as a company that had the best corporate governance structure in the country. The Hindu Business Line reported on 7 August 2002, "Since its inception, this is probably the first piece of negative news about Infosys".

In December 2001, former Infosys employee Reka Maximovitch filed a complaint in the Alameda Superior County Court, Oakland, US, alleging verbal sexual harassment, unwanted sexual advancements and unlawful termination of employment against Phaneesh Murthy, the highest-paid employee of Infosys. It created ripples in business circles and in the eyes of the public when he abruptly resigned from Infosys in June 2002 to "devote time and attention to pursue a successful defence of the suit".

Initially, Phaneesh Murthy refused to participate in the settlement initiated by Infosys on the terms specified by it. However, later on, he voluntarily signed the settlement and agreed to every condition that Infosys had set. As the company retained its right to sue Phaneesh for his actions and lack of contributions, it went ahead with the settlement without any contribution from Phaneesh.

The stand taken by Infosys in this case seemed to go against its image of a company considered to be a model of good corporate governance. Media reports blamed Infosys for having kept the issue under wraps for a long time neglecting to put in place a structured policy concerning sexual harassment, and for compromising on moral values. The company's share price declined by 6.6 per cent soon after Phaneesh left. This news and the

issue of sexual harassment at the workplace were debated heatedly in corporate and media circles, in India as well as abroad, as many more shocking events unfolded over the next 1 year.

Infosys Technologies maintained a studied silence on the episode on the ground that the matter was *subjudice*. On 11 May 2003, Infosys finally announced the amicable settlement with Maximovitch by agreeing to pay $3 million as compensation. The company contributed US$ 1.5 million and the balance US$ 1.5 million was contributed by the insurers under the company's Directors and Officers Liability Insurance Cover. Infosys refused to give more details about the manner in which the settlement was arrived at, and whether Infosys conducted any internal enquiry before Phaneesh Murthy submitted his resignation.

A crisis brings out the best and worst in any organisation or in any person. It is also true that a crisis provides a learning opportunity for them. Infosys also learnt its lesson and put in place principles of work ethics to be followed by its employees and a whistle blower policy. Infosys chairman and chief mentor, Mr. N. R. Narayana Murthy said later, "The litigation with the plaintiff is behind us. We have taken further steps to strengthen our internal processes and improve the checks and balances to handle similar situations".

Corporate Governance at Infosys

Infosys, beginning as a modest software consultancy firm in 1981, has become over the years, a large public company that conforms to internationally benchmarked standards of corporate governance. Admiration for Infosys both from within and outside the business community comes from its strong focus on corporate governance. It has been rated highly in several corporate governance reports, including one by rating agency CLSA, which has given it a high CG Star grade.

Infosys has set new and effective standards in *communicating with shareholders, stock exchanges, and general public* at large. Its annual report is said to be a trend-setter with respect to the disclosure norms evidenced by the sheer length and detail of the report. Its annual report has been commended as an ideal report by the Securities and Exchange Commission of US to be emulated American Companies. Infosys has demonstrated through its practices and procedures its commitment to enhance investor-relations and has amply rewarded its shareholders through its impressive performance by increasing shareholder value. In fact, the company pursues a value-based management methodology wherein it measures the company's performance on the basis of various tools and techniques such as brand value, economic value added, intangible asset scorecard, balance sheet including intangible assets, current-cost-adjusted financial statements and human resources accounting and value-added statements. It continuously strives to improve itself on all these parameters.

Infosys has started implementing best international governance practices even while the concept was getting crystalised, after the recommendations of the Cadbury Committee and the Confederation of Indian Industry's Code. The Kumar Mangalam Committee Report on Corporate Governance (1999) summarised the overall objective of the concept thus: "The fundamental objective of corporate governance is the enhancement of long-term shareholder value while, at the same time, protecting the interests of other stakeholders." Infosys has adopted these ideals as an article of faith, and observes it to the minutest details. While Infosys has complied with most of the recommendations made by the CII and those of the Kumar Managam Birla Committee on Corporate Governance, it was also the pioneer in benchmarking its policies with the best in the world. If best corporate governance practices are to be implemented in an organisation, it has to be done in a manner so as to ensure (i) an independent and proactive board, (ii) independent committees to decide executive compensation and for nomination and audit purposes (iii) an independent audit system. Infosys has put in place all these governance practices and has seen to their yielding the fruitful results for the overall welfare of all stakeholders.

One of the prerequisites of an Independent Board is to have a clear demarcation of responsibilities and authority between the chairman of the board and the senior officers of the management such as the chief executive officer, managing director, president and the chief operating officer. Infosys has achieved this separation between the board and management long back. The CEO is responsible for corporate strategy, brand equity, planning, external contacts, acquisitions by and board matters. The COO is responsible for all day-to-day operational issues and achievement of the annual targets in client satisfaction, sales, profits, quality, productivity,

employee empowerment and employee retention. The CEO, COO, executive directors and the other senior management personnel make periodic presentations to the board on their targets, responsibilities and performance.

Another important criterion suggested by various committees to ensure best global practices in Indian companies is to have an appropriate mix of executive and non-executive directors to maintain the independence of the board. To separate the board functions of governance and the management, Infosys has 8 executive directors and 8 non-executive directors, out of the 16 directors on its board. While the executive directors bring to the board their expertise and experience in managing the day-to-day affairs of the company and the problems and issues involved in decision making, the non-executive directors bring in international professionalism to corporate boards. The board members are known to possess expertise in skills, technology, finance, human resources and business strategy, all of which are essential to manage and guide a high profile, high growth, high tech, global software company. The directors at Infosys belong to the productive age group between 40 and 55 years of age so as to serve the board actively. They are not related to any senior manager or board members so as to be bereft of any influence. The board members are expected to attend and participate in all board meetings and also in the meetings of the committees to which they belong. While the executive directors are not allowed to serve on the board of any other company—unless it is an industry association or government body relevant to the software industry or one whose objective is promotion of social welfare—non-executive directors are not expected to serve on boards of competitor companies. Board meetings are regularly held with clear-cut agenda. Apart from routine meetings, the board also meets once in every 3 months to review the quarterly results and other issues.

An effective corporate board is one that delegates the resolution of important issues to specialised committees. Infosys has three committees—the Audit Committee, the Nomination Committee and the Compensation Committee. As suggested by various committees on corporate governance and to ensure independence of the board, the members of these committees are all non-executive directors. The degree of independence vested in these three committees ensures that vital areas such as compensation, audit and nominations are carried out in a just and equitable manner without being influenced by management. According to Nilekani, Infosys' experience with these committees has been quite beneficial. "These committees have been extremely effective, especially the audit committee. We have used it very effectively to audit the entire business practices of the company. We have internal auditors, external auditors. We present all the issues before the audit committee. The whole process has been very effective."

An ideal way to ensure better corporate governance is to assess the efficacy of the board of directors through an effective appraisal system. However, this ideal is rarely followed even in developed countries, and universally board performance is hardly monitored or evaluated. Infosys, to some extent, has put in place structures to ensure evaluation of performance of the Board. Says Nilekani: "All the working board members have performance indicators. At the beginning of every year when we present budgets to the board, we also present our individual performance indicators. What jobs we do? What are the goals for the year? We are measured on that. The compensation committee decides our benefits based on the performance." It is a self-evaluation process, and external directors also measure the performance of the internal board.

Effective and efficient risk management is one aspect of corporate governance that helps a company achieve its goal of maximising shareholder wealth. In today's competitive environment, companies have to, apart from employing shareholders' money productively, ensure that they do not expose their businesses to unwarranted risks. Infosys has put in place a risk management system that tracks every conceivable form of risk, arising out of client, geographic or technologies concentrations. The company's diversified business strategy, especially in terms of risk avoidance, has been effective and has ensured that there is no undue dependence either on a single client, territory or technology.

Corporate Social Responsibility

If wealth creation for the benefit of shareholders is an objective of corporate governance, social concern to protect the interests of all stakeholders and the society at large are also to be given due prominence. Infosys balances wealth and welfare strategically. Infosys has used its wealth and stands to contribute to improvements in the community. A core value of Infosys is a strong sense of social responsibility and commitment to help people

and community. It is actively involved in various community development programmes.

Infosys established the **Infosys Foundation,** a trust founded to further the company's commitment to social causes, to aid destitutes and the disadvantaged people. One per cent of Infosys' profit after tax is donated to the Foundation every year. The Foundation focusses on enhancing the living conditions of the rural population, healthcare for the poor, education, and promotion of Indian arts and culture. Last year (2003-04), Infosys initiated three social programmes to improve computer literacy of rural people as well as the teachers in rural areas. Along with Microsoft, infosys launched a programme, computers@ classrooms, as part of which old computers were given away to educational institutions.

The Infosys Foundation

"It is better to light a candle than remain in darkness." The Infosys Foundation starts with this humble, but thought-provoking philosophy. The foundation came into being with the objective of supporting the underprivileged in society. It began its activities in Karnataka in 1996. Today, the activities have been extended to Tamil Nadu, Andhra Pradesh, Maharashtra, Orissa and Punjab. The Foundation primarily aims at improving the health, education and basic facilities, benefiting a large number of individuals and institutions.

In a short span of time, the Foundation has successfully implemented projects in the the following areas:

- **Health care:** It has constructed many hospitals, wards in hospitals, donated costly equipment, distributed medicines for free and introduced various schemes to benefit those in need.
- **Social rehabilitation and rural upliftment:** The foundation has constructed orphanages, girls' hostels and shelters, and undertaken various initiatives to aid the lesser privileged.
- **Learning and education:** The Foundation has undertaken "A Library for Every School", one of the largest rural education programmes in the country. It provides financial support to promising students from economically weaker sections. It has constructed science centres and labs in rural schools, and in some cases, entire schools for the benefit of rural children.
- **Arts and culture:** The Foundation has coordinated a project to donate cassettes among rural schools in Karnataka to bring back life into the dying arts, puppet shows to enliven the theatre art, and encourages artistes to perform and also benefit financially.

Infosys Technologies contributed Rs. 5 crore to the Prime Minister's National Relief Fund to assist the victims of the giant Tsunami that ravaged south and south-east Asia in the last week of December 2004. The company also actively supported its employees' efforts across group companies globally, to make monetary and material contributions towards aid operations.

Infosys also instituted in 1999 the Infosys Fellowship Programme to foster excellence in education and offered funds at the Five IITs and three IIMs for Ph.D. programmes in computer science, management, law and accounting. Under this programme, the company grants Rs. 9 lakhs per fellowship for the entire duration of Ph.D. programme.

CONCLUSION

The founder and chief architect of Infosys, Narayana Murthy, is a visionary who exhibits a leading model of innovation and excellence in an industry that is rapidly evolving. He is capitalising on growing opportunities in a world that is increasing its reliance on e-commerce and technology to form a vital part of business infrastructure. Narayana Murthy's vision is to harness technology and the free market to create jobs, and in the alleviation of poverty. Infosys has created thousands of skilled, well-paid jobs and further opportunity for Indians to develop their expertise and skills. Infosys demonstrates that it is possible to create success and build prosperity among the poverty prevalent in India. Infosys Technologies is a company that the entire world looks up to, in terms of sticking to one's sound ethical judgment and doing business the "Right Way". It continues to set standards in everything that it does, and the people who make the company never think twice when they have to make a tough decision involving ethics. To them, "Dharma" is above all.

DISCUSSION QUESTIONS

1. Trace the history and the spectacular growth of Infosys as one of the best managed IT companies in India, and even of the world at large.
2. Discuss the vision and message of Infosys that have paved the way to its becoming the darling among IT companies in India.
3. Discuss the factors that have made Infosys as the most admired IT company in India.
4. What are the challenges Infosys faces to maintain its primary status amongst the IT companies in India? How has the management of the company worked out a business strategy to achieve that goal?
5. Discuss the role of business ethics in achieving corporate governance at Infosys. Has the Phaneesh Murthy case sullied the reputation of the company? Make a critical assessment of the impact of the scandal on the growth story of Infosys.

SUGGESTED READINGS

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  (b) Infosys recognised as a "globally most-admired knowledge enterprise for 2004" (December 3, 2004).
  (c) Infosys sweeps Businessworld Respected Companies Award (8 November 2004).
  (d) Infosys looks beyond the billion (24 April 2004).
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  (f) Infosys recognised as a most admired knowledge enterprise (14 August 2003).
  (g) Infosys contributes Rs. 5 crore for tsunami relief operations (29 December 2004).
  (h) Infosys settles sexual harassment suit against Phaneesh Murthy (12 May 2003).
  (i) Meticulous millionaire (8 November 2002).
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Case Study 2

Tata Steel: A Company That Also Makes Steel

(This case is based on reports in the print and electronic media. It is meant for academic discussion only. The author has no intention to tarnish the reputations of corporates or executives involved.)

The Beginning and Growth

In the 1890s, Jamsetji Tata conceived of a dream project—a modern steel plant, with state-of-the-art-technology to produce 1 million tonnes of steel. Work on the steel plant commenced in 1907 in Jamshedpur which became operational in 1912. The capacity of the unit at the time of independence was around 1 million tonnes and this was increased to around 2 million tonnes by 1960. With the policy of the Indian government to give priority to the public sector to reach the commanding heights of the economy, the company, like many others in the private sector, was not allowed to grow until the liberalisation of the economy in 1991. ln fact, at the height of the socialist fervour of the 1970s, there was even a suggestion on the nationalisation of Tata Steel taking resort to the Industrial Policy Resolution that permitted nationalisation of any industry if needed in public interest. Fortunately, the government of the day did not have the resources to pay adequate compensation to the shareholders of the company after nationalisation and the effort was aborted.

Tata Steel is one of twenty-eight major corporations within the Tata Group and is the largest private sector steel company in the country with its headquarters based in Mumbai. The company's stock is listed and traded on the Bombay Stock Exchange and the National Stock Exchange, New Delhi.

Tata Steel, today, is among the world's foremost steel makers and India's largest integrated private sector steel manufacturer. Its 4 million tonne per annum steel plant in Jamshedpur, and mines and collieries, span eastern India. It employed over 48,800 persons as on April 2002, out of whom 43,000 were directly involved in the steel business. Its net sales were approximately $2.2 billion in 2002–03.

The company decided to focus on modernisation of the production facilities in phases. Through careful de-bottlenecking and marginal investments, capacity increased to a level of 3 million tonnes in 1996. Low prices, slow growth in consumption and the reluctance of financial institutions to fund the steel sector came in the way of the company's expansion. Over the next 3 years, the company added another million tonnes to its capacity.

The present huge growth in demand for steel globally especially from fast-track developing countries like China, along with higher prices have imparted the much-needed impetus to the steel industry. For the first time in several decades, there is enthusiasm on the part of the steel industry to take to large-scale expansion.

Liberalisation Unleashes Expansion

The opening up of the Indian economy has brought about a previously unheard of growth in the steel industry. In July 2004, B. Muthuraman, Managing Director, Tata Steel, referred to plans for expanding capacity of the company to 7.5 million tonnes by 2007. In subsequent months, however, the company has rapidly widened its sights. In December 2004, he assured that Tata Steel would become a 15 million-tonne company by 2010. "Jamshedpur alone will produce 7.5 million to 8 million tonnes. The recently acquired 2 million-tonnes capacity, Natsteel, Singapore, will be expanded by another 2 million tones", outlined Muthuraman. A greenfield, port-based plant at Orissa, with an initial capacity of 3 million tonnes and another similar capacity plant in a different state are planned to be set up, he said.

Focus on Select Businesses and Core Competency

When Ratan Tata succeeded J. R. D. Tata as chairman, a comprehensive review of identifying and focussing on the core businesses of the group was made. Several of the well-established businesses of the group that did not sync with the company's major involvement in steel production were phased out. These included electronics, cement, soaps, pharmaceuticals and textiles. Interestingly, there were suggestions that steel could be one of these!

While it took 90 years to reach a capacity of 3 million tones, the company has expanded it five-fold in just 14 years! The shift of demand in large volumes to populous developing countries such as China and India has helped in the evolution: "From the commercialisation of the Bessemer process for producing steel in 1856, for around 100 years, upto

1960, the industry witnessed handsome growth of 7 to 8 per cent per annum. During 1960–80, the rate of growth dropped to around half that level, to around 4 per cent. During 1980–2002, the growth rate was even half of this, at around 2 per cent. In the earlier growth phase up to 1960, the US and Europe recorded handsome growth. In the subsequent decades, Japan and South Korea recorded high growth", observed Muthuraman. But in India capacities were not being created in a big way. "The steel industry burdened for years with over capacity, of around 250 million tonnes, had not invested on fresh capacity. With the slack totally adjusted, naturally, there is this impact on prices. Price of steel started rising and this affected the ordinary consumer adversely."

Protecting Consumers from Steep Increases in Prices

Tata Steel is conscious of the imperative to protect consumers of steel from steeper price increases. With the high increase in the cost of basic inputs, such as coal, iron ore, scrap and petroleum products, there has been a focus on achieving cost-efficiencies. The company has been especially considerate to its *bona fide* customers for whom the prices are offered at around Rs. 5000 per tonne lower than market prices. With 70 per cent of products going directly to customers, this large section of consumers is treated with special concern. The company also strictly enforces its maximum retail price at the dealer end. To serve the domestic consumers better, Tata Steel also decided to limit exports last year to 15 per cent of total sales.

The industry earned very modest profits for several years. In the early 1980s, annual profits were in the region of Rs. 6 crore. But costs of expansion and modernisation have been shooting up. Since 1992, when the company started expansion and modernisation, it has spent over Rs. 10,000 crore.

Quantum Growth Planned

Right through its history, Tata Steel has earned profits every year and declared dividends (in 2002, it was one of five companies the world over that earned a profit). The present era of high profits has prepared the company to aim for quantum growth. Muthuraman provided an idea of the funds required: "The 6 million tonne plant in Orissa will require Rs. 16,400 crore, expansion of capacity at Jamshedpur by 3.5 million tonnes will call for Rs. 9800 crore and acquisition of Natsteel needs Rs. 1300 crore. Thus total funds required will be in the region of Rs. 27,500 crore." To achieve higher growth in production and to reduce cost per unit, Tata Steel has invested heavily in industrial research. It has enabled the company to earn the proud position of the world's cheapest producer of steel. There have been collaborative research projects with IIT-Kharagpur, Indian Institute of Science, Bangalore and with research institutions in Sweden, Germany and Japan. As a result, there has been a steep increase in the number of research papers published and intellectual property claims registered. Tata Steel spent a dollar per tonne of steel produced on R&D, which compares well with $1.8 per tonne spent by leaders like Nippon Steel.

Such focus on development has helped Tata Steel strive continuously to improve the quality of its product mix and also to increase the share of branded products, both of which helped it to have better realisations for a given quantum of output. Combined with the success in achieving continuous increases in production through rising operational efficiency, reduction in specific consumption of raw materials refractories, there is the twin advantage of handsome increases in labour productivity and a much more than proportionate increase in after tax profits. Of course, the steep increase in prices through the last couple of years has also contributed to this big jump.

Close Attention to HR

At the root of the success of Tata Steel lies its close and continuous attention to human relations. The success of the management in regularly and continuously interacting with the union leaders has helped in resolving differences. "Succession of leaders believed that the temper of employees is as crucial as the temperature of the furnaces." The tradition of maintaining a most cordial relationship with workers in the truest sense of Trusteeship wherein it is believed that the employer is ordained by Divine Providence to take care of the interest of workers and hence the resources of the enterprise are entrusted to him, has been built by J. R. D Tata on the very humane foundation laid by Jamsetji Tata still continues.

Among the most interesting aspects of Tata Steel's evolution is its seamless and smooth success in downsizing. In 1994, for producing 2 million tonnes, the company employed around 80,000 workers. Today, for producing 4 million tonnes, the company employs only 39,000 workers. The

reduction was on a well-delineated strategy of right sizing: "We closed a sheet mill that earlier produced buckets and *dubbas.* The open-hearth furnace continued to be operated for years more as a museum piece. We scrapped it and built a new blast furnace. We had extensive communications with the unions on rationalisation of manpower." "We decided to focus on our core areas of steel-making and decided on a lot of outsourcing of services such as security, milk distribution and power distribution. From April, 2004, we also formed JUSCO, transferring 1400 workers of Tata Steel to the new company entrusted with the task of running the township and bidding for such jobs nationally and globally", explained Niroop Kumar Mahanty, Vice President, Human Relations Management of Tata Steel.

Numerous opportunities were also provided to employees to become entrepreneurs. "VSS (Voluntary Separation Scheme) had an attractive remuneration package for those opting for VSS. We provided interest-free loans up to Rs. 2 lakh; they were paid their basic salaries up to retirement (without annual increments and allowances but with all retirement benefits) which worked out to some 55 per cent of the last drawn pay. A transition support centre was set up to advise the retirees on investing their resources and also to try and find jobs. They were kept on the rolls for three months and paid the fare for interviews to them." "Through VSS, the company cut down nearly 26,000 jobs. After such large-scale downsizing, the company introduced massive programmes of retraining and repositioning of employees. A huge exercise of cross-matching skills was done. We encouraged workers to pass trade tests and acquire technical qualifications", observed Mahanty.

Administering the Township

It is well known that Tata Steel has been administering the Jamshedpur town for the past eight decades, and anyone who visits the place is so impressed by its orderliness, extensive civic facilities and cleanliness that they would cite it as a model town. The company has been subsidising around Rs. 100 crore on administering the township. The entire services relating to town administration, provision of transport services, running schools and hospitals are all done by the company. Kanwal Midha, General Manager, said that JUSCO has recently taken over the responsibility as a separate corporate unit: "Jamshedpur is spread over 64 sq. km and has a population of 7 lakh with 625 km of roads, 22,000 residential flats and bungalows of Tata Steel and around 15,000 of Tata Motors and 5000 of other Tata companies." In the township, over the years, the quality of municipal services has been maintained at high levels. JUSCO, with its considerable accumulated expertise in town management, especially in water and sanitation businesses, intends to become a national leader in these businesses and to bid for and undertake projects in other parts of the country.

Continuous Rebuilding

A 98-year plant obviously has evolved with different technologies and makeshift arrangements. Understandably, it lacks the advantages of building a state-of-the-art plant in a greenfield site. Large sections are getting scrapped and rebuilt on a continuous basis. New blast furnaces are being built to make iron-making more efficient. Simultaneously, capacities for cooking coal are being enhanced.

"We Also Make Steel"

Tata Steel coined a beautiful slogan impregnated with a lot of meaning more than a decade ago. "We also make steel." According to Muthuraman: "To me the statement represents everything Tata Steel does. It is pregnant with so much meaning and conveys a lot of things that making steel is not our only business, but a whole lot of other things define our business like corporate social responsibility, being ethical, spending effort and money on sports, having a green town caring for society...." Muthuraman deprecated the tendency to judge a corporate on a quarterly or yearly basis, not on the sustainability of its success over long period of time. The close involvement of the company in dozens of socially ameliorative projects has. understandably, been giving much more meaning to its corporate purpose than mere profits.

Tata's Social Concern and Commitment

Tata Steel's Vision

Tata Steel's vision statement tells all as to what it stands for. "To seize the opportunities of tomorrow and create a future that will make us an EVA positive company. To continue to improve the quality of life of our employees and the communities we serve."

Tata's Code of Conduct (Clause 1)

"Tata... shall not undertake any project or activity to the detriment of the nation, or those that will have any adverse impact on the social and cultural life patterns of its citizens."

Tata Steel's operating units have all adopted the Tata Business Excellence Model, an integral part of which is corporate social responsibility. About 12 – 14 per cent of its PAT (Profit After Tax) is set aside for the welfare of the people. The Tata code of conduct enjoins every company of the Group to act responsibly in the interests of the nation where it operates.

Recognised as a benchmark for Corporate Social Responsibility in India, Tata Steel is among few Indian Companies to be invited to join the UN sponsored Global Company Forum, comprising organisations committed to translating the UN decreed principles of human rights, labour and environment, into practice.

Tata Steel is already one of the dozen founder members of the Global Business Compact (GBC), an initiative of UN Secretary General, Kofi Annan. The credo of GBC is that industrial corporations have a larger role to play than merely to earn profits. Tata Steel is the only Indian founder member of GBC that has gained respect and recognition for its social concerns. One of the secrets behind the success of a longevity of a corporate lies in its being part of the society. The belief of the company in such tasks was well-stated by Muthuraman: "Our corporate growth is further strengthened by our efforts in the areas of social development, relief and rehabilitation and sports. Initiatives such as Mission Hariyali, Child Survival Projects, Aids Awareness Programmes, Operation Muskaan etc., help us improve the quality of life of the communities we serve and other stakeholders."

Since 1998, the ethical principles that govern the company's activities have been articulated in the Tata Code of Conduct, which applies to all Tata Companies. In 2008, taking cognisance of the changing expectations within the society and the increasingly global scale of the Tata Group's activities, the Code was updated in consultation with Corus and other Tata Steel Group Companies. The revised Code of Conduct was adopted by the Tata Steel Group Board in October 2008, and now applies to all companies within the group.

Environmental Improvements

Tata Steel uses suitable resources, technology and work ethics to reinforce its concern for the environment and its desire to conserve natural resources. "It is committed to reducing its environmental footprint and to achieve the target levels set by it."

Apart from improving the general standard of rural population, Tata Steel has been dealing with the problems of education, health, hygiene, family welfare, agriculture extension, improving the welfare requirements, sports, games and culture. In addition to the above, it has also involved itself with the needs of the environment improvements by way of bringing the awareness amongst masses of the benefits of land reclamation/rehabilitation and afforestation.

Intensive efforts have been made for the utilisation of barren and subsided land, as also utilisation of fire areas by large-scale plantations. Over 9 lakhs of plants have been planted, during the past 8 years with a survival rate of 70 per cent. Enormous experience has been gained in the process and every effort is being made to use even the smallest bit of land to provide a shade of greenery in the area.

Several measures have been taken for controlling water pollution by use of waste water for growing crops and vegetables, supply of drinking water to the colonies after proper treatment and launching a pisci-culture programme into the village ponds. Several wells and tube wells have been constructed and repaired for the local population.

Environment Cell

Tata Steel created a separate Environment Cell that independently looks after matters of the environment and pollution control activities of the division. They have regular meetings every month to review pollution control activities. This cell is continually being expanded.

A laboratory to test air and water samples so as to monitor the environmental activities has been set up. The company appointed a team from C M R S, Dhanbad, to study the extent of pollution in their various establishments and to suggest action to be taken for reducing the pollution. A comprehensive programme of surface environmental studies with respect to air, water and noise has been undertaken. Based on the studies conducted and their recommendations, appropriate steps are being taken

Corporate Governance at Tata Steel

Good "corporate governance" should be an integral *part of all of these processes*, not just (as often assumed) social responsibility and corporate

citizenship. After all, a good corporate citizen needs to be accountable to stakeholders while conducting business as well as when investing in the community at a later date.

Tata Steel has gone some way in ensuring corporate governance at all stages of the business process. Every year the company aims to exceed its targets on the Employee and Customer Satisfaction Indexes, and the Corporate Citizenship Index. In order to improve its internal management systems, it has also adopted the following two systems of evaluation:

- Tata Code of Conduct Follows guidelines established by the UN Global Compact. A company signing to the Tata Code of Conduct entitles that company to use the Tata brand name. It prescribes principles by which all employees are expected to act.
- Audit committee.

Presently, the governance checklist includes inter alia annual operating plans, budgets and updates, capital budgets, quarterly results, minutes of all meetings of various committees, remuneration of senior executives, legal issues.

Tata's Code of Conduct (Clause 8)

A Tata company shall strive to provide a safe and healthy working environment and comply, in the conduct of its business affairs, with all regulations regarding the preservation of the environment of the territory it operates in.

A Tata company shall be committed to prevent wasteful use of natural resources and minimise any hazardous impact of development, production, use and disposal of any of its products and services on the ecological environment.

Social Investment

Tata Steel's social investment reflects its "after-profit" practice, work in and for the community that is not directly related to the "business of business". Again, Tata Steel has internal procedures that guide policy, meaning that community initiatives are seldom *ad hoc*. Given below are six of these initiatives or procedures which are being followed religiously:

1. Tata Council for Community Initiatives (TCCI): TCCI is a product of the Tata Group's commitment to the community. It serves to help the Tata companies in their business-community relations, by drawing up "Tata Guidelines for Community Development", designing programmes, then implementing them. Programmes include training courses in which Tata companies conduct technical (IT, Vocational) training to members of the community. This is done with the help of company volunteers, often management staff. A forthcoming project involves forming a Tata Corps of Volunteers, under which employee volunteering will play an increasingly important role in developing business-community relations.

2. Tata Social Evaluation, Responsibility and Accountability (ERA): ERA is a procedure by which Tata's community projects are evaluated for their impact on the target communities and their level of accountability. Although ERA is not independent of Tata, such procedures are influential in improving programme delivery and ensuring continuing self -evaluation and learning.

3. Global Business Coalition (GBC): The Global Business Coalition on HIV/AIDS aims to check the growth of the disease with the help of over a hundred major international companies. Believing that business holds the necessary marketing skills, management and infrastructure to be able to raise awareness in rural communities, the GBC encourages companies to campaign with imagination and consistency.

Tata Steel has done just that and won an award in June 2003 for "Best Initiative". Initially, Tata focussed on educating employees, but now targets over 600 villages in the State of Jarkhand. This is done through the dissemination of mass media, as well as more inventive schemes, such as student workshops which employees are trained to deliver, or travelling street plays in local languages that reach the rural illiterate. Tata Steel paid for six condom-vending machines in the city of Jamshedpur in public places, which are also proving to be a success. At one of these locations, a busy coach station, there is also a clinic where passers-by can have free check-ups and learn more about HIV/AIDS.

4. Volunteer Database: A "Directory of Employee Volunteers" was established by the Tata Group as an efficient way of matching jobs in the community with employee skills and interests. A corporate committee, comprised of a senior executive, union and government officials, interacts with the communities to ascertain their needs. This is done on a quarterly basis with senior citizens of each village, and biannually with target women's groups.

5. Health initiatives: Working with the government to prioritise projects, Tata Steel's

involvement in health initiatives remains largely philanthropic, with the exception of the Global Business Coalition for HIV/AIDS awareness scheme. Tata Steel has invested in a local hospital which treats an average of 2300 people per day. It has also bought specialized cancer-treating equipment, and part-finances the running of one blood bank, two rehabilitation centres and five homeopathic clinics. Donations to the clinics and centres are regular and on a long-term basis, which does indicate a move from *adhoc* sponsorship to a more strategic social investment. This is organised by the Family Welfare department.

6. Culture and education: Education and Youth Development Programmes have built and maintained infrastructure for sports across Jarkhand. Over 1500 young people are currently training at Tata Steel's two sporting academies, six training centres or their Adventure Foundation. Awards are given to employees who excel in sports. A Tribal Cultural Centre was built in 1993 and a Jubilee Amusement Park in 2001 to enrich the cultural heritage of the city of Jamshedpur.

Tata Steel has also invested in education, part-financing eleven schools and colleges that teach nearly 10,000 students per year.

Looking to the Future

Along with the TCCI's forthcoming project to formalise employee volunteering, Tata Steel also hopes to align more with global standards and initiatives. In 2001 Tata Steel produced a Corporate Sustainability Report following guidelines established by the Global Reporting Initiative. This is another step forward for the company looking to make its mark on the new corporate responsibility agenda.

(The author is obliged to Mr. S. Viswanathan for his permission to include excerpts from "Tata Steel: Rolling Ahead, Gathering Mass", Industrial Economist 15–29 January & 30 January–14 February 2005.)

CONCLUSION

Tata Steel Ltd is one of the forerunners of the Indian industry in several respects. It is the largest private sector steel company in the country. It is also the country's largest integrated private sector steel manufacturer, apart from being among the world's foremost steel makers. This is not the only distinction the company has to fame; it has a lot of other things. The company is also known for its corporate social responsibility. It is known for its ethical stances and its close involvement in dozens of socially ameliorative activities, sports, building a grown town in Jamshedpur providing its people all possible facilities to lead a life of ease and comfort. No wonder Tata Steel has become a national leader in town planning which is being emulated by other industries and even government planners.

DISCUSSION QUESTIONS

1. Trace the genesis and the growth of Tata Steel. Also explain how the company has acquired the status of one of the world's foremost steel makers and India's largest integrated private sector steel manufacturer.
2. Jamshedpur city has been praised by people as a model town. What are the factors that have contributed to the evolution of the Steel city as a model city?
3. Explain Tata Steel's CSR policy. In your assessment, to what extent has Tata Steel put into practice the precepts of CSR policy?
4. What does Tata Steel's motto "We also make steel" signify? What are the areas the company had made its presence before CEO Muthuraman pursued the policy of promoting the growth of the firm's core competency?
5. Discuss Tata Steel's stress on environmental protection and related issues.

SUGGESTED READINGS

- "Corporate Social Responsibility, Putting Principles, into Practice", A Tata Steel Publication.
- www.tata.com/o_ february beyond_business/community/index.htm

Case Study 3

ITC Limited: Is Corporate Governance Only Skin Deep?

(This case is based on reports in the print and electronic media. The case is meant for academic purpose only. The writer has no intention to sully the reputations of corporates or executives involved.)

Company Profile

ITC is one of India's foremost private sector companies with a market capitalisation of over US$10 billion and a turnover of US$3 billion. Forbes magazine has rated it amongst world's leading companies. Among India's private sector corporations, ITC ranks third in pre-tax profits. ITC has evolved over the years from a single-product company to a multi-business corporation. Its businesses are spread over a wide spectrum. ITC has a diversified presence in cigarettes, hotels, paperboards and specialty papers, packaging, agri-business, branded apparel, packaged foods and confectionery, greeting cards and other FMCG products. ITC is rapidly gaining market share even in its new businesses of branded ready-made garments, greeting cards, packaged foods and confectionery, while it is an outstanding market leader in its traditional businesses of cigarettes, hotels, paperboards, packaging and agri-exports. ITC is considered to be nationalistic to the core as one of India's most valuable and respected corporations, which contributes substantially to the country's revenues, employment, exports, and socio-economic development. ITC's strength emanates from its corporate strategy that aims at creating multiple drivers of growth anchored on its time-tested core competencies: large distribution reach, superior brand-building capabilities, effective supply chain management and acknowledged service skills in hotel business. In the not too distant future, ITC's strategic forays into new businesses are likely to get it a significant share of these emerging high-growth Indian markets. For instance, ITC which has 3.5 lakh tonnes capacity in paper and paperboard in its four production units including 1 lakh tonnes of Elemental Chlorine-Free (ECF) paper for food packaging, has announced in August 2005 its plan to invest Rs. 2500 crores during the next to 3 years to enhance its production of ECF by two lakh tonnes, which will increase the company's total capacity to 5.5 lakh tonnes in this segment.[1] Likewise, the company, encouraged by the tremendous response to its new food products such as "Ashirwad" brand atta and Sunfeast brand biscuits, hopes to achieve more than 100 per cent growth in turnover in this fast-growing segment in 2005. Against the present turnover of less than Rs. 400 crore, ITC Foods hopes to increase the turnover to more than Rs. 800 crore by the end of the financial year 2005.[2]

ITC continuously endeavours to enhance its wealth generating capabilities in a globalising environment to consistently reward its 1.50 lakhs shareholders, fulfil the aspirations of its stakeholders and meet societal expectations. ITC employs over 20,000 people at more than 60 locations across India. The "Business Today-Stern Stewart" study ranked the company among the top five sustained value creators in India.

ITC's Mission and Vision

The vision of the company is very well captured in its corporate positioning statement:*"Enduring Value for the Shareholder for the Nation."* Vision: *Sustain ITC's position* as *one* of *India's most valuable corporations growing value for the Indian economy and the Company's shareholders. Mission: To enhance the wealth generating capability of the enterprise in a globalising environment delivering superior and sustainable stakeholder value.*

Core Values

ITC has adopted certain Core Values that would enable the company to be a customer-focussed, highs-performance organisation which creates value for all its stakeholders:

- **Trusteeship:** To redeem the Trust of all its stakeholders by adding value all the time.
- **Customer Focus:** To deliver to the customer his/her needs in terms of value, quality and satisfaction.
- **Respect for People:** To give respect and value people in all respects.
- **Excellence:** To do what is right, do it well and win.
- **Innovation:** For better processes, products, services and management practices.
- **Ethical Corporate Citizenship:** To pursue exemplary standards of ethical behaviour.

Corporate Governance at ITC

ITC has grown to its present status of one of India's premier companies with a multi-product portfolio from a single product. ITC's businesses are as vast as they are different, from tobacco to hotels, from paper to international commodities trading. These businesses differ in their very nature, the manner of their evolution and the methods of their operations. All these diverse factors have influenced in one way or the other the form of governance at ITC. "The challenge of governance for ITC, therefore, lies in fashioning a model that addresses the uniqueness of each of its businesses and yet strengthens the unity of purpose of the company as a whole."

ITC, like any other Indian corporate, has been highly influenced by economic liberalisation, globalisation and the wide challenges and opportunities they have thrown open. To adapt themselves to a market situation replete with risks and to attract larger investments, companies have to be more open, transparent and adopt international governance practices. ITC's governance policy recognises the challenge of this new business reality in India.

ITC defines corporate governance "as a systemic process by which companies are directed and controlled to enhance their wealth generating capacity. Since large corporations employ vast quantum of societal resources, we believe that the governance process should ensure that these companies are managed in a manner that meets stakeholders' aspirations and societal expectations."

Core Principles: ITC's corporate governance initiative is based on two core principles. namely: (i) management must have the executive freedom to drive the enterprise forward without undue restraints; and (ii) this freedom of management should be exercised within a framework of effective accountability.

ITC believes that any meaningful policy on corporate governance must provide empowerment to the executive management of the Company, and simultaneously create a mechanism of checks and balances, which ensures that the decision making powers vested in the executive management is not only not abused, but is used with care and responsibility to meet stakeholder aspirations and societal expectations.

The Governance Structure

Flowing from its vision and mission and amplified by its core principles, corporate governance in ITC is achieved at three interlinked levels, namely,

- Strategic supervision by the board of directors.
- Strategic management by the Corporate Management Committee.
- Executive management by the Divisional Chief Executive assisted by the Divisional Management Committee.

It is ITC's belief that the right balance between freedom of management and accountability to shareholders can be achieved by segregating strategic supervision from strategic and executive management. The board of directors as trustees of the shareholders will exercise supervision through strategic direction and control, and seek accountability for effective management from the Corporate Management Committee (CMC). The CMC will have the freedom, within board approved direction and framework, to focus its attention and energies on the strategic management of the Company. The divisional chief executive, assisted by the divisional management committee, will have the freedom to focus on the executive management of the divisional business.

The 3-tier governance structure thus ensures the following:

(a) ***Strategic supervision*** (on behalf of the shareholders) being free from involvement in the task of strategic management of the company, can be conducted by the board with objectivity, thereby sharpening accountability of management.

(b) ***Strategic management of the company,*** uncluttered by the day-to-day tasks of executive management, remains focussed and energised.

(c) ***Executive management of the divisional business,*** free from collective strategic responsibilities for ITC as a whole, gets focussed on enhancing the quality, efficiency and effectiveness of its business

Board of Directors

The crucial role of the board of directors in leading ITC to adopt and follow corporate governance standards are as follows: As envisaged by

internationally accepted corporate governance practices the primary role of the board of directors is that of trusteeship to protect and enhance shareholder value through strategic supervision of ITC and its wholly owned subsidiaries. As trustees they will ensure that the company has clear goals relating to shareholder value and its growth. They should set strategic goals and seek accountability for their fulfilment. They will provide direction, and exercise appropriate control to ensure that the company is managed in a manner that fulfils stakeholder aspirations and societal expectations. The board will periodically review its own functioning to ensure that it is fulfilling its role.

ITC Board Structure

The ITC board is a balanced board, consisting of executive and non-executive directors, the latter including independent professionals, as envisaged by the codes of corporate governance. Executive directors, including the executive chairman, do not generally exceed 1/3rd of the total strength of the board. The non-executive directors comprise eminent professionals, drawn from amongst persons with experience in business, finance, law and public enterprises. Directors are appointed, re-appointed for a period of 3–5 years, and in the case of executive directors up to the date of their retirement, whichever is earlier. The board determines from time to time the retirement age for both executive and non-executive directors. The board specifies the maximum number of company directorships which can be held by members of the ITC board. Non-executive directors are expected to play a crucial role in imparting balance to the board processes by bringing an independent judgement to bear on issues of strategy, performance, resources, standards of company conduct etc.

The board meets at least six times a year and as far as possible meetings are held once in 2 months. The annual calendar of meetings is agreed upon at the beginning of each year. As laid down in the Articles of Association of the Company, the quorum for meetings shall be one third of members and decisions shall be taken by simple majority, unless statutorily required otherwise. Meetings are governed by a structured agenda. All major issues included in the agenda are backed by comprehensive background information to enable the board to take informed decisions. Agenda papers, as far as practicable, are circulated at least three working days prior to the meeting. Normally items for the board Agenda, except those emanating from board Committees, would have been examined by the CMC. Minutes are circulated within 15 working days of the meeting and confirmed at the next meeting. Board decisions record the related logic as far as practicable.

Committees of the ITC Board

The board has the following committees whose terms of reference are determined by the board from time to time:

Audit Committee: To provide assurance to the board on the adequacy of internal control systems and financial disclosures. The head of internal audit will act as coordinator to the audit committee, but will be administratively under the control of the director accountable to the board for the finance function.

Compensation Committee: To recommend to the board compensation terms for executive directors and the senior most level of management below the executive directors.

Nominations Committee: To recommend to the board nominations for membership of the CMC and the board, and oversee succession for the senior most level of management below the executive directors.

Investor Services Committee: To look into redressal of shareholder and investors grievances, approval of transmissions, sub-division of shares, issue of duplicate shares etc.

Composition of these committees along with their objectives, role, responsibilities will be as on the next page.

Corporate Management Committee (CMC): The primary role of the CMC is strategic management of the Company's businesses within board approved direction/framework. The CMC will operate under the superintendence and control of the board. The composition of the CMC will be determined by the board (based on the recommendation of the nominations committee), and will consist of all the executive directors and three or four key senior members of management. Membership of the CMC shall be reviewed by the Nominations Committee annually. The CMC shall be convened and chaired by the executive chairman of the company. The company secretary shall be the secretary of the CMC.

Committees of the ITC Board		
Committee	**Members**	**Chairman**
Audit committee	Directors of the company, as may be decided by the board, with not less than three members, all being non-executive directors with majority of them being independent, and with at least one director having financing and accounting knowledge. The director accountable to the board for the finance function, head of internal audit and representative of external auditors shall be the permanent invitees with the company secretary to act as the secretary	One of the independent directors, to be determined the board
Compensation committee	Non-executive directors, as may be decided by the board, with the director accountable to the board for the HR function as the Secretary	One of the independent directors, to be determined the board
Nominations committee	The executive chairman and all the non-executive directors.	Executive chairman.
Investor services committee	Directors of the company, as may be decided by the board, with the company secretary as the Secretary.	One of the non-executive directors, to be determined the board.

Source: www.itccorporate.com

Executive Chairman of ITC: The executive chairman of ITC shall operate as the chief executive for ITC as a whole. He shall be the chairman of the board and the CMC. His primary role is to provide leadership to the board and CMC for realising company goals in accordance with the charter approved by the board. He shall be responsible for the working of the board, for its balance of membership (subject to board and shareholder approvals), for ensuring that all relevant issues are on the agenda, for ensuring that all directors are enabled and encouraged to play a full part in the activities of the board. He shall keep the board informed on all matters of importance.

All these bodies and governance norms with regard to the board of directors, board committees and their structures faithfully follow the recommendations of national and international committees on corporate governance.

Face-to-Face Interaction with Shareholders

A general meeting of the shareholders of the company is held at least once a year to consider and approve the report of the directors, the annual financial statements with the notes and schedules thereto, declaration of dividends, any other returns or resources intended for distribution, the appointment of directors, appointment of auditors and other important matters requiring shareholder approval. The annual general meeting is the principal forum for face-to-face interaction with shareholders, where the entire board is present. The chairman addresses the shareholders on issues of relevance to the company and provides clarifications to shareholders on behalf of the board. The board encourages open dialogue with all its shareholders—be it individuals, corporates or foreign investors.

Cornerstones of ITC's Corporate Governance: ITC's governance philosophy rests on the following cornerstones: trusteeship, transparency, empowerment and accountability, control and ethical corporate citizenship. ITC believes that the practice of each of these leads to the creation of the right corporate culture in which the company is managed in a manner that fulfíls the purpose of corporate governance.

Trusteeship: Large corporations like ITC have both a social and economic objective. Inherent in the concept of trusteeship is the responsibility to ensure equity, namely, that the rights of all shareholders, large or small, are protected. Moreover, corporate governance in large corporations represents a coalition of interests, namely, those of the shareholders, creditors and bankers, business associates and employees. This belief, therefore, casts a responsibility of trusteeship on the

company's board of directors, who are expected to act as trustees to protect and enhance shareholder value, as well as to ensure that the company fulfils its obligations and responsibilities to its other stakeholders.

Transparency: Transparency implies explaining a company's policies, decisions and actions to those to whom it has responsibilities. Such transparency should lead to maximum appropriate disclosures without jeopardising the company's strategic interests. Internally, transparency means openness in company's relationship with its employees, as well as the conduct of its business in a manner that will bear scrutiny. Obviously, transparency enhances accountability.

Empowerment and Accountability: Empowerment is an essential concomitant of an organisation's core principle of governance that management must have the freedom to drive the enterprise forward. Empowerment is a process of actualising the potential of its employees. Empowerment unleashes creativity and innovation throughout the organisation by truly vesting decision-making powers at the most appropriate levels in the organisational hierarchy.

In such a scheme of things, the board of directors are accountable to the shareholders, and the management is accountable to the board of directors. Empowerment, combined with accountability, provides an impetus to superior performance and improves effectiveness, thereby enhancing shareholder value.

Control: Control is a necessary concomitant of its second core principle of governance namely, the freedom of management should be exercised within a framework of appropriate checks and balances. Control should prevent misuse of power, facilitate timely management response to change, and ensure that business risks are pre-emptively and effectively managed.

Ethical Corporate Citizenship: Corporations like ITC have a responsibility to set exemplary standards of ethical behaviour, both internally within the organisation, as well as in their external relationships. Unethical behaviour corrupts organisational culture and undermines stakeholder value.

More on Corporate Citizenship

The governance processes in ITC continuously reinforce and help realise the Company's belief in ethical corporate citizenship. According to ITC Chairman, Y. C. Deveshwar, ITC endeavours to pursue the Triple Bottom Line, which is centred on the company's "Commitment as a Corporate Citizen to contribute to the nation's economic, social and ecological capital."[3]

ITC: A Commitment Beyond the Market

ITC believes that its aspiration to create enduring value for the nation provides it the motive force to sustain growing shareholder value. During 1996–2005, for instance, Total Shareholder Returns, measured in terms of increase in market capitalisation and dividends, grew at a compound rate of more than 23 per cent per annum. This performance has placed ITC among the foremost companies in the country in terms of efficiency of servicing financial capital. In a testimony to ITCs ability to generate shareholder wealth, the company's market capitalisation recently touched the milestone and symbolic landmark of US$10 billion—an extraordinary performance indeed!

India's Salvation Lies in the Upliftment of the Rural Poor

It is imperative for the Indian economy to not only sustain high rates of growth over many years but also ensure that such growth is inclusive so as to free millions of our disadvantaged citizens from the indignity of poverty. The requisite high rates of inclusive growth can only be achieved by putting in place an effective growth strategy for rural India, which is home to 62 per cent of the Indian population and 70 per cent of its poor. The competitiveness of the Indian farmer has to be significantly enhanced and he has to be effectively linked to remunerative opportunities in world markets.

ITC's multiple businesses have created diverse farmer partnerships: some of these associations are almost a century old. The interdependence between ITC's agri-based businesses and the farm sector has provided the company a sustainable platform to make a sizeable contribution to rural India.

India's rural transformation cannot be brought about by the government alone. Nor can the efforts of only a few enterprises make a decisive difference. What is required is a revolution inspired by public–private partnership that will transform lives and landscapes. ITC's efforts in

Enduring value for the shareholder		
		(Rs. in Crores)
PARTICULARS	**1995–96**	**2004–05**
Gross income	5188	13585
Market capitalisation	5571	33433
Profit after tax (before exceptional items)	261	1837
Profit after tax (after exceptional items)	261	2191
EPS—basic (Rs.) (before exceptional items)	10.64	73.74
EPS—basic (Rs.) (after exceptional items)	10.64	87.97
Net worth	1121	7896
Book value per share (Rs.)	45.69	316.54
Capital employed	1886	8517

Source: http://www.itcportal.com/shareholder_23_1/shareholder-index.html

this direction have proved that it is possible to create and sustain a model that can harmonise the need for shareholder value creation while making a substantial contribution to society. It would be mission fulfilled for ITC if its example succeeds in inspiring others.

Transforming Lives and Landscapes

ITC's diversified business portfolio has enabled the Company to create and nurture numerous farmer partnerships in many value chains. These cover multiple crops and locations. Leveraging these partnerships, ITC has created a number of unique community development programmes by synergising its social sector initiatives with its business plans.

ITC's e-Choupal Movement

The immense potential of Indian agriculture is waiting to be unleashed. The endemic constraints that shackle this sector are well known. These are, *inter alia* excessive dependence on the monsoon, fragmented farms, weak infrastructure, unorganised markets, too many blood-sucking intermediaries, variations between different agro-climatic zones etc. These pose their own challenges to improving productivity of land and quality of crops. The unfortunate result is inconsistent quality and uncompetitive prices, making it difficult for the farmer to sell his produce in the world market.

ITC's proactive solutions to these problems is the e-Choupal initiative; the single largest information technology-based intervention by a corporate entity in rural India. Transforming the Indian farmer into a progressive knowledge-seeking netizen. Enriching the farmer with knowledge; elevating him to a new order of empowerment.

What Is the e-Choupal Model?

Under this model, ITC has created and maintains its own IT network in rural India to identify and train local farmer to manage the e-Choupal. The computer, typically housed in the farmer's house, is linked to the Internet via phone lines or, increasingly, by a VSAT connection, and serves an average of 600 farmers in 10 surrounding villages within about a 5 km radius.

Five years ago, ITC leveraged the power of the internet to empower the small and marginal farmer with a host of services related to know-how, best practices, timely and relevant weather information, and transparent discovery of prices. Such customised knowledge is intended to progressively raise farm productivity and incomes by linking the Indian farmer with markets, both domestic and international. The ITC e-Choupal also acts as an alternative marketing channel, creating enhanced competition among buyers, to the benefit of the farmers.

The ITC e-Choupal can serve as a powerful and effective delivery channel for a host of goods and services for the rural economy, including those related to insurance, credit, education and health. In effect, the e-Choupal is potentially an efficient delivery channel for rural development and an instrument for converting village populations into vibrant economic organisations.

Implementing such a model poses many difficulties not the least of which is the low level of literacy. Despite challenges of implementation, this initiative now comprises about 5200 installations covering nearly 31,000 villages and serving over 3 million farmers. Over the next 7–10 years it is ITC's vision to create a network of 20,000 e-Choupals and over 700 Choupal Sagars entailing investments of nearly Rs. 5000 crores, thereby extending coverage to 100,000 villages— representing one-sixth of rural India. This networked rural delivery infrastructure comprising digital, human and physical assets would complement the initiatives embodied in "Bharat Nirman" and create a front-running example of public-private partnership for rural transformation. The realisation of such a vision, of course, is dependent on the progress of reforms.

As ITC's chairman Y. C. Deveshwar summed it up in a recent interview with Economic Times: ITC wants to create a high-quality, low-cost fulfillment channel for India. "The e-choupal was the first step in the last mile towards complete backward integration. It's also the first mile on a new information highway around which multiple suppliers and buyers can coverage. It can make a huge impact on rural well-being," he said.

The farm-to-factory model operates on the principle of providing crop management inputs to farmers throughout the season. Post harvest, the hub operates as a price discovery mechanism for farmers, with ITC initially as the main buyer. Consequently, while ITC's own supply chain has become more cost-effective, avoiding the *mandis*, farmers have access to timely information and good growing practices.

What is so special about ITC's e-choupal? It is a virtual "e-business." All the basic rules help create a successful e-commerce model and being leveraged to chop costs and boost volumes, that in turn improve revenues. "There is no guarantee that ITC will achieve its ambitious goal of expanding the e-choupal network to 100,000 villages and 10 million farmers in 5 years. But, what it has achieved so far paints a tantalising picture of the possibilities of e-business for rural India. And it offers valuable insights into using creativity and pragmatism to overcome barriers in implementing e-business solutions," says Prof. Mahanbir Sawhney, McCormick Tribune University's Kellogg School of Management, in a case study on the project. Professor David Upton of Harvard's business school agrees.[4] "It provides an excellent example of combining social goals with profitability. It demonstrates how a deep understanding of social context, along with a powerful vision can result in a stellar implementation. And it shows how everyone can win when inefficiencies are removed from a supply chain," he told ET in a recent inverview. The e-Choupal initiative also creates a direct marketing channel, eliminating wasteful intermediation and multiple handling, thus reducing transaction costs and making logistics efficient.

Digital Transformation

ITC began the silent evolution of rural India with soya growers in the villages of Madhya Pradesh. For the first time, the stereotype image of the farmer on his bullock cart made way for the e-farmer, browsing the e-Choupal web site. Farmers now log on to the site through Internet kiosks in their villages to order high quality agri-inputs, get information on best farming practices, prevailing market prices for their crops at home and a broadband weather forecast—all in the local language. In the very first full season of e-Choupal operations in Madhya Pradesh, soya farmers sold nearly 50,000 tons of their produce through the soya-choupal Internet platform, which has doubled since then. The result marks the beginning of a transparent and cost-effective marketing channel and bringing prosperity to the farmers' doorstep.

Linking Farmers to Remunerative Markets

Farmers grow wheat across several agro-climatic zones, producing grains of varying grades. Though these grades had the potential to meet diverse consumer preferences, the benefit never trickled down to the farmers, because all varieties were aggregated as one average quality in the mandis. With ITC's e-Choupal intervention, farmers have discovered now the best price for their quality at the village itself. The site also provides farmers with specialised knowledge for customising their produce to the right consumer segments. The new storage and handling system preserves the identity of different varieties right through the "farm-gate to dinner-plate" supply chain. It also encourages the farmers to raise their quality standards and attract higher prices.

Social and Farm Forestry

ITC's afforestation project is driven by the realisation that India's poor forest cover—a meagre 11 per cent of the geographical area of the country against a desirable 33 per cent—has serious implications for the rural poor. Forests and common property resources constitute as much as 20 per cent or more of the total income source of such households. ITC has effectively leveraged its need for wood fibre to provide significant opportunities to economically backward wasteland owners. The main plank of ITC's forestry projects is the building of grassroots capacities to initiate a virtuous cycle of sustainable development.

ITC also makes available high-yielding, disease-resistant clonal planting stock developed through biotechnology-based research at its Bhadrachalam unit. The commercial viability of these clones is evident from the fact that farmers have brought 29,000 hectares under such plantations, wherein more than 100 million saplings have been planted. ITC intends to scale up the afforestation endeavour to cover over 100,000 hectares by planting more than 600 million saplings during the next 8–10 years, creating in the process over 40 million person days of employment among the disadvantaged.

Another 10,000 hectares have been planted by the forest departments of Andhra Pradesh, Tamil Nadu, Karnataka, Maharashtra and West Bengal.

Integrating Watershed Development

Some dry and despairing facts stare India in the face. The present average soil loss in the country is about 16.35 tonnes per hectare per year, which is at least 3 to 5 times worse than what it ought to be. Nearly 67 per cent of the cultivated area in the country faces severe moisture stress for 5–10 months a year. Crop productivity in dry lands is low, unstable and highly vulnerable to seasonality.

ITC's integrated watershed development initiative is a key intervention to reverse such moisture stress in some of the more acutely affected, drought-prone districts of the country. Currently, 550 small and large water harvesting structures with a storage capacity of 16 billion litres built by ITC provide critical irrigation to nearly 7000 hectares of land in Andhra Pradesh and Karnataka. ITC has also embarked upon a comprehensive natural resource management initiative called "Sunehra Kal" in the vicinity of choupal locations.

Women's Empowerment

The need of the hour is to diversify rural livelihoods. Towards this end, ITC has forged an empowering partnership with rural women—the most effective development workers. ITC's intervention leverages micro-credit and skills training to generate alternate employment opportunities. Increased income in the hands of rural women means better nutrition, health care and education for their children.

Working with NGOs, ITC has organised village women into micro-credit groups. Group members make monthly contributions to create a savings corpus. The corpus is used to extend soft loans to group members, thereby eliminating the stranglehold of the moneylender. The system of mandatory contribution further strengthens the savings habit, leading to capital augmentation.

ITC provides training to group members to handle bank accounts and understand the nuances of government development programmes. Empowered groups function autonomously and take their own decisions, including sanction of loans to fellowmembers and collection of repayments. Well-managed micro-credit groups with no default records receive further support from ITC in the form of seed money for self-employment activities.

Venture funds provided by ITC have already spawned hundreds of women entrepreneurs. Their earnings, ranging from Rs. 70–50 per day, not only supplement household incomes but also significantly enhance their self-esteem. These programmes aim to provide the wherewithal for sustainable incomes for at least 200 additional women each year.

Concentration on Primary Education

ITC's education support programmes are aimed at overcoming the lack of opportunities available to the poor. ITC believes that the extensive network of government-supported schools must be made more attractive to children. It provides critical support to state-run schools to maximise enrolment and minimise dropouts. So far, ITC's rural education initiatives cover over 10,000 children through 94 supplementary leaving centres and support to government primary schools. ITC aims to cover at least 5000 additional children each year. The company reserves one rupee out of every "classmate" note books sold towards rural development initiatives including primary education in villages.

Its initiatives include improving school buildings, constructing toilets, providing electricity connections and supplying fans and lights. ITC provides students with uniforms, satchels and books. So far, 20,000 children have benefited in 4 states.

ITC's EHS Philosophy

ITC as one of India's premier corporations attaches paramount importance to its responsibility to contribute to the preservation and enrichment of the physical environment. The company's commitment finds expression in its Environment, Occupational Health and Safety (EHS) philosophy which recognises the need to preserve and enrich the environment and provide a safe and healthy workplace for its employees, while constantly creating productive economic resources.

ITC's EHS commitment

(a) To contribute to sustainable development through the establishment and practice of environmental standards that are scientifically tested and meet the requirements of relevant laws, regulations and codes of practice.
(b) To factor in environment, occupational health and safety in the planning and decision making process.
(c) To disseminate information and provide appropriate training to enable all employees to accept individual responsibility for environment, health and safety, implement best practises and work collectively to create a culture of continuous improvement.
(d) To instill a sense of duty in every employee towards personal safety, as well as that of others who may be affected by the employee's actions.
(e) To provide and maintain facilities, equipment, operations and working conditions which are safe for employees, visitors and others at the company's premises.
(f) To ensure safe handling, storage, use and disposal of all substances and materials that are classified as hazardous to health and environment.
(g) To reduce waste, conserve energy and promote recycling of materials wherever possible.
(h) To institute and implement a system of regular EHS audit in order to assure compliance with laid down policy, benchmarked standards and requirements of laws, regulations and applicable codes of practice.
(i) To proactively share information with business partners towards inculcating world-class EHS standards across value chains of which ITC is a part.

Global Honours

ITC constantly endeavours to benchmark its products, services and processes to global standards. The company's pursuit of excellence has earned it national and international acclamations. ITC is one of the eight Indian companies to figure in Forbes A-List for 2004, featuring 400 of "the world's best big companies." The ET 500 survey by "The Economic Times, " rating companies on the basis of market capitalisation, ranks ITC 9th among 500 listed Indian companies. ITC has several firsts to its credit: It has won the inaugural "World Business Award," the worldwide business award recognising companies who have made significant efforts to create sustainable livelihood opportunities and enduring wealth in developing countries, instituted jointly by the United Nations Development Program (UNDP), International Chamber of Commerce (ICC) and the HRH Prince of Wales International Business Leader's Forum (IBLF). ITC Infotech finds a place of pride among a select group of SEI CMM Level 5 companies in the world. The company is also the recipient of the Corporate Social Responsibility Award 2004 from The Energy and Resources Institute (TERI) for its e-Choupal initiative. The award provides impetus to sustainable development and encourages ongoing social responsibility processes within the corporate sector. ITC has won the "Golden Peacock Global Award for Corporate Social Responsibility (CSR) in Emerging Economies for 2005." The company received this award for two of its unique initiatives that are impactfully transforming lives and landscapes in rural India—ITC's e-Choupal and social and farm forestry. ITC is the only Indian FMCG company to have featured in the Forbes 2000 list. The Forbes 2000 is a comprehensive ranking of the world's biggest companies, measured by a composite of sales, profits, assets and market value. The list spans 51 countries and 27 industries. According to an analysis based on data from the Centre for Monitoring Indian Economy (CMIE), the ITC Group is among the "Top 10 wealth creator groups" in the private sector for the financial year 2003–04. This ranking was based on market capitalisation of group entities. ITC has won the

"Enterprise Business Transformation Award" for Asia Pacific (Apac), instituted by Infosys Technologies and Wharton School of the University of Pennsylvania for its celebrated e-Choupal initiative. ITC has been ranked 29th among India's Top 500 Companies in 2003 by Dun & Bradstreet (D&B). Dun & Bradstreet is the world's leading provider of business information services, which are universally accepted as key measures of corporate performance.

Every discerning analyst will agree that ITC has won a bagful of honours—some of them very prestigious indeed, for its strict adherence to excellence in everyone of its operations and its social activism. Though most of its social initiatives are related to its industrial pursuits, it has gone much beyond to espouse the causes of the underprivileged and the rural poor. However, there had been certain acts of commission and omission within the organisation which never came to the knowledge of ITC's stakeholders until the BAT–ITC spat and the company's FERA violations came to limelight.

The BAT–ITC SPAT

History of BAT–ITC Relationship

ITC's history dates back to 1905, when British American Tobacco (BAT) set up the Peninsular Tobacco Company (Peninsular) in India. Peninsular was involved in cigarette production, tobacco procurement and processing. It set up a full-fledged sales organisation named the Imperial Tobacco Company of India Limited in 1910. BAT set up another cigarette manufacturing unit in Bangalore in 1912, to cope with the growing demand. A new company called Indian Leaf Tobacco Company (ILTC) was incorporated in July 1912, to handle the raw material (tobacco leaf) requirements, the poor quality of tobacco obtained from Bihar prompted ILTC to search for better alternatives, leading to the establishment of the South India Leaf Area (SILA) in Andhra Pradesh. By 1919, BAT had transferred its holdings in Peninsular and ILTC to Imperial Tobacco Company. Following this, Imperial replaced Peninsular as BAT's main subsidiary in India. Throughout the 1920s, Imperial Tobacco Company appointed distributors and agents in various parts of the country. As sales were growing faster in North India than in other regions of the country, Imperial set up its third factory at Saharanpur in UP in 1924. In 1925, Imperial set up a printing factory at Munger to cater to the printing and packaging needs of the Company. In 1928, Imperial's head-office in Calcutta was inaugurated.

The Unfolding of the Spat

All of a sudden in March 1995, a press release issued by the UK-based parent company of ITC, British American Tobacco (BAT) shocked the Indian corporate world. Expressing a lack of confidence in K. L. Chugh, the chairman of its Indian subsidiary. ITC, the press release demanded his resignation. The incident took place soon after Chugh had accused BAT of trying to forcibly increase its stake in ITC to gain majority and that BAT was not in favour of ITC's diversification into the power generation business.

Though the ITC–BAT relationship had been strained for quite some time, the move took ITC by surprise. The surprise element was BAT's claim that it was not demanding Chugh's resignation because of the shareholding issue, but because it had detected certain financial irregularities in the company. BAT said, "Chugh should resign in the interests of the company, its employees and its shareholders."

Soon after, Chugh called a press conference, at which he made it clear that be would not step down. "Just because one of the shareholders throws a tantrum does not mean the chairman goes." He reiterated his stand that BAT was trying to increase its stake and added that BAT only wanted to use ITC's funds for its own benefits. Chugh also said that ITC did not need BAT.

Soon, the inside details of the ITC–BAT conflict became public knowledge as a series of allegations and counter-allegations from both the parties surfaced in media reports. Commenting on the showdown, a report said, "As skeletons come tumbling out, ITC's carefully nurtured public image as a professionally managed enterprise has been tarnished."

The End—An Anti-climax

However, the entire episode ended in an anticlimax. BAT claimed that Chugh had departed from the standards of professional management and wanted him to resign on charges of financial irregularities. These charges were confirmed by an audit committee, which however, cleared Chugh of all charges. But, unexpectedly, at a press conference summoned by him Chugh announced

his resignation stating the difference of opinion between him and BAT was not good for the growth of ITC and hence he had decided to put in his papers. Surprisingly, media reports revealed that BAT had agreed to drop all charges against Chugh, gave him a hefty severance package and offered him the exalted Chairman Emeritus position at ITC. It sounded obvious that this understanding between Chugh and BAT was meant to avoid washing dirty linen in public. Till date the investing public are not aware of the reasons for the sudden spat and the real terms of the hatch-up between BAT and Chugh.

ITC—FERA Violation Story

Notwithstanding the conferment of so many global honours on ITC for its adherence to corporate governance practices and its commitment to social responsibility, ITC got into serious trouble with the Customs and Revenue Intelligence Enforcement authorities of Government of India for FERA violations. There were allegations of dubious international deals by ITC and its partners, the Chitalias, for excise duty evasion and share price manipulations.

In October 1996, officers of the Enforcement Directorate, Customs and Department of Revenue Intelligence raided various ITC offices in Kolkata. The raid was due to the suspicion of officials that ITC had contravened FERA violations to the tune of $ 100 million. On 30 October 1996, ED officials arrested, after finding conclusive evidence of FERA violations during the raid, K. K. Kutty, Director and Head of the International Business Division (IBD), a subsidiary of ITC, G. K. P. Reddi, former IBD Director and Chairman, E. Ravindranath, former Vice President, Operations, IBD and M.B. Rao, former Export Manager, IBD. The arrests were made under section 35 of FERA, to conduct interrogations on FERA violations by ITC in international trading deals during 1991–95. All the arrested officials were remanded to judicial custody until 13 November 1996.

On 31 October 1996, former chairmen of ITC Ltd, J. N. Sapru and Krishen Lal Chugh were summoned to the ED's office in Kolkata for interrogation. They were arrested the same day. On 5 November 1996, the ED interrogated ITC chairman, Y. C. Deveshwar, who promised to submit a complete report on alleged FERA violations. By mid November, the ED arrested a few more ITC executives taking the total number of arrested officials to 15.

By June 1997, ITC's board of directors was facing prosecution on account of allegations of FERA contravention. An ED official said, "For the first time in Indian corporate history, the entire board of directors of a company has been held liable for irregularities." The case attracted extensive media attention, resulting in serious debates regarding the stringent FERA regulations and the need for efficient corporate governance practices in companies. The issue was discussed in both the Houses of Parliament, where MPs accused ITC of poor corporate governance practices and lack of transparency. The MPs wanted the Department of Company Affairs (DCA) to investigate into the matter, as they felt ITC had contravened various sections of the Companies Act and wilfully and deliberately misinterpreted information causing loss to the shareholders. Though ITC performed very well on the financial front for the fiscal 1996–97, charges of FERA violation, excise duty evasion and share price manipulation in the early 1990s seemed to have tarnished the company's image beyond repair.

CONCLUSION

ITC, though basically a cigarette-manufacturing company, has earned several positive distinctions to fame. It is one of India's foremost private sector companies having a market capitalisation exceeding US $ 10 billion. In fact, the venerable Forbes magazine has placed ITC amongst the world's leading companies. The company which was basically known as a cigarette-producing company has evolved over the years as a multipurpose corporation and now has a strong prcesence in hotels, paperboards, speciality papers, packaging, agri-business, branded apparel, packaged foods, confectionary and greeting cards. ITC has adopted several core values and tries to live by them. ITC is passionately engaged in transforming the lives of the rural poor, farmers and the marginalised sections of society through various innovative initiatives amongst which the e-choupal movement is the foremost. This movement combines social goals with profitability, apart from being a direct marketing initiative, eliminating wasteful intermediation and multiple handling, thus reducing transaction costs and making logistics more efficient. No wonder, the e-choupal movement has attracted worldwide attention both in academic and business circles.

DISCUSSION QUESTIONS

1. Elaborate on the company profile of ITC Ltd. Relate ITC's growth to the core values it follows.
2. Explain the pursuit of corporate governance of ITC Limited. What are the diverse features of corporate governance of ITC Ltd?
3. Discuss the salient features of the e-Choupal movement. How does it create connectivity between ITC's activities and the company's goal of rural rejuvenation?
4. What is ITC's EHS philosophy? How is this philosophy translated into the firm's commitment to various social causes?
5. Discuss the reasons for the conflict between BAT and ITC. How was the spat settled between them?

NOTES

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SUGGESTED READINGS

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- www.itcportal.com

Case Study 4

The Tussle over Corporate Governance at Reliance

(This case is based on reports in the print and electronic media. The case is meant for academic purpose only. The writer has no intention to sully the reputations of corporates or executives involved.)

A Brief Note on Ambani's Entry into Indian Industrial Scenario

Dhirubhai Ambani was the second son of a poor school teacher from Chorward village in Gujarat. He studied up to 10th standard and decided to join his elder brother, Ramniklal, who was then working in Aden. The first job Dhirubhai held was that of an attendant in a gas station. Half a century later, he would become chairman of Reliance Petroleum Limited, a company that owned the largest oil refinery in India. When he died in Bombay after a stroke on 6 July 2002 aged 69, the Reliance group of companies that Dhirubhai established had a gross annual turnover of Rs. 75,000 crore or close to US$ 15 billion. The group's interests include the manufacture of synthetic fibres, textiles and petrochemical products, oil and gas exploration, petroleum refining, tele-communications and financial services. Before the split took place between his progenies, Mukesh and Anil, the Reliance group had total revenues of over Rs. 99,000 crore (US $22.6 billion) and net profit of Rs. 6,200 crore (US $1.4 billion). Its revenue was equivalent to 3.5 per cent of the country's GDP. It contributed 10 per cent of India's indirect tax revenues. Its exports to more than 100 countries constituted over 6 per cent of the country's exports. The Reliance Group has also India's largest number of investors in the country at 3.1 million that constitutes about one-fourth of the country's total investing public.

Reliance Industries Ltd—A Mammoth Corporate

In its website, Reliance Industries Limited (RIL) asserts that it is India's largest private sector company on all major financial parameters with a gross turnover of Rs. 74,418 crore (US $17 billion), cash profit of Rs. 9,197 crore (US $2.1 billion), net profit of Rs. 5,160 crore (US $1.2 billion), net worth of Rs. 34,452 crore (US $7.9 billion) and total assets of Rs. 71,157 crore (US $16.3 billion). RIL emerged as the only Indian company in the list of global companies that create most value for their shareholders, published by *Financial Times* based on a global survey and research conducted by Price Waterhouse Coopers in 2004. RIL features in the *Forbes Global* list of world's 400 best big companies and in *FT Global 500* list of world's largest companies.

RIL was adjudged the "Best Managed Company" in India in a study by *Business Today* and AT Kearney in 2003. The company also bagged the credit for being "India's biggest wealth creator" in the private sector over a 5-year period in a study by *Business Today*—Stern Stewart in 2004. RIL alone accounts for:

- 17 per cent of the total profits of the private sector in India.
- 7 per cent of the profits of the entire corporate sector in India.
- 6 per cent of the total market capitalisation in India.
- Weightage of 13 per cent in the BSE Sensex.
- Weightage of 10 per cent in the Nifty Index.

Reliance was Mired in Controversies Since its Inception

The textile tycoon's meteoric rise was not without its fair share of controversy. In the days of the licence control raj, Dhirubhai, more than any of his fellow industrialists, understood and appreciated the importance of "managing the environment," a euphemism for keeping politicians and bureaucrats happy. However, no one can deny the fact that he was more than a legend in his own lifetime. He successfully convinced more than three million investors—most of whom, belonged to the middle class—to invest their hard-earned money in his group companies. Much of the credit for the spread of the so-called "equity cult" in India in recent years should rightfully go to Dhirubhai, even if the Reliance group was often accused of manipulating share prices.

In 1958, after trading in a range of products, primarily spices and fabrics, for about 8 years, Dhirubhai achieved the first of the many goals he had set for himself when he became the owner of a small spinning mill at Naroda, near Ahmedabad. In 1977, Reliance Industries went public and raised equity capital from tens of thousands of

small investors. From then onwards, Dhirubhai started promoting with a single-minded purpose his company's textile brand name, "Vimal." He did not look back since then.

However, if there was a positive side to the founder of India's largest industrial empire, there was a negative side too, which people with an ethical bent of mind abhorred. Reliance group of companies was mired in endless series of controversies right from its inception. In 1985 a series of articles written by Arun Shourie and an RSS-sympathiser and chartered accountant, Gurumurthy, in the *Indian Express*, meticulously detailed a host of ways in which the government of the day bent backwards to help the Ambanis. One article was on the subject of how the Reliance group imported "spare parts", "components" and "balancing equipment" of textile manufacturing machinery to nearly double its production capacities. The article claimed that the Ambanis had 'smuggled' in a complete textile plant. Another story detailed how companies registered in the tax haven, the Isle of Man, with ludicrous and unimaginable names such as Crocodile Investments, Iota Investments, and Fiasco Investments had purchased Reliance shares at one-fifth their market prices. Curiously, most of these firms were controlled by a bunch of non-resident Indians who had the same surname, Shah. In 1990, when the Ambanis wanted to acquire managerial control of one of India's largest construction and engineering companies, Larsen & Toubro, government-owned financial institutions such as LIC and GIC stonewalled its attempts as the V. P. Singh government did not approve of Reliance's tactics. Ambanis had to beat a hasty retreat after incurring huge losses and suffering a loss of face. More than 11 years later, the Reliance group suddenly sold its stake in L & T to Grasim Industries headed by Kumara Mangalam Birla. This transaction too attracted adverse attention. Questions were raised about how the Reliance group had increased its stake in L & T a short while before the sale to Grasim had taken place. The Securities and Exchange Board of India (SEBI) instituted an inquiry into the transactions following allegations of price manipulation and insider trading. Reliance had to later cough up a token fine imposed by SEBI.

There were other controversies involving the Reliance group. Two senior executives of the Reliance group were accused of violating the Official Secrets Act after a cabinet note was found in their office during a police raid. Earlier, there had been a major uproar in the stock exchanges over alleged cases of "switching" of shares and the issue of duplicate shares by the company. In 2002, Raashid Alvi, a member of the parliament, levelled a large number of allegations against the Reliance group and distributed voluminous bunch of photocopied documents to journalists that included the letter in which a Reliance group company had sought to "buy peace" with the income tax department. The MP accused the Reliance group companies of manipulating their balance sheets and annual statements of accounts. A week after Dhirubhai's death, the Department of Company Affairs (DCA) confirmed that there was indeed a basis to some of the allegations raised by Alvi and that there were certain discrepancies in the balance sheet issued by Reliance Petroleum 7 years earlier. The DCA subsequently confirmed that different Reliance group companies had transferred interest income to one another in a questionable manner. More recently, the government of India accused Reliance Infocomm of violating its license norms by illegally routing international calls as local calls to avoid payment of levies to the telecom PSUs. The company was ordered to pay Rs. 150 crore in penalty for this violation. In February 2005, Reliance Infocomm came in for adverse publicity when a New Delhi City Court told the Delhi Police to file a status report by 15 March as the company had been accused of violating provisions of the law against pre-natal sex determination by depicting such information of foetus on its website.

The Puzzle over the Absence of Dhirubhai's Will

The phenomenal growth of Reliance group of industries in a short span of less than three decades (1977–2004) has become nothing short of the country's industrial folklore. Dirubhai Ambani used every means available to him to build a world class company. In a short period of its existence, Ambanis' Reliance has overtaken the venerable 100 year old Tata Group Companies. Reliance had its ups and downs in its chequered history, more ups than downs, thanks to Dhirubhai's policy of playing a politically correct role and ensuring that public policies do not stand in the way of his company's fast-track growth.

When Dhirubhai Ambani died in 2002 leaving his then Rs. 60,000 crore industrial empire to his sons, Mukesh and Anil, it was thought he had

left a well-laid system of working arrangement between the brothers and perhaps a will. But it is now known—after Anil started spilling the beans publicly about lack of corporate governance practices in Reliance—that there has been no will. Reliance-watchers are puzzled as to why the shrewd and extraordinarily methodical Dhirubhai Ambani who deftly crafted one of India's most celebrated business empires, did not leave a will. People who know him confirm that it was not in Dhirubhai's character to overlook something so fundamental. Perhaps, he did not leave a Will as it would have exposed the complex shareholdings of the Group through the maze of investment companies, in the opinion of Bala V. Balachandran, J. L. Kellogg distinguished professor, Northwestern University. Dhirubhai Ambani ensured that other people funded his business, but he and his progenies controlled it. "Dhirubhai knew that. He also knew that without a will you can't see the transparency of the complex shareholding of hundreds of investment companies. But without the will, you can control the whole thing," adds Balachandran. It is an irrefutable fact that the Ambanis built Reliance through sweat and toil and through enterprise and ingenuity. They also built Reliance through a maze of investment companies. It is how the family controls 34 per cent of the equity in Reliance Industries, even as it continues to raise and invest thousands of crores in equity and debt (*Businessworld*, 10 January 2005, p. 41).

Corporate Governance at Reliance—Claim and the Reality

Reliance Industries Limited (RIL) on its Corporate Web site (http:www.ril.com/aboutus/about_corpgover.html) has this claim to make on the corporate governance practices adopted by the company: "Reliance is one of the pioneers in the country in implementing the best international practices of corporate governance. In recognition of this pioneering effort, the Institute of Company Secretaries of India has bestowed on the company the National Award for Excellence in Corporate Governance for the year 2003…." Reliance's corporate governance principles uphold its global standing at the forefront of corporate governance best practice. Reliance continues to review its corporate governance practices to ensure that they continue to reflect domestic and international developments to position itself to conform to the best corporate governance practices. It takes feedback into account in its periodic reviews of the guidelines to ensure their continuing relevance, effectiveness and responsiveness to the needs of local and international investors and all other stakeholders."

Anil's Accusations

However, after the Ambani siblings started a public tussle over "ownership issues," the younger scion of the Ambanis sought the group flagship company's board meeting to discuss corporate governance issues. As the rift widened with the media playing the proverbial role of the monkey acting as an arbiter adding to the sibling rivalry, more and more details of corporate governance failures at Reliance came to light. On 13 December 2004, the Securities and Exchange Board of India (SEBI), the Indian capital market regulator directed the Stock Exchanges to look into corporate governance issues at Reliance Industries Ltd. SEBI also claimed that it was looking into the buy-back controversy at RIL (*Businessworld,* 10 January 2005, p. 38).

Apart from these murky issues which became public knowledge, Anil sent a 500-page missive to RIL Board on corporate governance issues on 15 December 2004, which highlighted several lapses. The bulky note sent to the Corporate Governance Committee of the board of the flagship company RIL, of which Mukesh is the chairman and Anil the vice-chairman, deals extensively with what the younger brother regards as flaws in corporate governance within the group. Anil is reported to have made specific allegations about irregularities and improprieties being committed by the company. According to him the company's accounts did not provide the necessary explanations, details and disclosures and there was silence on related party transactions, specially those involving Infocomm group (L. C. Gupta, "An unusual whistle-blower," *Economic Times*, 10 May 2005").

Anil has, in fact, made an issue of what he perceived to be a conflict of interest between the business interests of Anand Jain, a close associate of Mukesh, and various key positions he holds in the group. Anil had even resigned as vice-chairman and director from the board of Reliance group company IPCL, saying he would not share a seat on it with Jain, whom he accused of conspiring to divide the family. Anil had virtually turned down IPCL's request to reconsider his resignation, saying various issues, including corporate governance and

disclosure need to be resolved before any rethinking on his decision. Requesting "appropriate steps" in the interest of RIL's 3 million shareholders, Anil expressed "deep concern that RIL has failed to adhere to highest standards of corporate governance, transparency and disclosure." The extensive note is understood to have covered various issues, including questioning the manner of RIL's investment of Rs. 12,000 crore in Reliance Infocomm. Anil also disagreed with the Reliance board over the buy-back proposal as a response to falling share prices ever since the differences between the Ambani brothers became public. In the perception of the board, the precipitous fall of 12 per cent in RIL stock price was inexplicable as nothing had fundamentally changed in terms of business strategy, operational efficiency or future outlook. Hence buy-back arrangement would act as a corrective measure to restore the share prices to normalcy.

There were also other questions such as Rs. 50 crore sweat equity allotted to Mukesh in Reliance Infocomm constituting 12 per cent of the company's stocks. (Valued notionally at Rs. 70,000 crore which he annulled at the board meting on 27 December 2004) and the conversion of Rs. 8100 crore preference capital held by Rliance Industries in Reliance Infocomm, which Anil wanted to be converted into equity. Generally, it is believed that Anil was unhappy with some share transfers that had taken place after Dhirubhai's death.

Response of the Corporate Governance Committee

The Corporate Governance Committee headed by Y. P. Trivedi, an independent director, when being questioned about Anil Ambani's 500-page note on issues relating to corporate failure at RIL commented that there was no breach of governance norms at RIL. He said that eminent retired judges had endorsed the corporate governance practices, thus virtually giving a clean chit to the company. He further asserted that the Vice-Chairman and MD Anil Ambani's refusal to sign financial results at the board meeting had no implications on the company. It was not necessary for the company to inform the Exchanges, that Anil Ambani did not sign the financial results, Trivedi said after the board meeting (PTI). The corporate governance committee did not find any violations on issues referred to it.

RIL Board Passes Corporate Governance Committee Report

Belying expectations of a stormy affair, Reliance Industries transacted all its business including passage of about 25 resolutions peacefully. "The board passed all the resolutions although some of these were not unanimous," RIL board sources told PTI immediately after the 2-hour long meting. Besides approval of financial results, the board accepted the report of its Corporate Governance Committee. Sources indicated that on many of the resolutions, Anil either abstained or dissented, but did not give details. The board meeting demonstrated without any ambiguity that Mukesh was in total control of RIL and its affairs, and Anil's attack had been dented. "There is little that 1 person can do against 11 persons who are not ready to listen," one of Anil's close aides was reported to have said.

Disturbing Questions on Corporate Governance

The report of the Corporate Governance Committee, headed by Y. P. Trivedi, was the bone of contention with Anil questioning the credentials of the members even before the meeting of the board saying that it did not even bother to consult him while raising the issues by him. Among the issues raised by Anil included non-disclosure of the marketing agreement between RIL and Reliance Infocomm and elder brother Mukesh's conflict of interest as CMD of RIL, Reliance Communications and Infrastructure and Reliance Infocomm. These murky goings-on in the RIL board have raised some disturbing questions on corporate governance practices adopted at RIL, especially the wide differences that existed between the principles highlighted and practices followed in the company.

Independent Directors—Were They Really Independent?

It has also been reported in the Press that three independent directors on the Reliance Indutries Ltd (RIL) Board—D. V. Kapur, S. Venkitaramanan and Y. P. Trivedi—or their relatives have had a pecuniary relationship with the company and its associate companies like Reliance Capital and Reliance Infocomm. According to Clause 49 of the

Listing Agreement of RIL, "An independent director means a non-executive director who, apart from his director's remuneration, does not have any material pecuniary relationship or transactions with the company, its promoters, its senior management or its holding company, its subsidiaries and associate companies." It also says that an independent director is one "who… for the last 3 years… is not a partner or executive of a consulting firm that has a material association with the entity." If such a relationship exists, a director cannot be independent. As RIL has an executive chairman, Mukesh Ambani, the Companies Act requires that at least 50 per cent of the directors on its board should be independent. Kapur, Venkitaramanan and Trivedi make up three of the six independent directors on the RIL board, whose credentials as independent directors were being questioned. Trupai, a fourth independent director, died on 26 January. The penalty for not complying with the Listing Agreements is a fine of up to Rs. 25 crore and imprisonment of up to 10 years, according to the Securities Contract (Regulation) Act, 1956." (Independent Directors Had Financial Ties with RIL, *Business Standard*, New Delhi, 30 January 2005.)

New Norms of Corporate Governance and its Compliance

With so many serious doubts about RIL's governance practices having been brought to light in the wake of the rift between the Ambani siblings, a pertinent question remains to be answered. Did RIL keep up with the new and vastly changed governance norms? Today's definition of "good" corporate governance is very stringent compared to what it was during the days Dhirubhai built Reliance. Arun Maira, Chairman, Boston Consulting Group (India), explains the two fundamental differences between governance then and governance now. "A decade ago, it was enough to manage efficiently and produce results. That is what the Ambanis excelled at. They produced superlative results, almost always. Delighted shareholders, be it government institutions, foreign investors or retail shareholders, never questioned the means. Today, it is not enough to manage efficiently and produce results. Values and (the) means by which things are done, are as important," Also then, corporate governance was all about protecting shareholders' interests. But that has changed now. "In recent times, the power of corporations has increased vis-à-vis other organs of society, including governments. There is danger in this if business corporations see their responsibility only towards their shareholders, and not more broadly towards society. Therefore, the board, the prime organ for corporate governance, must be held responsible for the broader role and responsibility of the corporation to society."

The Role of the RIL Board is Being Questioned

Under these changed circumstances and value systems, his board was finding itself in unfamiliar territory 2 years after Dhirubhai's demise. Probing questions are being asked about its role. The independence of independent directors is coming under scrutiny. Incriminating documents, which have never left Reliance's vaults, are now being thrown around freely. Even public documents are now pointing to the board's calpability. Dhirubhai, who built Reliance through a maze of investment companies, also built the board of Reliance Industries. And the board is only as good as the chairman and CEO allow it to be. The result of the controversial board meeting is, therefore, no surprise. At the meeting, all board members, barring Anil, backed Mukesh. They gave a clean chit to the investments in Reliance Infocomm, expressed faith in Mukesh's leadership, and made some genial remarks about corporate governance. The board would have done the same thing had similar allegations come up during Dhirubhai's days (Business World, January 10 2005, p. 44).

For instance, in the 2004 annual report of RIL, the board had signed a statement under the statutory section on corporate governance that "None of the transactions with any of the related parties were in conflict with the interests of the company" (p. 42). In the light of revelations in the aftermath of Anil's taking cudgels against governance issues at RIL, the statement implies that the board saw nothing wrong in Mukesh acquiring Rs. 50 crore worth of shares in Reliance Infocomm at par, while RIL itself paid Rs. 8100 crore for shares worth only Rs. 84 crore. The board, reaffirmed this at its controversial meeting in January 2005.

Did the RIL board think twice before it signed that statement? The Indian Companies Act, Caluse 49 of the Listing Agreement that companies sign with the Stock Exchanges (as prescribed by Securities and Exchange Board of India) and Accounting Standards 18 of the Institute of Chartered Accountants of India (ICAI) together prescribe a five-point check for the board and the statutory auditors, before such a statement is signed.

(1) As per Section 299 of the Companies Act, "Every director of a company who is in any way, whether directly or indirectly concerned or interested in a contract or arrangement, shall disclose the nature of his concern or interest at a meeting of the board…." "The exact nature, extent and manner have to be clearly submitted in a prescribed format." Now the important question is: Did Mukesh disclose the full extent of his interest to the board? It is widely known that a complex maze of companies controlled by Mukesh was used to set up Reliance Infocomm. Reliance Industries' investments and Mukesh's sweat equity* of Rs. 50 crores were routed through this channel.

If RIL's claims that the company follows international governance practices, then its CMD. Mukesh should have made a complete disclosure of all his interests, including the sweat equity to the board (which was bound to disclose it explicitly to shareholders). The same can be said of several other related-party transactions within the group.

(2) The Securities and Exchange Board of India's code on corporate governance prescribes that the board of every listed company set up an audit committee. This must be constituted entirely of non-executive directors and must be headed by an independent director. This is mandated by Section 292 A of the Companies Act and by Clause 49 of the Listing Agreement. Among other things, the audit committee has to "review any related party transactions, i.e. transactions of the company of material nature, with promoters or the management, their subsidiaries or relatives etc. that may have a potential conflict of interests with the company at large". The audit committee also has powers to consult the statutory auditors of the company and demand clarifications regarding any area of concern.

The Reliance Board too did set up such a committee—comprising four independent directors: Y. P. Trivedi (Chairman) Venkitaramanan (Vice chairman), T. R. U. Pai and M. P. Modi. But this committee found no reason for any conflict of interest. It was on the basis of this finding that the board signed the above-mentioned statement. However, subsequent disclosures about the sweat equity and other questionable transactions within the group, open up the audit committee's actions to scrutiny. (*Businessworld*, 10 January 2005, p. 44).

(3) Section 301 of the Company's Act prescribes that every company maintain a register of contracts in which its directors are interested in. It also has to specify details, including the date of the contract and the terms and conditions of the contract. Besides, Section 297 specifies that board approval is required for contracts in which directors are interested parties. In cases of business emergencies, such transactions may happen without board permission. But they have to be cleared by the board within 3 months of the transaction through a resolution. The significant point here is that under Section 301, the register has to be signed by every director, which implies that they are aware of and have approved these transactions. Moreover, this register has to be kept open for inspection by any shareholder. And if a minority shareholder feels that his interests have been prejudiced, he can approach the Company Law Board.

(4) As an abundant caution, the Companies Act (Section 300) also declares that directors are not to participate in discussions or vote in resolutions in which they might be considered to be interested parties. For example, when the Reliance Industries Board was discussing Reliance Energy, Anil Ambani was not supposed to be present. Similarly, when Reliance Infocomm was being discussed, Mukesh should have stayed out. Reports suggest that Mukesh may have actively participated in such discussions.

In contrast, in companies like Infosys which follow scrupulously such regulations, interested directors have stepped out when their boards discussed issues relating to them.

The key question here is this: Did the RIL Board realise that Mukesh was an interested party? Did the Board recognise that his personal interests in Reliance Infocomm might be in conflict with the interests of Reliance Industries?

* Equity shares issued at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property or valuation additions, by whatever name called. Discount for sweat equity is discount to the market price of the share and not the initial issue price.

(5) Apart from the board and the audit committee, the statutory auditors too have a clear responsibility with respect to related-party transactions. Accounting Standards (AS) 18 of the ICAI goes into great length in its definitions of related parties and the kind of disclosures required. It defines a party as related if the party has the ability to control or exercise significant influence over the other party (Mukesh clearly has influence over Reliance Infocomm and Reliance Industries). It also defines a related party transaction as a transfer of resources or obligations between related parties, irrespective of whether a price is charged. It goes to the extent of saying that a related-party relationship has to be disclosed irrespective of whether a transaction has taken place or not. And in the event of transactions, the auditors have to ensure: (a) full disclosure of all details of the transaction along with the amounts involved, and (b) any other elements of the related-party transactions necessary for an understanding of the financing transactions.

In the Reliance Industries annual report, detailed disclosures of transactions between Reliance Industries and other related parties have been made (though the sweat equity is not specifically mentioned). However, shareholders may feel that they were not given other details necessary for a correct understanding of the financial transactions.

Has the spirit of these laws been upheld? The answer is a clear no. If the actions of Reliance directors are compared to those of some of their peers from other companies, they fall short of standards set even within India, let alone international standards. Such standards have not been observed at Reliance, even at the concerned board meeting. According to press reports Mukesh was present and even voted on resolutions pertaining to Reliance Infocomm.

Related-party relationships are not peculiar to Reliance alone. ICAI's AS 18 states: "Legally, there is nothing wrong in such transactions. The law does not restrict such transactions," They are certainly well within the ambit of law, as long as: (a) the interested director makes full disclosures to the board, (b) the board exercises sound, independent judgement to determine whether these represent a conflict of interests with the company, and (c) the board makes full, clearly understandable disclosures to all shareholders.

In the case of Reliance, the directors and the board could be challenged on all the three counts.

A Corporate is a National Asset, and Not of a Family

"When an institution becomes very important to society, it no longer belongs only to its financial investors and promoters. It belongs to society. Thus, Reliance "belongs to" India now, not the Ambani family. Therefore, concepts of governance must encompass the role of trusteeship for society, and not merely questions about the interests of the owners," says Maira of Boston Consulting Group.

Anil Ambani expected that everything in RIL should have been done by trust, rather than by the unscrambling of the investment structure, which would bring with it difficult problems of its own. The media war that Anil Ambani has unleashed against his brother is an attempt to force him to clarify the ownership structure to Anil's satisfaction. In this, he seems to have the support of other members of his family too, who also want the ownership structure to be clarified, even while they accept that the control of the group to rest with Mukesh. The complaint of the Anil camp is that even the way dividends flow to these investment trusts and companies and then managed is not clear. Reliance paid out Rs. 733 crore in dividends last year alone, which means these Trusts and companies received a lot of money, approximately Rs. 249 crore.

The Final Settlement

After an acrimonious and festering feud between the brothers that lasted more than 8 months, what appears like an amicable settlement seems to have been arrived at thanks to the strenuous efforts of family friend M. V. Kamath, the CMD of ICICI Bank with the blessing of their mother Kokilaben Ambani.

At the AGM on August 3, Mukesh—who now controls RIL—gave out the details of how the Rs. 1,00,000-crore Reliance group will be split between himself and Anil. RIL's holdings in the three firms (Reliance Capital, Reliance Energy and the Telecom ventures) that have landed in Anil's lap will be transferred to three special purpose vehicles (SPVS). RIL shareholders will be allotted shares in the SPVS in the same proportion as their holdings in RIL. As per the arrangement, for every 100 shares held, the RIL shareholder will get 5 shares of Reliance

Capital, 7 of Reliance Energy and 100 of Reliance Communications Ventures Ltd (RCVL), a new holding company for all its telecom ventures. In addition, the same RIL shareholder would get 100 shares of Global Fuel Management Services Ltd (GFMS), another new firm to handle natural gas supplies from RIL for Anil's proposed power project in Uttar Pradesh.

The partition between the two brothers and the settlement to transfer all holdings of Reliance industries in Reliance Energy (55 per cent), Reliance capital (47 per cent) and Reliance Infocomm (45 per cent) into a holding company to be listed in the stock exchanges implies that all Reliance shareholders benefit by the unlocking of value in these companies, whose initial promoter was Reliance Industries Ltd. However, the so-called settlement brings to the fore several issues, which need to be investigated by the Department of Corporate Affairs and the SEBI. The controversial areas that ought to be investigated are:

(i) Role and the quality of board of directors
(ii) The reliability or otherwise of disclosures by the company
(iii) Promoters' cross-holdings and web of investment companies
(iv) Related-party transactions harmful to shareholders and
(v) The Reliability of disclosures in the company's financial statements.

On the face of it, Mukesh Ambani has a larger slice of the cake, with interests in the group spanning diverse fields such as oil & gas, petrochemicals, textiles, life science and healthcare. With the oil and gas prices on a roll and the matured business spinning cash profits, the group should do well. After the disinvestment of its other activities, the group will be more focussed and enjoy a better valuation in the stockmarkets. If oil and gas, exploration and production, as also the petrochemicals (after the likely merger of IPCL in RIL) were to be spun off into separate entities, the valuation may still be better.

Anil Ambani, on the other hand, will be in the new economy business of information technology, communications and entertainment (ICE). In the first 7 months since launch, the infocomm company was able to garner subscribers to the tune of one million every month. This is expected to grow at around 100 per cent every year over the next 5 years. The acquisition of Flag Telecom, offering a bouquet of products through its 55,000 km long cable network to international carriers, is expected to see a further ramp-up in the overall subscribers at the retail as well as the service providers' levels."

CONCLUSION

The so-called settlement leads us directly to the issue of corporate governance. Even as the entire nation tries to decipher the truth behind the series of accusations that one brother is levelling against the other, it is losing sight of a key issue: Governance failure at Reliance is not a problem only with the second generation of Ambanis. "The seed of the problems we are having with corporate governance started in Dhirubhai's lifetime," Besides, the Reliance struggle is not only about a clash of egos between estranged brothers. It is also about big money. It is about sharing Rs. 1,00,000 crore, even if you share the same blood which built it from scratch.

If we are now aware of the major charges of governance failure at Reliance, it is only because one of the brothers chose to make it public. The RIL Board continues to pretend that nothing is wrong. But one thing is certain. Anil is not a whistle-blower trying to protect shareholder interests. If we admit that corporate governance lapses in Reliance Industries are not of recent vintage, then both Mukesh and Anil are equally responsible for the current state of affairs. This only proves what experts of corporate governance have been saying. Corporate governance cannot be imposed by law or by the regulator. It has to be practised by those at the top so that it could percolate down to the bottom. That alone can bring about better governance practices among Indian corporates.

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Case Study 5

The Tylenol Crisis: How Ethical Practices Saved Johnson & Johnson from Collapse

(This case is developed from published reports, and is purely meant for class room discussion. It is not intended to serve as endorsement of sources of primary data or illustrations of effective or ineffective management.)

Company Background

Robert Wood Johnson along with his two brothers, James Wood and Edward Mead Johnson, formed a partnership in 1885 to make commercial use of the discoveries of Sir Joseph Lister, a reputed English surgeon, who identified airborne germs as the invisible assassins that caused infection in the operating room. This partnership firm was incorporated as Johnson & Johnson in 1887 and began its operations in New Brunswick, New Jersey. It developed Listers' methods of manufacturing antiseptics, and supplied to hospitals in the United States the first ready-made, sterile, ready-to-use, wrapped and sealed surgical dressings. The company's first products were improved medicinal plasters containing medicinal compounds mixed in an adhesive. Johnson & Johnson introduced a slew of products in course of time that included antiseptic surgical dress materials, adhesive plasters and even a book on antiseptic practices titled *Modern Methods of Antiseptic Wound Treatment*, which for many years remained the standard text on antiseptic practices. Johnson & Johnson's international growth, which commenced in 1919 with the establishment of an affiliate in Canada, spread rapidly. New subsidiaries were created in more than 50 countries including Australia (1931), Sweden (1956), Japan (1961), Greece (1973), Korea (1981) and Egypt (1985). One of the landmarks in the extensive growth of Johnson & Johnson was the writing of credo by General Johnson that codifies the company's ethical and socially responsible approach to conducting business. The credo epitomises the company's responsibility to the people who use its products and services—to its employees to the community and environment and to its shareholders.

The Tylenol Crisis

Johnson & Johnson's subsidiary, McNeil Consumer Products has an analgesic called Tylenol which became a market leader in the $1.36 million US analgesics market with 37 per cent share. Tylenol also accounted for 17–18 per cent of Johnson & Johnson's net earnings and 7.4 per cent of the company's worldwide revenues for the period 1981–82. Tylenol was the absolute leader in the market for pain-killers outselling the next four leading pain-killers including Anacin, Bayer, Bufferin and Excedrin.

On 30 September 1982, the CEO of McNeil Consumer Products received a shocking news that seven persons had died mysteriously after taking cyanide laced capsules of Extra-Strength Tylenol in Chicago's West Side. The deaths that were broadly reported in the media spread like wildfire and became the cause of a massive, nationwide panic.

The company's immediately initiated investigations revealed that a malevolent person or a group of such persons, for reasons known to him/them, presumably replaced Tylenol Extra-Strength capsules with cyanide-laced capsules, resealed the packages, and deposited them on the shelves of at least half-a-dozen or so pharmacies and food stores in the Chicago area. The Extra-Strength Tylenol capsules were each found to contain 65 milligrams of cyanide, 10,000 times more cyanide to kill a human being. The poisoned capsules were bought and used, by seven unsuspecting persons who died a horrible and instantaneous death. Johnson & Johnson, the parent company of McNeil Consumer Products Company which made the concerned Tylenol had to suddenly explain to the world why its trusted and premium product was killing unsuspecting people.

McNeil Consumer Products Company officials asserted that the cyanide-laced capsules had not emanated from either of its plants. A spokesman of the parent company, Johnson & Johnson, informed the media of the strict quality control at the plants or in the company's premises. Since the cyanide-laced Tylenol had been discovered in shipments from both the company's plants and had been found only in the Chicago vicinity, officials came to the conclusion that the tamperings could have taken place only after the product had reached Illinois. It was also found that the poisoned capsules were from four manufacturing lots and that they were taken from different pharmacies/stores over a period of weeks or even months. It was also observed that the person or persons whose vicious act caused the seven deaths should have spent a few hours in tampering with and

resealing the bottles with five or less cyanide capsules and one with ten and then placing them back on the shelves of five different stores in the Chicago area. Four different individuals who died had consumed the deadly cyanide coated pain-killer from four different bottles, while a family of three died after consuming it from the fifth.

The publicity about the cyanide laced capsules created a nationwide panic immediately and with the expansion of 24 hour electronic media, people were bombarded with more and more news on the subject. Aroused by such sensational news through the media, people started calling hospitals to enquire about Tylenol. A Chicago hospital was reported to have received 700 telephone calls just on a single day. People in cities across the United States were admitted to hospitals on suspected cyanide poisoning. It was reported that within the first 10 days of the crisis, Johnson & Johnson received 1411 telephone calls on its most controversial product of the time.

Another interesting offshoot of the incident was that there were a number of copycats who attempted to stimulate the tamperings in Chicago. In the first month after the seven deaths that occurred due to the poisoned capsules, the Food and Drug Administration (FDA) counted 270 incidents of suspected product tampering. In the considered perception of the FDA, this large number of product manipulations might have been due to the mass hysteria created by the media frenzy that led to blame any type of headache or nausea on food and medicine they thought that they might have been poisoned. The FDA estimated that only about 36 of the cases were "genuine" cases of tamperings.

Johnson & Johnson's Crisis Communication Strategies

James Burke, chairman of Johnson & Johnson, reacted in a matured manner to the adverse media reports by forming a seven-member strategy team forthwith. There were two questions that had to be addressed urgently without any loss of time. The first and foremost question was "How do we protect the people?" and the second, "How do we save this product?" Even against the advice of some worried insiders, the company initiated its first action by cautioning the users of the medicine. Through the use of the media, the company immediately alerted consumers across the country not to consume any type of Tylenol product. They advised the consumers not to resume using the product until the extent of tampering was determined and necessary corrective action initiated. Johnson & Johnson withdrew all forms of Tylenol capsules from the store shelves in Chicago and the surrounding area, after stopping the production and advertising of the drug. Further, after realising the vulnerability of the product with the discovery of two more contaminated bottles of the now much-maligned product, the company ordered the withdrawal of all Tylenol capsules from the width and breadth of the United States of America.

Even though the company was convinced that there was little chance of discovering any more cyanide coated tablets, Johnson & Johnson made it known that they would not like to take any risk with the safety and health of the Tylenol-consuming public, even if it cost the company its reputation and millions of dollars. A day later, the Food and Drug Administration also advised consumers to avoid taking Tylenol capsules. It was estimated that the recall included approximately 31 million bottles of Tylenol, with a retail value of more than $100 million. The normally media-shy company also used the media extensively, both for public relations and paid advertising, to inform the public on their strategy during the crisis. The company established a 1800 hotline for consumers to call to enable the company executives to respond to enquiries from them concerning the safety or otherwise of Tylenol. It is worth repetition here that within the first 10 days of the crisis, Johnson & Johnson received 1411 telephone calls enquiring the company on the various aspects of the Tylenol crisis.

The Impact of the Strategy

It is now well known that the recall of the Tylenol capsules was not an easy decision to make for the company. Many well-informed analysts were of the opinion that recalling all Tylenon-related products could adversely affect the business prospects of the company. There was a great deal of discussion on the recall of the pain-killer at the national level. Some company executives were really concerned about the panic that could be caused to the industry over such a widespread recalling of the company's premium product. There were others too who felt that the nation-wide recall of Tylenol would effectively bury any chance for the product to survive in future.

What Johnson & Johnson faced was an unusual situation for a large corporation of its size and reach in facing a crisis of such dimensions. Johnson & Johnson's handling of the Tylenol tampering crisis was considered to be one of the best in the history of public relations by experts in the field. Moreover, in many such instances companies in crisis had put themselves first and ended up doing more damage to their reputations than if they had immediately taken responsibility for the crisis. According to many commentators, the way Johnson & Johnson handled the crisis became the model and lesson for crisis management. It was the considered opinion of many that the company's response to the crisis demonstrated clearly its commitment to customer safety and quality of its product. Besides, the candidness with which the company approached the issue and the open and transparent communication with public helped the company maintain a high level of credibility and customer trust. In the case of many other companies, the top brass would have thought of the huge financial loss the company would have to incur and also its reputation once it decided to recall its own product at a national level. But in this case, the then chairman and CEO of Johnson & Johnson, James E. Burke, said, "It will take time, it will take money, and it will be very difficult; but we consider it a moral imperative, as well as good business, to restore Tylenol to its preeminent position." Burke and his executives rather than thinking about the huge financial implications, followed both the letter and spirit of the company's credo which said that the company's primary responsibility "is to the doctors, nurses and patients, to mothers and fathers and all others who use our products and services. In meeting their needs, everything we do must be of high quality."

In the wake of Tylenol tampering, Burke sent immediately a team of scientists to find the source of tampering. The former commissioner for the US Consumer Product Safety Commission, R. David Pittle, commented: "They did the right thing and they did it promptly. Putting consumer safety above all else can help develop a loyalty from the consumer." All these public relations work paid off ultimately. The public at large were led to believe that Johnson & Johnson was the victim of a conspiracy by one or more malevolent persons to sully the company's reputation and to destroy a premium product that was its major profit earner. In this connection, it is worth recalling an article that appeared in the Washington Post on 11 October 1982. It said: "Johnson & Johnson has effectively demonstrated how a major business ought to handle a disaster. What Johnson & Johnson's executives have done is to communicate the message that the company is candid, contrite, and compassionate, committed to solving the murders and protecting the public." The much-respected newspaper also applauded Johnson & Johnson for being honest with the public and stressed the fact that it must have been difficult for the company to withstand the temptation to disclaim any link between Tylenol and the deaths of seven people. It also added that the company never attempted to do anything, other than try to get to the bottom of the deaths. It also mentioned that Johnson & Johnson almost immediately put up a reward of $100,000 for nabbing and nailing the killer.

Johnson & Johnson's Strategy to Win Back Public Trust

The strategy adopted by Johnson & Johnson to win back the trust of the public both for reinstating its product and restoring its own reputation in the aftermath of Tylenol crisis was implemented in two phases. The first phase was the actual handling of the crisis. The comeback of both Johnson & Johnson and Tylenol was the second phase in the company's strategy to win back the trust of people on both counts. The planning of phase one started almost immediately as phase one was being implemented.

With regard to ***phase one*** the company adopted a public relations campaign almost immediately following the discovery of the deaths in Chicago and linking it to Extra Strength Tylenol capsules. As the plan was being considered, Johnson & Johnson's top executives put customer safety first before they got worried about their company's profit and other financial concerns.

The initial media reports focussed on the deaths of American citizens from a trusted consumer product. In the beginning, the product tampering was not known, thus the media made a very negative association with the brand name. Before the crisis, Johnson & Johnson had not actively sought press coverage, but as a company in crisis they recognised the advantage of open communication in clearly disseminating warnings to the public as well as a clear enunciation of the company's stand. The company immediately alerted consumers across the United States, through

the media, not to consume any type of Tylenol product. The company advised consumers not to resume using the product until the extent of the tampering could be determined. As mentioned earlier, the company also stopped the production and advertising of Tylenol and ordered the recall of all Tylenol capsules from the market. Along with the nationwide alert and the Tylenol recall, Johnson & Johnson established relations with the Chicago Police, the Federal Bureau of Investigation (FBI) and the Food and Drug Administration. This way the company could have a part in searching for the culprit who laced Tylenol capsules and could help prevent further tampering. Johnson & Johnson also arranged several major press conferences at the company's corporate headquarters. Within hours, an internal video staff set up a live television feed via satellite to the New York metro area. This allowed all press conferences to go national. Jim Burke got more positive media exposure by going on 60 minutes and the Donahue show and giving the public his command messages.

The media was not only focussed on the deaths, but it was also pervasive. Throughout the crisis over 100,000 separate news stories ran in US. newspapers, and hundreds of hours of national and local television coverage. A post-crisis study by Johnson & Johnson said that over 90 per cent of the American population had heard of the Chicago deaths due to cyanide-laced Tylenol. News clipping services found over 125,000 news clippings on the Tylenol story. One of the services claimed that this story had been given the widest US news coverage since the assassination of President John F. Kennedy. Media reporting continued to focus on Tylenol killing people until more information about what caused the deaths was made available. In most crises media focusses on the sensational aspects of the crisis, and then follow with the cause as they learn more about what really happened.

In ***phase two*** Johnson & Johnson concentrated on a comeback plan. Actually this phase was already on by the time the first phase was being implemented. To restore the confidence and trust of the public in Tylenol, and to make the product tamper-free, Johnson & Johnson followed a series of concerted measures: First, the company brought in a new Triple Safety Seal Packaging—a glued box, a plastic seal over the neck of the bottle, and a foil seal over the mouth of the bottle. Tylenol became the first product in the industry to use the new tamper resistant packaging within 6 months after the tampering of the product was reported. The company made the announcement of the new Triple Safety Seal Packaging at a press conference at the manufacturer's headquarters. Before the crisis, Tylenol was a premium product and had a massive advertising budget and it was number one alternative to aspirin in the country. On the comeback trail Johnson & Johnson unleashed an extensive marketing campaign and promotional programme to bring Tylenol back to its premium position as the number one over-the-counter analgesic in the United States.

Secondly, to promote the use of Tylenol among customers who might have strayed away from the brand as a result of the tampering, the deaths and the adverse media publicility, the manufacturing subsidiary of Johnson & Johnson, McNeil Consumer Products, provided $2.50-off by coupons that could be used towards the purchase of any Tylenol product. The coupons could be obtained by consumers calling a special toll-free number. This offer was also made in November and December through an advertisement blitzkerg in popular newspapers where the $2.50 coupon was printed.

Thirdly, to promote the product, salesmen at McNeil were advised to recover former stock off the shelves and place the new-look Tylenol by putting a new pricing programme into effect. This new programme gave consumers discounts as high as 25 per cent. Also, a totally new advertising campaign was launched in 1983.

Finally, more than 2250 salesmen from Johnson & Johnson and its subsidiaries were instructed by the company to make presentations to doctors, surgeons and the medical fraternity. These presentations were made to promote support for the re-introduction of Tylenol.

The Success of the Comeback Trail

The Tylenol comeback was a great success. Many executives attribute the success of the comeback to the quick actions of the corporation at the onset of the Tylenol crisis. They think that if Johnson & Johnson had not been so direct in protecting the public interest, Tylenol capsules would not have reemerged so easily.

In the wake of Tylenol crisis, the nationwide recall of the product and the media frenzy that followed in the aftermath of the death of seven users, there were a number of people who

believed that Tylenol could never be resurrected. Many marketing experts thought that Tylenon was doomed by doubts that the public would have had as whether or not the product was safe. "I don't think they can ever sell another product under that name," advertising genius Jerry Della Femina told the New York Times in the first days following the crisis. "There may be an advertising person who thinks he can solve this and if they find him, I want to hire him, because then I want him to turn our water cooler into a wine cooler."

But many skeptics including Della Femina were proved quite wrong in assuming that Tylenol could never be brought back to the shelves again. Not only is Tylenol still one of the top selling over-the-counter drugs in the country, but it took very little time for the product to return to the market. Johnson & Johnson's handling of the Tylenol tampering crisis is considered by public relations experts to be one of the best in the history of public relations. This was possible because of the company's realistic reading of the crisis situation, its seriousness, a workable strategy and the tremendously sympathetic media reports, which did much to boost the company's work and played a huge role in Johnson & Johnson's public relations campaign. If the company had not fully cooperated with the media, they would have, in turn, received much less positive media coverage. Disapproving coverage by the media could have easily destroyed Tylenol's reputation permanently, and with it Johnson & Johnson's as well.

Analysts have come to recognise Johnson & Johnson's handling of the Tylenol crisis as the example for success when confronted with a threat to an organisation's existence. Berge lauds the case in the following manner, "The Tylenol crisis is without a doubt the most exemplary case ever known in the history of crisis communications. Any business executive, who has ever stumbled into a public relations ambush, ought to appreciate the way Johnson & Johnson responded to the Tylenol poisonings. They have effectively demonstrated how major business has to handle a disaster." The Tylenol case was the base for many of the crisis communications strategies developed by researchers over the last 20 years.

Reasons for Success of Efforts Taken by Johnson & Johnson in the Tylenol Crisis

We can list a number of favourable factors that have contributed to the success of the efforts initiated by Johnson & Johnson in the aftermath of the Tylenol crisis: (i) by making it known to the consumers in particular, and the public in general, through the use of the media, Johnson & Johnson proved that it was a victim of someone's criminal behaviour of tampering its product and causing death to innocent victims; (ii) Johnson & Johnson provided the victims' families counseling and financial assistance even though they were not responsible for the product tampering; (iii) any negative feelings by the public against the company were lessened as the media showed Johnson & Johnson taking positive remedial action to help the victims' families; (iv) the company's developing a Triple sealed packaging and tamper-free sealing and the random inspection procedures before the shipment of Tylenon to retailers brought in a sense of trust and confidence on the most–maligned product of the time; (v) by the media portraying the company as the unfair victim of a hostile act of an outsider created a wave of sympathy for the company; (vi) Johnson & Johnson's willingness to accept losses by pulling the Tylenol product across the country deepened the sympathy with the public; (vii) the Johnson & Johnson Tylenol crisis is an example of how an organisation should communicate with the public during a crisis. The organisation's leadership especially set the example from the beginning by making public safety the organisation's number one priority and concern. This is particularity important given the fact that Johnson & Johnson's main mission with Tylenol is to enhance the public's well-being or heath; and (viii) more importantly, the leadership of the company rose to the occasion and acted commendably during the crisis, especially in the matter of its relations with the Fourth Estate. Johnson & Johnson did not have a proactive public affairs programme before the crisis. The only media relations the company engaged in was in the advertising and marketing area. During the crisis, the company realised the importance of maintaining a good, if not cordial, relationship with the media if it were to surmount the problem of its life and death. This realisation and their subsequent establishment of excellent rapport with the media quickened the process of the public accepting Tylenol.

CONCLUSION

After the crisis and the commendable follow-up measures, Johnson & Johnson has completely recovered its market share of Tylenol, lost during the crisis. The company was able to re-establish the Tylenol brand name as one of the most reliable over-the-counter consumer products in the US. Since the time of the crisis and its successful resolution, analysts are able to categorically affirm that Johnson & Johnson's handling of the Tylenol crisis is definitely an excellent example other companies should emulate, when they find themselves on the brink of a disaster.

DISCUSSION QUESTIONS

1. Trace the genesis and growth of Johnson and Johnson. How did the Tylenol crisis affect the onward growth march of J&J?
2. Explain in your own words the Tylenol crisis. What were the factors that accentuated the crisis?
3. Discuss the impact of the strategy adopted by Johnson & Johnson to recall the Tylenol capsules in the aftermath of the news that seven patients died after using them to cure their headache and illness.
4. What was the strategy adopted by Johnson & Johnson to win back public trust? Did it have the desired impact?
5. Explain in your own words the story of how ethical practices saved Johnson & Johnson from virtual collapse.

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Case Study 6

How Unethical Practices Almost Destroyed WorldCom

(This case is developed from published reports, and is purely meant for classroom discussion. It is not intended to serve as endorsements of sources of primary data or illustrations of effective or ineffective management.)

Company Background

WorldCom was founded in 1983 by Bernard Ebbers, David Singleton and Murray Waldren, who were reported to have sketched months earlier their idea for a long distance company on a napkin in a coffee shop in Hattiesburg! It was initially called LDDS—Long Distance Discount Service. Ebbers was elected President and CEO of the new company, though he lacked the technical education and expertise to run a technology—based company. Ebbers was a sort of Jack of all trades and had been a milkman, bartender, bar bouncer, car salesman, truck driver, garment factory foreman, hotelier and high school basketball coach. However, Ebbers took less than a year to make the company—which started with about $650,000 in capital and soon incurred $1.5 million in debt—profitable. LDDS became a public company in 1989 with its acquisition of Advantage Companies. What followed was a series of more than 60 mergers and acquisitions throughout the late 80s and early 90s. This strategy was to deliver economies of scale that were much needed for companies to make it big in the booming telecom market. On 25 May 1995, the company officially changed its name to WorldCom after shareholders approved it. In 1996, WorldCom purchased MFS Communications Inc. MFS's Internet subsidiary, UUNET gave WorldCom a substantial international presence. In September 1998, the company made its biggest acquisition, paying a price of approximately $40 billion for the well-known long distance provider MCI. The deal was financed by 1.3 billion of WorldCom's shares, valued at approximately $28, and $7 billion in cash. By 1998 WorldCom had become a full-service provider offering a host of telecom services, giving it an edge over competition.

The series of mergers and acquisitions fuelled WorldCom's growth making it one of the largest telecom players, serving big clients in 100 countries including the US Defence and State Departments. It reported revenues of $40 billion in 2000. By 2002, it became the No. 2 residential long-distance carrier in the US. Its services spanned the globe and it had offices all over the world. It had the world's largest Internet backbone, thousands of government contract and 20 million customers worldwide. The company had more than $30 billion in revenues, $104 billion in assets and 60,000 employees by July, 2002. The company was a hot favourite with the investing public with its stock price climbing to an unbelievable $64.51 in June 1999. Ebbers became "famous" for the way he had engineered the success of WorldCom. He was rated as one of the richest Americans by Forbes with his personal fortune estimated at $1.4 billion. Ebbers and Scott Sullivan, the CFO of the company, were hailed by analysts as industry leaders.

Nemesis Catches Up with WorldCom

With its usual acquisition trail, WorldCom attempted to acquire yet another telecom company, Sprint, in October 1999. However, the Department of Justice objected to this move smelling something fishy in the deal. This was an important milestone in WorldCom's history. The turndown made WorldCom top officials realise that mergers and acquisitions were not a sustainable growth strategy. Ebbers seemed to lack a strategic sense of direction and the company started to drift.

By 2001, WorldCom's growth started melting down, due, in large part, to the downturn in the economy. A decline in revenue, overcapacity and huge debts forced the company into a severe financial crunch. By 2000, the company realised that its earnings would fall short of the projected figures by a huge margin of approximately 40 per cent. This began to worry the over-ambitious CEO and other top brass of the company as to how the market would react to the decline in WorldCom's earnings.

In June 1999, WorldCom's stock was trading at double digit figures, but by January 2004 it had become worthless, dropping to a measly $0.50. Bernard Ebbers resigned as CEO after stock prices hit the bottom. In June 2002, WorldCom announced that it had inflated its profits by improperly accounting for more than $3.9 billion. CFO Scott Sullivan was fired by the board, and Controller David Myers was asked to step down. Trading of WorldCom's shares was stopped and the Department of Justice was asked to investigate the scandal. In August 2002, another $3 billion was found to be improperly accounted for. The company

was asked to rework its financial statements for 2001 and 2002.

The Unfolding of the WorldCom Scandal

With the falling value of WorldCom's shares, huge debts and the mounting pressure from the investing public, Ebbers resigned in April 2002. It was only after John Sidgmore took over as CEO, did the fraudulent activities of Ebbers and his team came to light. Sidgmore appointed KPMG as the company's new financial auditors, who scoured through company records with a fine tooth-comb. The revelations they made were indeed startling.

The Truth Behind the Scandal

WorldCom had made unrealistic financial targets and was not able to match them. In order to meet these targets and present a favourable picture to the public to make it appear that the targets had been achieved, Sullivan used certain accounting treatments that had no basis in the generally accepted accounting principles. These were supported by David Myers, Controller at WorldCom. It was the general practice at WorldCom to make accounting entries, that were not supported by documentation, at the directive—verbal or through email—of the top brass of the company.

A careful analysis by KPMG revealed that the company was capitalising its line costs—a major operating expenditure for all long distance carriers. Line costs are described as those costs, which WorldCom paid to other companies for using their communication network. Reportedly $3.055 billion was misclassified in 2001 and another $797 million in the first quarter of 2002 by resorting to this false accounting practice. WorldCom was treating its current expenses—an item that would affect net income—as a capital account. This accounting manoeuvre would have little or no impact on the key income figures that were analysed by the market and the investing public. WorldCom hoped that it could sustain its market value by fooling the market.

KPMG auditors discovered that "line costs" that were actually an operating expense was treated as a capital expenditure, thereby spreading the expense over many years. This accounting treatment affected the pre-tax income figures and the earnings, numbers that are considered as important from the investors angle, and signified the financial health of the company. WorldCom had misreported its pre-tax income and earnings by almost $3.8 billion for the years 1999–2002.

The extent to which the books were "cooked" was so shocking that in some cases where WorldCom reported a profit for the quarter, the company actually had incurred a loss when the statements were reworked. In 2000 and 2001, WorldCom claimed a pre-tax revenue of $7.6 billion, $2.4 billion respectively. However, after a complete reworking, it was found that the company had incurred a loss of $49.9 billion and $14.5 billion for the respective years. The company had also written off approximately $80 billion of the stated book value of assets on the balance sheet.

In July 2002, KPMG also announced that it had unearthed yet another accounting irregularity. The reserve accounts, which companies establish to fund unpredictable events in the future such as tax liabilities, was manipulated by the company to increase the net income figures. WorldCom set up reserves to make payments for the line costs. The bills for these costs were generally not paid for even several months after the costs were incurred. According to the generally accepted accounting principles, the company was required to estimate the expected payments and match the expense with the revenue. If the bill amount came in lower than expected, then the company could reverse some of the accruals with the extra accounted in the income statements as a reduction in line expense. However, in 1999 and 2000, Scott Sullivan instructed employees to release accruals amounting to $3.3 billion, that he claimed were too high to meet future payments. Several business units, however, were left with accruals for future cash payments that turned out to be insufficient when the time came for the bills to be settled.

WorldCom executives submitted dubious financial statements to the SEC. According to a company source, WorldCom created two versions of the accounts—the actual version, that reflected the actual operating expenses and a "final" version that was rigged to meet market expectations.

Reasons for the Fiasco

Corporate culture: Worldcom had a bewildering variety of people, cultures, accounting practices and business strategies, as the company had acquired as many as 60 business entites each of which

had its own set of business culture which hardly synthesised into common unified culture even after the merger. "We had offices in places we never know about. We'd get calls from people we didn't know existed" recalled one Worldcom accountant. More surprisingly, the various departments of the corporate office such as finance, Legal, network operations, and human resources were located in different cities, hundreds of miles away from one another. Ebber considered it a colossal waste of time to unify and coordinate the company's works or to synthesise its practices. It was reported that many employees were unaware of the existence of an internal audit department and most felt that they did not have an independent outlet to express their concerns about company policies or behaviour. In all, the company had a hodgepodge culture with no well defined rules of behaviour for anyone. Moreover, the structure at WorldCom was very hierarchical. The company encouraged an attitude that employees must do what they are told and not to ask questions. Challenges to the bosses' orders were met with rude remarks and sometimes threats. Employees of the various accounting divisions at WorldCom were aware that their bosses were "up to something". They made or knew of entries that were not supported by proper documentation, prepared reports that were false and did not raise any objections to the malpractices. They simply followed "orders". Employees believed that they were forcefully subjected to these wrongdoings by Sullivan and if they objected, it would cost them their jobs, a risk that few of them were prepared to take.

It was also noted, as mentioned earlier, that the finance, human resources, operations and accounting departments were dispersed throughout the company offices, making it difficult for employees of these departments to interact with one another or share their concerns or exchange notes. The involvement of key personnel from these departments was restrained due to physical limitations.

Inorganic growth: The American media were all praise for the CEO Ebbers, who was able to successfully transform a small Mississippi-based company into one of the largest global players in the telecommunication industry. Ebbers resorted to a series of mergers and acquisitions, taking over 60 companies in all, to build his empire. Nearly all of these transactions were financed by the highly valued WorldCom stock, financed by the booming stock market of the mid and late 1990s.

However, as the industry growth slowed down and the economy entered a recession, the company's stock prices fell from as high as $64 per share to as low as $2. This situation found Ebbers in a tight spot as he had bought enormous quantities of WorldCom stock to finance the several mergers and acquisitions, using the value of the stock as collateral. With the value of stocks almost worthless and debts rising, Ebbers took a personal loan of $400 million in October 2000, to pay-off a part of his debts.

Failing leadership: Bernard Ebbers, the CEO of Worldcom, was neither qualified not experienced enough to lead a telecommunications giant of such size and stature. He was a former basketball coach from Edmonton, Alberta, who by fortuitous circumstances, bought a long-distance resale service LDDs and made it big through several acquisitions and mergers. Thus he lacked the corporate culture a company such as Worldcom should have developed and instil such traits among the thousands of professionals employed in the company. Moreover, Ebbers was more interested in building his own fortunes rather than createing long-term shareholder value. WorldCom's success became dependent on Ebbers ability to continue to post double-digit growth figures in spite of a recession. However, with the decision of the SEC to halt WorldCom's plans to acquire Sprint, Ebbers was left with no back-up plan. He did not provide the leadership necessary to see the company through hard days, in a legitimate manner. Although he might not have been aware of the exact nature of the accounting treatments, he was aware that "financial gimmickry" was being resorted to by his CFO Scott Sullivan to meet revenue and profit targets. Sullivan testified that Ebbers was aware of the practices resorted to in order to boost profits.

Recession in the economy: During the mid and late 1990s, WorldCom's business was booming, with the telecom industry and the economy in general growing rapidly. With the close of the 1990s, the economic scenario of the country took a drastic change. The telecom industry slowed, consumer price wars intensified and a rise in the demand for mobile phones affected the income statement of almost all the telecom companies. WorldCom was no exception to this.

Vast oversupply of capacity: The US Telecommunications Act of 1996 was intended to improve competition in the telecom industry. The Act enabled companies to compete in one

another's markets. As a result, several telecom companies sprang up to meet the surge in the demand for telecom services, furthered by an overly optimistic projection of Internet growth. Most of these companies borrowed heavily to expand their capacities. When the dot-com boom ended, WorldCom and other companies faced reduced demand. With excess capacity proving to be a burden, it was quite obvious that the management of such companies would have resorted to manipulation to conceal the falling revenues.

Unhealthy focus on profits: The management of WorldCom was limited in its outlook in the sense that it was only focussed on increasing its revenue and profit margins rather than building long-term shareholder value. The demand for revenue growth was so intense that managers were encouraged to bring in new business, i.e. revenue, even if it meant that long term costs outdid short-term gains. The aim was to report higher earnings ratio and income compared to the estimates. With the recession, and companies reducing their prices, WorldCom's Expense to Revenue Ratio (E/R), i.e, line cost expenditures to revenues was hit and the company was not able to maintain its targets. This pushed the top men in the company to resort to accounting irregularities to boost if not maintain the E/R ratio.

An Unconcerned and Malfunctioning Board of Directors: Richard Breeden, the man whom SEC nominated as the 'Corporate Monitor' to ensure the re-structuring of WorldCom after it filed for bankruptcy, indicated that WorldCom's collapse could have been avoided had the board of directors been more alert and was aware of the malpractices taking place within the company. In his words "The board let Ebbers behave like a Roman Emperor and he was allowed to do anything he wanted." Apart from several other failures of direction and governance, the board of directors of Worldcom ceded power over the direction of the company to Ebbers, who did not seem to possess the experience or training to be even remotely qualified for his position. The board has been criticised for being unable to control the CEO. The directors also indulged in lavish spending and were richly compensated, as was evident by their huge salary and severance packages. For instance, the CEO, Ebbers, the CFO, Sullivan, and the CFO, Ron Beaumont, were allowed lavish compensations far beyond any rational calculation of value added by them. Ebbers was sanctioned more than $400 million in loans. Several members of the board also served for unreasonably long tenures. This had made them too comfortable in their positions and they were incapable of using their powers effectively. For instance, the audit committee, and the compensation committee of the board, whose responsibility was to oversee the internal audit, external audit and financial reporting; and, to maintain systems by which company executives were compensated adequately were accused of being the least committed part of the board. The audit committee spent as little as three to 6 hours per year in carrying out its functions. Richard Breeden, the SEC-appointed Corporate Monitor also pointed out that they seemed to have little understanding on the company's internal financial workings. The compensation committee also failed to exercise its powers in an ethical manner. Ebbers was able to 'buy' loyalty within the company and the board by using "retention grants" which totalled approximately $238 million during 2000. Ebbers himself was granted huge and unsecured loans which were approved by the chairmen of the audit and compensation committees who were his long-term close associates. These loans were used to purchase various unrelated and usually overvalued businesses, which Ebbers used for his own entertainment and advancement. The compensation committee also approved a huge severance package for Ebbers and his wife amounting to $50 million, as well as interest subsidies worth nearly $40 million on the loans that he had taken.

The Financial Mess

After SEC's probe into the WorldCom fiasco, it was found that the company had a debt of $5.75 billion. Just few weeks prior to the accounting fraud becoming public, WorldCom had signed a credit agreement with 26 banks according to which WorldCom was to pay $2.65 billion per year. The banks, blissfully unaware of the financial crisis that WorldCom was in, agreed to sanction the loans without demanding any sort of collateral.

WorldCom also had $30 billion in bond debt. It listed approximately $104 billion in assets, but after it filed for bankruptcy, the real value of the assets was much less. Its market capitalisation that was $120 billion in 1991 fell to $408 million.

In 2002, WorldCom was to pay a $0.60 dividend on its MCI group tracking stock. The company, however, defaulted justifying that such a move could save them up to $284 million a year.

How the Stakeholders Were Affected?

Decline in the value of stock: The collapse of WorldCom affected its stakeholders to a great extent. The company's stock, which was rated earlier by Wall Street as B+ was downgraded to CCC-after the scandal. Pension holdings in the stock by WorldCom's employees became totally worthless. The company also wrote off about $82 million of its assets. The share value declined by 95 per cent leaving investors penniless. Millionaires became paupers overnight.

Workforce cut down drastically: The company cut down its work force by 17,000 and about 3500 had to leave within a week of the company filing for bankruptcy. WorldCom now has a workforce of about 40,000 employees, down from a huge figure of 101,000, that it employed in its heydays.

Customers: WorldCom's bankruptcy jeopardised service to its 20 million retail customers apart from the many government contracts, affecting 80 million social security beneficiaries, air traffic control for the Federal Aviation Association, network management for the department of defence and long distance services for both Houses of the Congress and General Accounting Office. Customers were not able to switch to other service providers as a full-scale switch could take months. Besides, WorldCom had drawn up contracts, requiring the customer to pay up to 50 per cent of the service charges as penalty for breach of contract. Therefore, many of them were forced to stay or else pay a huge price for shifting.

Thousands of companies across the globe who depend on WorldCom's UUNET for Internet services are also in a precarious situation. UUNET controls the wires that Internet service providers use to carry Internet traffic between cities and across continents. UUNET handles more than 40 per cent of the US Internet traffic including a majority of emails sent within the United States and the rest of the world.

Financial institutions: Twenty five banks have sued WorldCom for defaulting on its loan payment amounting to $2.6 billion. Shareholders have started suing investment banks for wrongly advising them into putting all their money into one single stock such as WorldCom.

The Indian connection: The WorldCom fiasco has dealt a blow to the Indian telecom company VSNL. WorldCom owes VSNL approximately Rs. 400 crores. The two companies had signed an agreement to carry each other's long distance traffic to and from their respective countries. They had also signed an MOU for a frame relay service. WorldCom had plans to set up a manufacturing base in India in a strategic alliance with a Delhi based company. With WorldCom having filed for Chapter 11 under the US bankruptcy code, all these ventures are now hanging in the air.

WorldCom and Arthur Andersen—The Blame Game

On questioning, Arthur Andersen, WorldCom's financial auditors that had served as its external auditors since 1989, denied any knowledge of the accounting malpractices resorted to by WorldCom officials. The audit firm maintained that Sullivan had withheld information from them during the audits. Sources at Andersen said that Sullivan had even turned down the auditors' request to speak with Ronald Lomenzo, Seniro Vice President—Financial Operations. On their part, however, it seems that they "missed" several opportunities that might have led to the discovery of accounting malpractices. Andersen has been criticised for the inept handling of WorldCom's accounting policies, systems and books. Andersen's fault lay not only in not notifying line costs that were being capitalised but also for not having designed its audit to detect misclassifications of such large magnitude. Many observers also point out that Andersen should have taken into account the shockingly large and increasing financial loss of Worldcom and paid more attention to the possibility of aggressive accounting practices, especially when it was aware of such precedents in other corporations whose accounts it audited. Andersen had a series of audit failures including Enron and Worldcom which saw its large number of big corporations leave them in droves. However, unlike in the case of Enron, Andersen was prevented from destroying the documents while the suit against Worldcom was pending.

Postscript

In March 2002, the SEC launched an investigation into the books of accounts of WorldCom. A review of the loans approved by the Board of Directors of

WorldCom to CEO Ebbers, and the financial health of the company was undertaken. In June 2002, the SEC filed fraud charges against the company.

WorldCom subsequently filed for bankruptcy protection under Chapter 11 of the US Bankruptcy code, in what is considered as the biggest bankruptcy in the US corporate history, after the collapse of energy giant Enron. The company had uncovered $11 billion in accounting fraud and had reported earnings and understated expenses to the tune of $74.5 billion.

Ebbers, the erstwhile CEO of WorldCom pleaded not guilty, claiming that he was unaware of the accounting malpractices taking place in the company. Although CFO Sullivan testified against Ebbers, there was no direct evidence of his involvement, as Ebbers was shrewd enough to issue directives orally and never resorted to email. The jury, however, refused to buy the argument that a manipulation of such a large extent could go unnoticed by the CEO of the company. The jury convicted Bernard Ebbers of conspiracy, securities fraud and filing of false documents with the SEC, and sentenced him to a prison term of 25 years. Scott Sullivan, the mastermind behind the accounting frauds, was found guilty and sentenced to 5 years in prison. He has had to sell his $11 million Florida mansion to settle the various claims brought against him by the investing public.

Four other people were found guilty by the jury. WorldCom's Controller, David Myers and Director of General Accounting, Buford Yates, were sentenced to prison terms for aiding and abetting with Sullivan, as was the case with Betty Vinson and Troy Normand, both directors in the accounting department.

Settlement for Protection of WorldCom stakeholders

Richard Breeden, a former chairman of the US Securities and Exchange Commission was appointed "Corporate Monitor" on July 3, 2002, immediately after the SEC had filed charges of accounting fraud against Worldcom. With a view to preventing future violations of the securities laws, Worldcom consented to (i) a companywide programme of training in accounting, financial disclosure and ethics; (ii) a comprehensive review of internal control system and (iii) a review of its governance systems, policies, plans and practices. Breeden was given the responsibility of carrying out the governance review and recommending changes for the future.

Breeden submitted to the United States District Court for the Southern District of New York that concurred with the SEC to induct him into Worldcom, a study of corporate governance and a plan of action for changes that he wanted to put in place. He called this document "Restoring Trust." It had 78 recommendations on Corporate Governance at Worldcom including the establishment of a Governance Constitution for the company, increased shareholder communication, an active, informed and independent board, active board committees, Auditor rotation, compensation limits and so on.

CONCLUSION

The company, as part of its settlement with the SEC, had to implement the 78 odd recommendations made by Richard Breeden. He initiated a new board of directors who were more experienced and committed. He also initiated several changes in the way the company and the board, in particular, functioned. Michael Capellas, former President of Hewlett Packard, was selected as the new CEO. He also set up systems in the company, which called for more shareholder involvement in governance. The new CEO and all employees were asked to sign a pledge of "institutionalised ethics," which showed their commitment to sound corporate governance and high ethical standards.

WorldCom has sold of its peripheral business, but still holds on to major businesses such as MCI and UUnet. To signal a fresh start from bankruptcy, it was renamed MCI Inc.

DISCUSSION QUESTIONS

1. Discuss the phenomenal growth of WorldCom from its inception in 1983. What were the factors that fuelled its growth?
2. How did nemesis catch up with WorldCom? Trace the company's downfall from its heyday in 1996.
3. Expose in your own words the truth behind the Enron Scandal.
4. How were the stakeholders of Enron adversely affected by the financial scandal enveloping the firm?
5. Who was responsible for the downfall of Enron-WorldCom or Andersen? Substantiate your answer.

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Case Study 7

The Rise and Fall of Arthur Andersen

(This case is based on reports in the print and electronic media. The case is meant for academic purpose only. The writer has no intention to sully the reputations of corporates or executives involved.)

Arthur Andersen's Early Reputation

The name of Arthur Andersen was once synonymous with honesty, integrity and uncompromising values in the auditing and accounting profession. The audit firm's name stood tall even among the company of mammoth corporations for well over seven decades. However, with the change in circumstances, deteriorating value systems, low-moral standards and the never-ending greed of the firm's hundreds of partners in the USA brought about its downfall in the beginning of the new millennium.

Arthur Andersen was founded in 1913 by two partners, Arthur Andersen and Clarence Delaney, in Chicago. The partnership firm was originally known as Andersen, Delaney & Co and offered accounting services to companies. The firm changed its name in 1918 to Arthur Andersen and grew over the next 89 years to become one of the five largest accounting firms (after Pricewaterhouse Coopers, Deloitte Touche & Tohmatsu, Ernst & Young, and KPMG) with more than 1800 partners and 85,000 employees in as many as 84 countries. Arthur Andersen entered the 1990s with an unmatched reputation in audit and accounting based on the unrivalled commitment of its founder, Arthur Andersen, to rigorous and uncompromised audits performed by highly trained competent professionals. The reputation of Arthur Andersen and his willingness to refuse to change audits even if it resulted in the loss of a valuable client was an integral part of the culture at Arthur Andersen. For many years, Andersen's motto was "Think straight, talk straight". It was reported that Andersen was approached by a senior executive of a railway company to approve by signing on accounts, containing flawed accounting. He was informed that refusal would mean the loss of the account. Andersen refused in no uncertain terms, replying that there was "not enough money in the city of Chicago" to make him do it. However, the carefully built reputation came under severe strain in the late 1990s. Arthur Andersen suddenly found itself at the centre of an endless series of accounting scandals including Waste Management in 1997, Sunbeam in 1998, and the Baptist Foundation of Arizona in 1999. However, it was the collapse of Enron in November/December 2001 that finally caused clients to begin questioning the reputation of Arthur Andersen and eventually to defect to other accounting firms.

The Seeds of the Downfall

The collapse of Arthur Andersen, though appeared sudden, had a long history. Perhaps the seeds of the downfall could be traced to a series of developments in the second half of the twentieth century. Arthur, one of the founders and the guiding spirit behind the firm, died in 1947 and one of the partners, Leaonard Spacek took over as the CEO. Spacek too followed the lofty traditions of the founder. The culture of honesty, integrity and ethical practices against all odds was so deeply ingrained in the firm that Arthur Andersen was accorded the rare honour of being elected to the Accounting Hall of Fame of Ohio State University in 1953.

By early 1950s, the firm went on an expansion spree overseas and also began consultation and installation services taking cognizance of the vast potential that lay in information technology. Its activities widened to include other areas of non-audit services. In the early 1960s, the entire range of the firm's consulting activities was brought under Management Information Consulting Division (MICD), later on changed to Andersen Consulting in 1987. This consulting service was so successful that in 1994, Arthur Consulting's income equalled the total Andersen revenue, and continued to grow.

During the 1990s, while US corporations grew by leaps and bounds, beyond expectations of their promoters with increased productivity that brought in huge profits, incomes of Andersen's and its partners declined due to the firm having more than 1800 partners. The audit partners, who earned less than those of Andersen Consulting, were looked down upon by their peers in the latter profession. Under these circumstances, the audit partners were constrained to accept even clients with unsavoury reputations and those who were involved in illegal activities with a view to boosting their incomes. Eager to make millions of dollars in consulting and auditing fees, the firm looked the other way as clients like Waste Management, Global Crossing, WorldCom and Enron cooked

their books by manipulating accounts. Starting with Waste Management in 1998, the accounting irregularities came to light in quick succession. Enron was the last straw. In this case, the auditing firm reportedly approved falsified Enron financial statements concealing almost $ 20 billion of debt from stock and bond holders, regulatory agencies and Enron's own employees.

The Enron Fiasco That Brought Down Andersen

The Enron scandal broke in October 2001 when the energy firm announced a huge third-quarter loss and Arthur Andersen was forced to write down its equity sending Enron in a free fall towards bankruptcy in December 2001. When the American capital market regulator, Securities and Exchange Commission (SEC) in its investigation, subpoenaed information from Arthur Andersen relating to Enron, it was made public that relevant computer files had been erased and documents shredded. Although it was Arthur Andersen itself that made the SEC aware of the problems in its Houston office and all the important files were recovered, it still led to the indictment of Arthur Andersen on obstruction of justice charges on 15 March 2002. Arthur Andersen was eventually convicted by a federal jury of a single count of obstructing justice on 15 June 2002. The firm announced shortly thereafter that it would stop auditing publicly traded clients as of August 2002. The verdict was largely irrelevant as the majority of Arthur Andersen's publicly traded firms already had left the firm by that time and most of its international offices had been sold to the other four major accounting firms. Arthur Andersen had paid the ultimate price for the Enron audit failure.

Why did Enron Collapse?

The energy-trading company, Enron was one of Andersen's biggest and longstanding clients. Arthur Andersen had been Enron's auditors since the company's formation in 1985. When Enron reported its third quarter results in October 2001, it showed huge losses that sent its share prices tumbling by more than 10 per cent. The results revealed a loss of $638 million, a $35 million write-down due to losses on its partnerships, and a decrease in shareholders' equity by $1.2 billion. It was seen by analysts that millions of dollars of debts had been hidden in a complex web of transactions. It was also alleged that millions of dollars were funnelled to top executives, their families and selected friends and into partnerships they controlled. To disguise its true balance sheets, Enron used complex financial partnerships to conceal mounting debts. "Its trading operations relied heavily on complicated transactions, many relating to deals many years in the future." Most of these transactions ended in huge losses which were being shuttled around and hidden, eventually surfacing in 2001, when it was no more possible to hide such huge losses.

The SEC started an investigation into the firm and its results. Enron admitted it had inflated its profits and filed for bankruptcy in December 2001. Many of its top executives were convicted. Enron left behind huge losses—$15 billion in debts, worthless shares with investors and unemployment for 20,000 workers around the World. Banks that were exposed to Enron too lost huge sums—Citigroup $800 million, JP Morgan $900 million and an undisclosed amount by Merrill Lynch bankers who were also charged with fraud in connection with Enron transactions. Finally, Arthur Andersen which failed to audit the Enron books correctly too collapsed in the aftermath of SEC's investigation and subsequent conviction by the court.

Andersen's Document Policy Put in Force

Arthur Andersen was convicted first because of its destruction of evidence relating to its audit work for Enron just as the Enron scandal started surfacing. Enron was one of Andersen's biggest clients, earning for the firm audit fees of $25 million and consulting fees of $26 million in 2000. A large team of Andersen auditors and employees were based in Enron's offices, while Enron employed several past and retired employees from Andersen. Thus the relationship between the client and audit firm was too close and blurred. Besides, David Duncan, the client engagement partner based in Andersen's office at Houston was so close and committed toward his client that he was dubbed as a "client advocate" with a name for "aggressive accounting." But many audit employees within Andersen felt that Enron was a difficult and demanding customer who took liberty with accounts and was given to manipulations. There were serious doubts among

Andersen staffers about the accounting practices of some of Enron's off-balance sheet activities. But David Duncan and his team were able to override these expressed concerns by technical partners. In fact, one of such dissenters, Carl Bass, was removed from the engagement after Enron complained that he was being deliberately obstructive. Such was the unprofessional closeness between the Andersen lead auditors and the client Enron that the company was not only free to manipulate and fudge accounts that were inimical to shareholders' interests, but also had the tacit, and sometimes, open support of the then "credible" Andersen auditors.

In August 2001, immediately after the resignation of Enron's CEO, Jeffrey Skilling, the company's senior accountant Sherron Watkins, warned Kenneth Lay, the succeeding CEO and the Andersen partners of impending accounting problems. By August 28, potential improprieties at Enron were reported in the Wall Street Journal and an informal investigation was opened by the Securities and Exchange Commission. Andersen started damage control measures. By early September, the audit firm had formed a "Crisis Response" team that included Nancy Temple, the in-house counsel. By October 8, Andersen had appointed outside counsel as well in connection with its role in any potential Enron-related litigation. On the following day, Ms. Temple's note indicated that an SEC's investigation was "highly probable."

On 10 October 2001 the Andersen partner, who was warned by Ms. Watkins earlier, attended a company meeting that included personnel of the Enron engagement team and urged compliance with Andersen's document retention policy. Further investigation also revealed that Nancy Temple sent a number of memos and e-mails to Enron-related partners at the Houston office reminding them to comply with the firm's document destruction and retention policy as late as October 12. This policy enjoined all Andersen offices to destroy unnecessary information on their clients and retain only the most necessary information on them, after a client's work has been completed. The objective of this policy was to prevent unnecessary and unwanted data overload at Andersen. Andersen's policy was unquestionable *inasmuch* as it only called for retention in the firm's central engagement file of only such information as is relevant to supporting Andersen's work, but providing that document destruction should be discontinued once litigation is threatened. Andersen staffers complied with the policy by shredding documents related to Enron, though there was a lurking fear of government investigation in the minds of the Andersen engagement team. Andersen employees were told to stop the destruction of documents only after Andersen was formally served by the SEC with a subpoena for its recods relating to Enron.

On October 16, Enron announced that it would "take a $1.01 billion charge to earnings." On October 17, the securities and exchange commission notified the company of the investigation into the scandal and requested documents. On October 19, the SEC's request was forwarded to Andersen. The same day, Ms Temple sent an internal e-mail with a copy of the audit firm's document retention policy as an attachment. On October 20, the in-house counsel. Ms Temple advised everyone concerned to "make sure to follow the … policy." On October 23, Kenneth Lay declined to answer questions during an analyst query because of "potential law suits, as well as the SEC." After this call, the head of Andersen's audit engagement team for Enron instructed other partners on the team to comply with the policy. Substantial destruction of paper and electronic records ensued in Andersen's offices. It was reported that "The shredder at the Andersen office at the Enron building was used virtually constantly and, to handle the overload, dozens of large trunks filled with Enron documents were sent to Andersen's main Houston office to be shredded. A systematic effort was also undertaken and carried out to purge the computer hard drives and e-mail system of Enron-related files. In London, a coordinated effort by Andersen partners and others, similar to the initiative undertaken in Houston, was put into place to destroy Enron-related documents within days of notice of the SEC inquiry" (www.accountancyage.com, 5 April 2002). "Even after the SEC opened a formal investigation on October 30, the destruction continued until one day following service of a subpoena by the SEC" (Mark D. Robins, 7 June 2005).

Andersen's Response to Allegations

In a statement given to the US Congress in December 2001, Andersen auditors stated that they had forewarned Enron executives of possible illegal acts by the company when it had withheld crucial financial information. When the SEC's investigations commenced in January 2002 to unearth proofs against Enron and to find out the extent of Andersen's involvement in

the irregulatries, Andersen took a hostile and defensive strategy. Andersen, which had been both the external and the internal auditor of Enron when the company manipulated its financials, became the target of severe criticism for its failure to detect the irregularities. The audit firm which witnessed its reputation savaged by the Enron scandal came out fighting, pinning the blame for the company's collapse squarely on the management of Enron. Andersen executives involved in the Enron audit blamed the company entirely for withholding sensitive and crucial financial data. Andersen's chief executive, Joseph Berardino said he was not aware of any illegal behaviour behind the spectacular implosion of Enron. The failure of the company, he added, was simply a matter of economics and had nothing to do with the rigour of Andersen's accounting. "This is a company whose business model failed," he said. Relations between Enron and Andersen deteriorated when the firm sacked the auditor for destroying Enron-related documents.

Andersen's attempts to limit the damage from the fallout of Enron's collapse faced further challenge when a number of top executives from the accounting company faced the government's Energy and Commerce Committee. They included David Duncan, the Andersen partner for destroying documents related to Enron even as financial regulators investigated the company.

Mr Berardino, speaking on NBC, admitted there had been an error of judgment at Andersen but said information had also been held back from the auditors. "We have acknowledged in one case, we did make an error in judgment and that was corrected. And in another case, some information had been withheld that was extremely important to the decision on accounting. "The accounting reflects the results of business activities. And the way these events were being accounted for were clear to management and to the board, obviously in less detail to the board. But at its base, this is an economic failure."

Arthur Andersen was also facing increased scrutiny as more and more of their audit clients were being investigated for accounting irregularities. Global Crossing, a telecommunications company that owned one of the world's largest fibre optic networks; an Arthur Andersen audited firm, filed for the fourth largest bankruptcy in the US history. Amidst these scandals, and a few others, long time clients of Arthur Andersen deserted it and went to other auditors. Arthur Andersen's inability to solve the devastating lack of faith by companies, shredding of Enron documents, suspected corruption within company ranks and two large client bankruptcies led to disastrous consequences for the accounting giant. Clients were not the only ones to leave Arthur Andersen. Other top accounting firms, also broke ties with Andersen because they believed that the firm's tarnished image would hinder their collective ability to lobby Congress. To top it all, Enron also fired Arthur Andersen as their auditors, although this is probably not a surprise to many.

Andersen's Efforts to Win Back Their Credibility

To Andersen's credit, they took several steps to restore faith in their services and people. They instituted several self-imposed measures such as discontinuing internal audit services to audit clients that included the very lucrative IT consulting for audit clients. In addition, Andersen announced that they would no longer provide accounting services for EOTT Energy Partners and Nothern Border Partners. Both of these firms were affiliated in some manner with the bankrupt Enron. Neither firm claimed any problems existed with regards to Andersen's accounting practices. Andersen commented that this action was necessary due to concerns about their ability to serve as an auditor to these firms given the connections to Enron. Arthur Andersen also hired on 25 January 2002 Paul A. Volcker, former Federal Reserve Chairman, to lead the firm's reforms. Within 2 months it was reported that Volcker could not persuade the partners to accept his plan for change, as Andersen partners did not want to change how they did business. Moreover, all these initiatives were too little and came too late to revive the already terminally ailing Andersen.

The Last Straw

In April 2002, the Department of Justice (DOJ) initiated proceedings against Andersen. Duncan pleaded guilty to DOJ's charge of obstruction of justice by shredding documents. He further testified that the Andersen audit team did know about the accounting errors committed by Enron but the audit firm did not force the company to show these in its financial statements, as the amount involved was measly compared to Enron's vast resources and shareholders' equity.

But in mid 2001, the audit team forced Enron to write down $1.2 billion in shareholders' equity, and directed the company to attribute the write down to an accounting error. Further, Duncan also testified that Temple's e-mails did influence his team to shred Enron related documents and e-mails.

The prosecutors felt that apart from Duncan, Ms. Temple was also aware of the accounting manipulations and the fact that this could lead to SEC's probe. Her e-mails mentioned the need to protect Andersen from such a probe. Temple also asked Duncan to change an earlier internal memo to protect the firm from litigation as she strongly felt that there could be an SEC investigation into Enron. All these proved beyond any reasonable doubt that the thought of litigation either by SEC or by other public authorities was in the mind of Andersen officials.

In June 2002, when the trial began, it was the onus of the prosecutors to prove that Andersen deliberately destroyed Enron related documents and e-mails with a clear intention of obstructing the course of justice. During the course of the trial, the prosecutors were able to prove that Duncan's orders to shred Enron related documents and Ms. Temple's e-mails to various Andersen's executives reminding of the audit firm's document destruction and retention policy were meant to obstruct the course of justice when an official inquiry was about to commence.

The jury announced its verdict in the middle of June 2002 and held Andersen guilty of obstruction of justice. As a result, the SEC revoked Andersen's licence to audit public limited companies and ordered the firm to pay the highest amount of fine the crime carried. Once the verdict was pronounced, and its appeal to a higher court also was rejected, Andersen stopped auditing corporate clients by August 2002. To make matters worse, the SEC announced accounting irregularities in one of Andersen's most valuable clients and one of the leading Telecom companies in the US—WorldCom, which had filed for bankruptcy, becoming the largest ever company to do so in the US. The amount involved was also huge by any standards—it was estimated to be well over $9 billion. Though Andersen was already facing closure the irregularities in WorldCom proved beyond doubt that Enron was not an aberration, and that Andersen had been conniving with unscrupulous executives of big companies to fudge their accounts.

The colossal failure of Arthur Andersen, one of the Big Five's in auditing has evoked a sharp reaction from not only the investors, but also the general public and tremendously shook the confidence of investors. It also raised serious doubts about the veracity and reliability of financial statements made by companies and people wondered as to how to trust audited statements. Naturally, all sections of society felt strongly that they were let down by this long-trusted auditing firm.

Debate on the Role of Auditors

The collapse of Arthur Andersen in the wake of accounting manipulations found in Enron, WorldCom, Waste Management, Sunbeam, etc., brought about a heated debate among investors about the reliability of auditing. The debate threw in a number of reasons as to why even such reputed auditors failed to detect frauds in their clients' accounting.

(1) **Excessive greed of auditors:** If there had been a tremendous deterioration in ethical values at audit firms, it was mostly because the auditors seemed to be more concerned with getting huge payments from their clients for helping them amass wealth at the cost of investors. This changed attitude of auditing firms to whom revenues mattered more than ethics and integrity, was the reason for the downfall of Andersen.

(2) **Obsolete accounting standards:** It was also found that the then existing accounting standards in the US were not appropriate to match the accounting problems created by the fast-track growth-oriented companies like Enron and the changed value systems, wherein unethical practices, lack of integrity and transparency became the order of the day.

(3) **Conflict between auditing and consulting:** It was found that the auditing firms had shifted their focus from auditing to consulting, which offered highly lucrative compensations. Often times, there arose a conflict between auditing of a client and offering consulting services to the same client. This created certain problems that the partnership based audit firms could not tackle since they lacked the leadership necessary for coping with such problems.

(4) **Non-audit services became the focal point of auditing firms:** When auditors had only one primary responsibility, namely, auditing accounts and certifying to their veracity, there was no conflict of interest in the work place. But when Andersen became not only the internal

and external auditor for the same company, and the firm also provided a number of non-audit services such as risk management and litigation support services, there arose a number of problems leading to conflict of interest. This unhealthy practice started by Andersen gave auditors not only the opportunity but also the necessity to manipulate the accounts in accordance with the client's demands. Besides, companies like Enron and WorldCom offered huge remuneration for these services, which affected their loyalties. With such huge compensations in mind, the company's interests mattered to the auditors more than the interests of the investors. It was reported Andersen received $51 million in 2000, $25 million dollars as audit fees and $26 million as consulting fees from Enron.

(5) **Inefficient partnership model of audit firms:** With its attendant disadvantages, the partnership model of the audit firms did not provide sufficient control mechanisms for the partners of the firm. In the absence of a well-defined system of central control, partners worked independently and gave into their whims and fancies, and specially imposed their personal weaknesses in the way the firm was run. This was one of the major reasons for the deterioration of ethical values at audit firms and for Andersen's partners indulging in unethical practices. Auditors neglected their responsibilities towards investors, as they were more concerned about making a fast buck, rather than act as custodians of shareholders' interests which they are expected to be. Hence they failed to appraise investors of the companies' real financial position.

(6) **Auditors created a need for non-audit services:** It was increasingly found in the 90s that audit firms were literally trying to expand the scope of their work with their clients by creating a want in them for consulting services. Andersen also tried this trick to earn larger revenue through consulting services and generously rewarded auditors who managed to bring in more clients and revenues irrespective of their professional auditing skills.

(7) **Retiring auditors finding berths in boards of companies they audited:** This practice also became a cause for concern to many. There were many instances of retired auditors becoming members of boards of their client companies. This led to certain problems, as the auditors, because of their special relationship with former colleagues, did not strictly adhere to audit norms when manipulations were detected. It was reported that more than half of Waste Management's top management were retired audit partners of Andersen. This unhealthy practice also contributed to the downfall of Waste Management, which went bankrupt and was indicted for fraudulent financial practices.

Post Script

The failure of Andersen evoked a knee-jerk reaction from the Department of Justice, the US Congress and the market regulator, Securities and Exchange Commission. This was so initially. But with the passage of time more mature thoughts got crystallised and a number of protective measures have been initiated to protect the investor and to ensure that corporate managements adopt transparency, full disclosure and internationally accepted corporate governance practices. Many of the misdeeds that came to the forefront during the 90s stood corrected by the Sarbanes–Oxley Act which imposed huge fines for fraudulent acts, made it possible to send even top executives to jails and prevented non-audit services of auditing firms. The Act also made it compulsory for top executives to affirm under oath the veracity of financial statements.

As seen earlier, Andersen was indicted in March 2002, after a jury trial, of corruptly persuading its staff to withhold information from government proceedings by destroying its Enron-related documents with full knowledge that an SEC probe was likely to take place. A jury of 12 persons agreed with the governments' contention that one or more Andersen partners tried to interfere with an SEC investigation into Enron in October 2001. The conviction was affirmed by the Fifth Circuit Court of Appeals, when Andersen went on appeal, not only to clear its name but also to preempt hundreds of litigations from investors and of states in which thousands of workers and teachers lost their hard-earned savings. With its conviction, Andersen was fined the maximum $50,000 and put on 5 years' probation.

When Andersen appealed against the conviction, the US Supreme Court unanimously reversed the 2002 conviction of Arthur Andersen on charges of obstruction of justice in connection with the collapse of Enron on May 31, 2005. When the Supreme Court overturned the Andersen conviction, it clarified and narrowed the application

of one witness—tampering statue to the destruction of documents. The court held that "merely persuading a person to withhold documents or testimony from a government proceeding is insufficient to meet the elements of the crime, since there are many situations in which a person may lawfully persuade another to withhold documents or testimony from an official proceeding." The court added further that it is not wrong for a manager to instruct employees to comply with a valid document retention policy under normal circumstances. The jury erred and got Anderson convicted because they were not properly briefed on the finer elements of law and that some type of "dishonesty" was necessary to a finding of guilt. The court's decision has thus narrowed the application of the section of law (18 U.S.C.§ 1512 (b)) under which Andersen was convicted considerably. To be found guilty under this statue, the defendant must be conscious of wrongdoing and there must be a nexus proved between the corrupt persuasion to destroy documents and a particular government proceeding.

The Sarbanes–Oxley Act that was prompted by the Enron and Andersen fiasco and passed by the US Congress also added 18 U.S.C.§ 519, which makes it a crime if a person. "knowingly alters, destroys, multilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any [bankruptcy case], or in relation to or contemplation of any such matter or case."

This provision is much more comprehensive than § 1512(b) under which Andersen was convicted. In particular, it does not require a finding that a person was corruptly engaged in document destruction. Instead, to be guilty under this provision, a person who destroys documents merely must have intent to "impede, obstruct, or influence" a government investigation, or even just "in relation to or contemplation of" such an investigation. This seems to capture much of the conduct that the Supreme Court held § 1512(b) did not cover and which the jury instructions in the Andersen case erroneously captured.

Unfortunately, this reversal of Andersen's conviction comes a bit late to help Arthur Andersen in any way whatsoever, as the conviction amounted to an almost immediate death sentence for the audit firm. So although Arthur Andersen did go out of business and all of its 28,000 employees lost their jobs, it does have the Supreme Court opinion, which on "technical grounds" cleared its name in the case of obstruction of justice.

Present Status of Andersen

On May 31, 2005, the US Supreme Court reversed Andersen's conviction due to what it perceived as serious flaws in the vague instructions given to the jury. Once the court vacated Andersen's felony conviction, the audit firm was free to resume auditing work. But then, Andersen's name was so irreparably damaged, that as of 2010, it has not resumed its operations so as to be a viable entity. Besides, no company wanted Andersen's name on an audit. Even before surrendening its right to practice to the SEC, many of its state licences to practice got revoked. A new verb, "Enroned" to describe the demise of the company was coined and added to the auditing vocabulary. Its employee strength, which was 85,000 world wide at the peak of its glory, dwindled to a mere 200 in 2010, based mainly in Chicago. They are now primarily engaged in the handling of law suits and over the orderly dissolution of the company. Presently, Arssur Andersen 1LP has not been formally dissolved nor has it declared bankruptcy. Ownership of the partnership firm is vested with four limited liability corporations called Omega Management I through IV.

CONCLUSION

The story of Arthur Andersen is one of a meteoric rise and precipitous fall of an audit firm that was unable to maintain its core values in the midst of business turbulance when survival became the main issue. Its colossal failure evoked a sharp reaction from its investors and the general public and shook everyone's confidence in the business of auditing. If nowadays investors take audited statements of companies with a pinch of salt, Arthur Andersen's failure has a lot to do with it.

DISCUSSION QUESTIONS

1. Describe the genesis and fast track growth of Arthur Andersen, an international audit firm that had its roots in Chicago, the USA. What was the reason behind its stupendous growth?
2. Arthur Andersen had a dramatic downfall, just as it grew up by leaps and bounds. Discuss the reasons behind both the phenomena relating to the audit firm.
3. Explain the rise and fall of the audit firm, Arthur Andersen. What factors led to its downfall?
4. It is a well-publicised fact that the collapse of Arthur Andersen was due to its association with the energy company, Enron. Discuss the relationship between the two firms and how the close association led to the demise of Andersen.
5. Discuss the role of auditors in corporate managements. Would you agree with the view that the auditors are responsible to the stockholders and not to corporate managements? Substantiate your answer with examples, from what you have studied in "Corporate governance".

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Case Study 8

Global Trust Bank: The Bank That Went Bust

(This case is based on reports in the print and electronic media. The case is meant for academic purpose only. The writer has no intention to sully the reputations of corporates or executives involved.)

Liberalisation Ushers in New Generation Banks

Post-1991 the new economic policy of the government of India unleashed a process of liberalisation and deregulation. Like in all other sectors of the economy, there were reforms in the financial sector too and the new policy allowed the creation of private sector banks in the country after a lapse of almost three decades. The Reserve Bank of India opened the doors of the banking industry to new players, and the era of the "New Generation Banks" was on the cards. Private sector banks were being welcomed by the customers and the so-called middle class Indians were awaiting new banking options after growing tired of the poor service of nationalised banks. New banks were vying with one another to get a lead in this unbelievably huge market covering a banking public of almost 200 million people. There was a heady sense of anticipation in this industry and the expectations were high. Giant financial organisations like HDFC, ICICI and UTI started their own commercial banks and were able to leverage their reputation and cash reserves to establish credibility and financial stability. At the same time, the market was so big that there was enough space for all of them.

Emergence of Global Trust Bank

The Global Trust Bank (GTB), one of the earliest private sector banks permitted by the Reserve Bank of India (RBI) and the Union Government, was formed on 30 October 1994. Ramesh Gilli, Sridhar Subasri and Jayant Madhob were some of the major promoters of the bank. Global Trust Bank opened its first branch in Secunderabad in Andhra Pradesh and on the very first day of operation, collected Rs. 100 crore of deposits, which was really a record of sorts at that point of time. GTB's amazing feat on the first day of its opening showed that it could take on more established and powerful nationalised banks through an ecletic mix of ambitious planning and diligent execution. GTB promoted its products through aggressive marketing and live-wire innovative advertising. As a result of these hitherto unused initiatives in the banking business, the brand of GTB expanded rapidly both in terms of increased number of branches and of products and services. The brain behind it was Ramesh Gelli, a "banking genius" who captured the imagination of the banking public with his banking pyrotechnics. GTB appeared to have a bright future. To Gelli, it was indeed a long time dream come true.

GTB tried to prove that it was as fast as its competitors were, and therefore as good as they were, within a short span of time. The bank settled down quickly to focus on keeping its customers happy. In this, it achieved what few banks do—quick, powerful, foolproof systems that gave the front office executive time to provide the customer with a warm personal touch. To the banking public, it was a new experience. The banker was warm and friendly and their job was done in a jiffy. There was no effort to impress or intimidate the customer, and transactions were quick and uncomplicated. The front office youthful bankers performed their job well on moving the brand beyond the personality of its chairman. The promise of expertise was fulfilled and the transition to a warm but systems-driven GTB brand was complete.

Fast, Ultra-modern Cost-effective Banking Services

Since its inception in 1994, Global Trust Bank has been extremely technology savvy, using the latest technologies to deliver world-class service to its customers. Just as the banking job was done in an unconventionally friendly manner, GTB offered a number of products and services. The bank opened a large network of 275 ATMs, which allowed clients to withdraw and deposit cash, deposit cheques, to know the account balance, get a mini statement of transactions, transfer funds and also PIN change. To many middle class customers it was a delightfully new banking experience. The nationalised banks with which they were banking thus far had not yet started computerising their banking activities, while they could not afford the high cost of service charges of MNC banks.

As competition became intense, phone banking was introduced to attract customers. GTB's phone

banking was the quicktime response and less waiting time. Like in ATM, phone banking too permitted a customer to make a cheque book request, cheque status enquiry, cash credit status, and statement of account by fax.

Anywhere banking was another innovative service offered to delight the customer. One does not need to be an account holder of a specific branch to get the banking job done in any branch. Especially the cheque payments and collection services were very useful to corporate clients. Global Trust Bank also announced its foray into Electronic Commerce on 31 July 1999. Infosys Technologies Limited, India's leading software company, provided GTB with their software, BankAway, for this initiative. BankAway is a powerful electronic commerce platform that enables banks to provide an integrated financial services offering to both their retail and corporate customers—the one-click access to all their bank accounts, trade finance, cash management, bill payment, investments, on-line shopping and more. Global Trust Bank's core banking operations were based on Bancs2000, also provided by Infosys. Electronic commerce initiative is a step in the direction of offering to its customers world class banking services. With this, GTB joined a select band of banks across the world that offered this service. Ramesh Gelli, Chairman, Global Trust Bank, boasted: "We have always aimed to provide our customers with world-class products and the best service levels. Our Electronic commerce initiative is another step in this direction, through which our customers will be able to conduct all their financial transactions anytime, from anywhere in the world." Gelli announced that Global Trust Bank was the first bank in India to provide its customers access not only to their bank accounts, but also to their depository accounts. "Customers of our Global Securities Banking service will be able to inquire on their depository accounts over the Internet," said Gelli. "As and when the laws of the country allow for depository instructions to be accepted electronically, we will offer that facility also."

Global Trust Bank which offered phone banking and ATM services to its customers earlier, provided Internet as a delivery channel, enabling it to provide many more facilities to its customers. GTB initially offered its customers a "single view" of all their accounts with any of the bank's branches. Customers were able to inquire into their accounts and transactions, take a printout of their statement of accounts, request for transfer of funds between their accounts, cheque books and demand drafts etc. Internet banking was thus another out-of-the earth banking service that attracted more and more individual and corporate clients to GTB.

GTB had a huge server network, consisting of 10 Sun RISC-based machines, 10 Alpha servers, and around 50 Intel based boxes. The network essentially connected 104 branches and 275 ATMs across the country, providing a wide array of services including Internet and mobile banking.

Global Trust Bank's Financials

GTB made a flying start in 1993 but later ran into bad loan problems of Rs. 1500 crore. It had posted Rs. 272.7 crore net loss in the year ended March 31, 2003.

GTB's results for 2003–04 were as follows:

Deposits	-	Rs. 6920 crore
Advances	-	Rs. 3276 crore
Exposure	-	Rs. 1560 crore
Capital-adequacy ratio	-	-0.7 per cent
Net NPAs/Net Advance	-	20 per cent
Return on assets	-	-3.5 per cent
Gross NPA	-	Rs. 1100 crore
90-day provisioning norm against NPA	-	Rs. 1200 crore

Source: (www.rbi.org.in, www.capitaline.com, www.moneycontrol.com)

Better Services, No Doubt, but Problems Galore Inside

While the GTB brand and consumer encounters worked well, there seemed to be a lot of trouble behind the scenes. The bank was said to have funded scamsters like Ketan Parikh and its exposure to the securities market landed it in losses. The bank's success run was abruptly halted. There were serious allegations of rigging of the GTB share price. GTB's founder Ramesh Gelli tried to pull off a coup by merging his bank with UTI Bank and exit the company. Chiefs of both UTI bank and GTB had put on their best suits for the merger ceremony, when RBI pulled the plug. GTB's proposed merger with UTI Bank was called off unceremoniously by the banking regulator. Promoter Gelli was also allegedly sacked and instructed not to hold any post. More problems arose later when the Indian capital market regulator, Securities and Exchange Board of India (SEBI) prohibited GTB from raising money from the capital market. It was reported

that GTB was suffering from an overexposure to the capital market and the stock market fall left it with reportedly Rs. 11 billion of non-performing assets and a negative net worth.

By 2003, within 10 years of its existence, the Global Trust Bank had been involved in all sorts of regulatory hassles especially in the last 4 years of its existence. GTB came under the regulatory lens the first time for its association with stock scamsters like Ketan Parikh. Soon thereafter, Global Trust Bank had fallen to its lowest depth.

Global Trust Bank Placed Under Moratorium by RBI

On an application by the Reserve Bank of India, the central government issued an Order of Moratorium in respect of the Global Trust Bank Ltd on 24 July 2004. The Order of Moratorium had been passed by the government in public interest, in the interest of depositors and the banking system. The moratorium was to be effective from the close of business on Saturday, 24 July 2004 up to and inclusive of 23 October 2004 or and earlier date, if alternate arrangements were put in place. During this period, the Reserve Bank would consider the various options, including amalgamation of the Global Trust Bank Ltd. with any other bank and finalise the plans in public interest and with a view to ensuring that the public deposits were protected. During the period of moratorium, the bank would be permitted to make only those payments that were specified in the Order of Moratorium and the depositors of the Global Trust Bank Ltd would be permitted to withdraw up to Rs.10,000 from their savings bank account or current account or any other deposit account through any of the branches of the bank. Withdrawals through ATMs of the bank/ATMs shared with other banks would not be permitted so as to give effect to the monetary ceiling prescribed in the moratorium, but the customers could make withdrawals up to the limit specified at any of the bank's branches. Any requirement of cash at the branches of the bank for making permitted payments would be ensured in full by the Reserve Bank since cash balances were maintained with it by the Global Trust Bank Ltd.

This came as a hard blow to the 8 lakh customers of the bank who faced the possibility of losing their money. Customers were suddenly unable to transact because of the paralysed bank account, and those who needed more than Rs. 10,000 were unable to do so. The loss of trust, the anger and betrayal that customers felt toward the bank meant that the GTB could no more win back their confidence.

Investigations by Regulators into Sale of Shares by Promoters

RBI and SEBI, together with the market, were taken a back by the unusually large trading volumes in GTB shares that had no value and would be extinguished in due course. The promoters of GTB have been selling their stakes in the bank after the Reserve Bank's moratorium. Among those who off-loaded the scrip, Girish Gelli, director and son of promoter and former chairman Ramesh Gelli, sold 8,49,238 or (0.70 per cent) shares of the bank. The transaction happened after the RBI imposed the moratorium. Sridhar Subasri, one of the main promoters of the bank, who along with Gelli and Jayant Madhab, had set up the bank was also said to have sold off his entire stake in the bank of over 4 per cent. In July, Gelli had also sold around 3 lakh shares in the bank. In all, around 4 crore shares were traded within 1 week. Foreign stakeholders have also been continuously paring their stake in the bank; stake had fallen from 0.34 per cent in the quarter ended December 2003 to 0.25 per cent in the quarter ended June 2004. IFC Washington had a stake of 10.3 per cent in June 2004. FIIs had also been selling their stake in the bank in the last quarter. Goldman Sachs, along with other FIIs, had a stake of 4.76 per cent in the bank of which the former's stake was at 4.24 per cent in the quarter ended March 2004. The total FII stake in the June quarter had fallen to 0.98 per cent, after the crisis got worsened.

After that, for the GTB, it had been a trail of regulatory pursuit. The bank came under the glare of the Reserve Bank, the Securities and Exchange Board of India and the Joint Parliamentary Committee probing the stocks scam. Global Trust Bank came under SEBI scrutiny on alleged insider trading charges. Promoter Gelli was later banned by SEBI from conducting any stock market transaction. He was forced to leave the GTB board. The bank's Capital Adequacy Ratio (CAR) always stayed well below the RBI-mandated 9 per cent. GTB tried to induct Newbridge Capital to bring in the necessary fund. RBI rejected this request of the GTB Board.

SEBI Gets Cracking on GTB Deals

The Securities and Exchange Board of India then asked stock exchanges to disclose the buyers and sellers of Global Trust Bank (GTB) shares, both before and after the Reserve Bank slapped moratorium on the bank. "A full-fledged probe will be done only if we sense any malpractice. Our surveillance wing is looking into the transactions. Exchanges have also been asked to keep a watch," said a SEBI official. "This is in line with the surveillance exercise that SEBI carries out in case of any abnormal trading," said the official. "It would be difficult to take a view on the transactions, which took place weeks before the moratorium... the insider trading angle is a touchy issue, since only RBI and the finance ministry were privy to the information that a moratorium would be announced," said a SEBI official.

Countdown to Collapse of Global Trust Bank

The SEBI enquiry and the issue of the moratorium were the culmination of the crisis in the making since 2001. The genesis of the GTB collapse lay in now ousted promoter Ramesh Gelli's involvement in the Khetan Parekh securities scam of 2001, when he gave huge unsecured loans to the stock broker and group companies of Zee Telefilms. GTB's audited balance sheet for 31 March 2002 showed net worth of Rs. 400.4 crore and a profit of Rs. 40 crore. However, RBI's own inspection revealed that net worth was negative. In view of the very large variance in the assessment of GTB's financial position as reported by auditors and by RBI's inspectors, an independent chartered accountant was appointed to reconcile the position. GTB was placed under directions relating to certain types of advances, certain premature withdrawal of deposits, declaration of dividend and its capital market exposure. RBI also started monitoring GTB on a monthly basis. In view of the need to complete the statutory audit and to assess the steps necessary to be taken on the future set up of the bank, RBI permitted GTB time up to 30 September 2003 to publish its annual accounts. On 31 March 2003, GTB announced deposits of Rs. 6921 crore and advances (loans) of Rs. 3276 crore. On its balance sheet, it showed gross non-performing assets of Rs. 915 crore while total provisions (against bad loans) were Rs. 268 crore. RBI issued a press release in this connection which said: "Even though the financial statements show an overall loss, the bank has made an operating profit for the year 2002–03. The RBI welcome the decision taken by the GTB and its board to clean up the balance sheet". But RBI's subsequent inspection showed that bank's net worth had further eroded and capital adequacy ratio (CAR) was negative. GTB was advised to take immediate steps to infuse fresh capital to restore its CAR to 9 per cent and indicate a time-bound programme. The Bank was advised to explore options of raising capital through domestic sources or through merger with another bank. Ealier, Centurion Bank was able to get RBI permission for Sabre Capital of Rana Talwar to infuse capital to bail out the bank. However, GTB's proposal to RBI for infusion of capital and restructuring by global private equity major NewBridge Capital was rejected by the Central Bank.

The Cause of the Crisis

Ramesh Gelli, one of the promoters and the ex-chairman, refused to take the blame for the failure of Global Trust Bank, but held his management style of total delegation of power to senior managers and his hands-off approach responsible for the bank's collapse. Though there is a general perception that the woes of private banks were due to priority sector lending, available data disprove this theory. Of GTB's total NPAs of Rs. 1,500 crore, priority sectors such as agriculture and small industries together accounted for 22.5 per cent (agriculture less than 1 per cent and small industries 21.5 per cent). The bulk of NPAs, viz. 77.5 per cent, was from the non-priority sector lending. GTB had an exposure of about 52 per cent of its advances to the stock market, which was a blatant flouting of RBI directives, so that a part of the problem must have come about from erosion in the value of investments. In the 2 years between 1999–2000 and 2000– 01, the bank's capital market exposure went up to around 30 per cent of its total assets. When the market collapsed in February–March 2001, the value of securities came down drastically and the bank could not recover from this, even though its exposure was reduced by then.

Proposal to Merge GTB with OBC

The RBI that has a mandate to protect depositors of commercial banks had to rush through with the merger proposal in the last 1 month. Almost

all nationalised banks including Canara Bank, Andhra Bank, J&K Bank were approached. Even Corporation Bank was also sounded out. The RBI finally zeroed in on (Oriental Bank of Commerce) as the bank's NPA level had come down drastically recently. Once the regulator selected the bank, it thrashed out all the merger modalities such as safeguarding the depositor's money and retention of employees. RBI officials had at the time of the announcement of the amalgamation of Oriental Bank of Commerce said that there would unlikely to be any swap ratio. As a part of the scheme, the entire amount of the paid-up capital and reserves of GTB would be treated as provision for bad and doubtful debts and depreciation in other assets. Estimates showed that GTB had a negative networth of around Rs. 900 crore. The capital of the bank as on 31 March 2003 was at Rs. 121.35 crore while reserves and surplus was at Rs. 146.16 crore. The Reserve Bank's decision followed hectic activity in the corridors of the Ministry of Finance to save the bank following negative reserves. The RBI and the Securities and Exchange Board of India were to oversee the merger so that it was completed quickly. OBC was to take over GTB, with all its assets, loans and NPAs. The bank was to take over GTB's Rs. 1500 crore bad loans in exchange for which it would get 104 branches of GTB and 8 lakh customers. The RBI sop of no swap ratio was the icing in the cake for OBC. If any surplus remained after accommodating all appropriations, only then would shareholders get the amount on a pro-rata basis.

Synergy between GTB and OBC

There couldn't have been a better proposal for merger. North-based OBC got almost a million customers and 104 branches mostly in the southern states of AP and Maharashtra. With GTB's net worth being negative there was no share swap. But OBC could well be paying a big price. It was adding Rs. 1500 crore of GTB's bad debts to its clean balance sheet. However, OBC's CMD, B. D. Narang, was confident of recovering 40 per cent of GTB's debts. The scheme of amalgamation drafted by the Reserve Bank of India clearly stated that all GTB employees would continue to retain their jobs and get the same salary package and work on the same terms and conditions as applicable prior to the closure of business hours on July 24. But "salary fitment problems" could only be a part of the "people problems" to be faced by OBC.

The OBC said it had made the offer to merge GTB with itself as it perceived synergy between the two banks. The OBC got customers from the GTB and its branches, many of which were based in South India wherein the nationalised OBC has a limited presence. The two banks also shared a common technology platform. "There is a terrible amount of synergy between the two banks. We are a north-based bank and they are a south-based one. We should be able to clean up the books in a very short time," Oriental Managing Director B. D. Narang told reporters.

Who is to Be Blamed for the GTB Fiasco?

This was a classic case where the gullible investors were made to pay a heavy price for their trust in a crafty and manipulating banker and the inefficiency of the regulator. The 8 lakh and odd investors placed their hard-earned money into GTB because of the reputation of the promoter Ramesh Gelli, considered to be a wizard in the banking circles; the bank did remarkably well in the early days; it provided excellent customer-friendly services and all their banking operations were modern and computerised; and above all, there were no plausible adverse reports about its stricky investment from the regulators. Then, why blame and penalise them? The fiasco does throw up several uncomfortable questions pertaining to Reserve Bank's regulatory policies with regard to the banking industry. One of the questions, uppermost on the minds of the unwary GTB depositors, is why did the RBI wait so long despite being aware of the murky goings-on in GTB?

(1) The RBI could have moved against GTB in 2002 itself when its inspectors stumbled upon the bank's crooked ways and could have superceded the GTB Board under the Banking Regulation and RBI Act. Having done so, it could have appointed its own executives to clear up the mess, before putting it up on the block or inducting a new management, like it did in case of the Centurion Bank.

(2) Some analysts recall that the RBI indicted Gelli in 2001 for being hand-in-gloves with the scamster Khetan Parekh in the stock market manipulations. Gelli was later removed as the Chairman of GTB. That there were skeletons in the GTB cupboard was known since the Gelli-Khetan-Parikh connection was unearthed in the aftermath of the 2001 stock scam. Even after the replacement of Gelli as the

Chairman of GTB, why did the RBI fail to address the fundamental problem with GTB, its murky management practices and shady financials? Matters did not mend in GTB even after the RBI brought in R. S. Hugar as Chairman and provided substantial liquidity support. Should not serious action have been initiated then itself so that the gullible investors who lost everything now would have been adequately protected?

(3) The Central Bank was also aware of the fact that GTB was misleading investors and depositors by overstating its net worth, profits and understating its NPAs. To be doubly sure, the RBI got an external auditor to scan the books, and the findings were confirmed in February 2003. With the result, GTB came under the RBI scanner for certain advances, capital market exposure, premature withdrawal of deposits, and was tracked on a monthly basis. GTB was advised to change its auditors and given time till 30 September 2003 to publish results for FY03. On 30 September 2003, the RBI said it welcomed GTB's move to clean up the balance sheet after the GTB turned in an operating profit. Did not all these show that the RBI itself was gullible enough to be taken for a ride by GTB executives?

(4) After all, in just 10 months, the RBI had gone back on its view about the GTB, and placed it under a 3 month moratorium, creating a needless liquidity crisis for the poor GTB depositors. The RBI could have taken action against GTB 2 years earlier, but because of its procrastination everyone who had anything to do with the bank had to suffer. If this is the case, is there not a need for regulating the regulator?

Global Trust Bank Is now Oriental Bank of Commerce

The government of India sanctioned the scheme for amalgamation of the Global Trust Bank Ltd with the Oriental Bank of Commerce. The amalgamation came into force on 14 August 2004. All the branches of Global Trust Bank Ltd now function as branches of Oriental Bank of Commerce with effect from this date.

(i) Customers/Depositors of GTB: Customers, including depositors of the Global Trust Bank Ltd, operate their accounts as customers of Oriental Bank of Commerce with effect from August 14, 2004. Oriental Bank of Commerce has made the necessary arrangements to ensure that service, as usual, is provided to the customers of the Global Trust Bank Ltd.

(ii) Shareholders of GTB: In accordance with the Scheme of Amalgamation, if any surplus remained after meeting all the liabilities out of the realisation of assets of the Global Trust Bank Ltd, the shareholders might receive pro-rata payment. As part of the merger proposal, OBC would get Income Tax exemptions in transferring the assets of GTB in its book during the merger process, while all the bad debts of the merged entity would be adjusted against the cash balances and reserves of GTB.

OBC was confident of turning around the GTB within one year. According to OBC chairman B. D. Narang, GTB "suited it" because of synergies. While weakness of GTB has been bad assets, strength of OBC is recovery. Since the GTB is a south-based bank, it would give OBC the much needed edge in the southern part of the country. Moreover, both the banks have a common core banking solution "Finacle," which will help in the consolidation.

Post-merger Scenario

Soon after the merger, skeletons started tumbling out of GTB's cupboard and Oriental Bank of Commerce, with which GTB was merged, lodged a complaint with the CBI about advances made by the latter that had serious financial improprieties. According to Oriental Bank, internal investigations revealed that GTB had taken high credit exposures in certain accounts. In some cases the exposures exceeded the norms prescribed by the Reserve Bank of India. OBC found a high degree of imprudence on the part of GTB officials in exercise of sanctioning powers. GTB had abetted certain group of borrowers to siphon off funds through the banking channel. The conduct of most of these accounts revealed that deliberate attempts had been made to camouflage the position of non-performing assets (NPAs) by making fresh sanctions in sister or allied concerns including some front companies.

On the basis of internal investigations, Oriental Bank filed criminal complaints with the CBI in the following cases:

(i) A case was filed against Unitel Software Limited for having caused wrongful loss to the

tune of Rs. 676.79 lakh to the erstwhile Global Trust Bank in the matter of sanction, disbursal and utilisation of the credit facilities.

(ii) The CBI registered a case against Ashok Advani of *Business India* Publications, Mumbai, and concerned officials of the erstwhile GTB for cheating the bank to the tune of Rs. 15 crore by obtaining credit facilities through misrepresentation. Whereas the publication had been the client of GTB since 1994 and had defaulted in repayment of credit facilities sanctioned earlier, it was falsely mentioned in the process note that the account of *Business India* was a new one.

(iii) The CBI registered a case against Petro-Energy Products Co. Ltd, since the company cheated GTB to the tune of Rs. 78.41 crore at Bandra, Mumbai branch and Rs. 23.15 crore at the Chennai branch.

(iv) The CBI registered a case against Shonk Technologies International Ltd, for a wrongful loss to the tune of Rs. 38.49 crore caused to the erstwhile GTB through misrepresentations and diversion of funds for purposes other than for which the loan was sanctioned.

(v) The CBI has registered a complaint at Bangalore against Pearl Distilleries Ltd, for having caused wrongful loss of Rs. 10.28 crore to GTB in the sanction, disbursal and utilisation of credit facilities.

A finance ministry statement on the complaints filed by OBC said that some other cases were also being looked into and further complaints would be lodged with the CBI in due course. OBC's move comes days after the Finance Minister, P. Chidambaram, assured the Parliament that criminal cases would be filed in matters relating to GTB shortly. Stating that "serious financial improprieties" were revealed in the five accounts during the post-merger due-diligence conducted by OBC, the Finance Ministry said "High degree of imprudence in exercise of sanctioning powers have been observed where the bank appears to have abetted certain group of borrowers to siphon off funds through banking channel."

CONCLUSION

This case study that chronicles the rise and fall of the new generation commercial bank, the Global Trust Bank, discusses the causes that led to its downfall. It also goes into the failure of the regulatory system, though it was well-posted with the developments that ultimately brought about the GTB's Collapse. Familiarity with the case provides a clear backaround of GTB's failure and how such a situation can be avoided in future if corrective measures are initiated in time by regulatory authorities to arrest such bank failures. When we analyse the factors that led to the failure of the 10-year old Global Trust Bank which entered the banking industry with a lot of fanfare and hype, it appears to be the same old story in which several players have enacted their roles to suit their convenience, but ultimately it is the small, unwary and gullible investor who has to pay a heavy price. In this GTB case too, the unethical practices of the much-trusted promoter Gelli in funding the stock market scamster Ketan Parikh, in manipulating the bank's financials with the help of his auditors, while portraying to the outside world a façade of technology-savvy banking wizard, the lethargy of the banking regulator, RBI, which notwithstanding its inspection team finding accounting manipulations in GTB choosing not to act in time to protect the bank's shareholders seem to have together brought down the bank and its investors. Or were there some other factors too that were responsible for the collapse of one of the much-hyped New Generation Banks?

DISCUSSION QUESTIONS

1. The collapse of the Global Trust Bank should be attributed not only to the lack of ethics and avariousness of its promoters, but also to the lack of competence and alacrity of the regulators. Would you agree? Explain your stand the Global Trust Bank.
2. From the hindsight of ultimate failure, trace its emergence as the most technology-based bank in Inida.
3. Explain the causes that contributed to the collapse of the Global Trust Bank.
4. Comment: "The failure of the GTB is also the failure of the banking regulatory system in the country."
5. What was the cause of the crisis of the Global Trust Bank? To what extent the promoter of GTB played a leading role to accentuate the crisis?

SUGGESTED READINGS

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- Infosys' Press Release, "Global Trust Bank launches Electronic Commerce Initiative with BankAway from Infosys".
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Case Study 9

The Enron Fiasco: Does End Justify the Means?

(This case is based on reports in the print and electronic media. The case is meant for academic purpose only. The writer has no intention to sully the reputations of corporates or executives involved.)

Enron Presented a Contrasting Scenario

Between 1996 and 2001, Enron was considered the darling of American industry and of investors. By December 2000, the company reported $15 billion in assets, $100 billion in revenues and 25,000 employees worldwide. Enron was one of America's fastest growing companies. Its double-digit revenue growth in the late 1990s became triple-digit growth with the launching of EnronOnline in late 1999. The energy major's revenue growth was accompanied by profit growth. In 2000, for instance, Enron shares' returned around 90 per cent, when most technology stocks lost value. Enron was widely acclaimed as a model of an "old economy" company transforming itself as a powerhouse of the technological, fast-tracked "new-economy" company.

All these achievements catapulted Enron to the status of a true market darling. The company was considered a role model for others to emulate, and McKinsey, the world-renowned consulting firm had been citing Enron frequently as an example of how innovative companies could outperform their more traditional rivals. Enron won Fortune magazine's "America's Most Innovative Company" award among the magazine's list of Most Admired Companies in a row of 6 years between 1996 and 2001. The energy giant became the world's largest marketer of natural gas and the first to introduce online trading. Fortune also rated Enron 24th on its list of "Best Companies to Work For", 29th on "America's Fastest Growing Companies", 2nd on "Reputation of Employee Talent" and 1st even ahead of General Electric—on "Reputation of Quality Management."

Come December 2001, heavens have fallen on the investors of Enron. Enron, till then perceived as one of the world's largest electricity and natural gas traders, filed for Chapter 11 bankruptcy protection. Only in September 26 that year the Company's Chairman and CEO, Kenneth Lay assured loyal employees of Enron: "The third quarter is looking great" and persuaded them to buy the company's stocks. Just 3 weeks after this false assurance with a view to persuading them to buy stocks that he and his co-executives would sell before announcing the results on October 16, Enron reported a $618 million third-quarter loss and disclosed a $1.2 billion reduction in shareholders' equity. When Enron collapsed, most of its employees were devastated as they lost their retirement and other savings tied up in Enron shares. In addition to their losing their jobs, they also faced financial ruin. By contrast, Lay made $205 million in stock-option profits in the previous 4 years.

The exasperating swiftness with which things happened stunned the market. Billions of dollars worth of shares and bonds were literally wiped out of one of the New Economy's most admired companies that has brought about one of the largest bankruptcies in the US history. What brought about Enron's collapse? "Multiple theories abounded, and they all had one core idea in common: the roots of the collapse spread both deep and wide through the company's history" (Bert Spector).

Enron's History

Enron came into being in July 1985 as a result of the merger of Houston Natural Gas with InterNorth, a natural gas company based in Omaha, Nebraska. With energy having been deregulated in the late 1970s in the United States, there was ample scope for bigger entities to consolidate new natural gas discoveries to enjoy economies of scale and to benefit from free market prices. Gas was conveyed through pipelines and was traded in centres as per the demand that existed. The above-said merger integrated several pipeline systems owned by these companies to create an interstate natural gas pipeline system. The merged entity owned the largest natural gas pipeline system in the US with around 37,000 miles stretching from the border of Canada to Mexico and from the Arizona–California border to Florida, apart from considerable oil and gas exploration and production interests. Apart from natural gas, Enron also traded electricity since 1994. The company appointed a laissez–faire oriented energy economist who became the Under Secretary of the US Interior Department, Kenneth Lay, as the Chairman and CEO in 1986. Lay had been working as the CEO of Houstan Natural

Gas, after his stint in Washington, and was mainly instrumental in bringing about the merger.

Having considerable degree of natural gas pipeline system in the country, Enron aimed to "become the premier natural gas pipeline in North America." Between 1985 and 1990, the company purchased gas from producers and sold it to local distributors while shipping it through the company's pipeline. However, though this gas distribution business brought in considerable revenue to the company, it was only less than $5 billion in 1985, which was far less compared to what Enron made in 2000, at $100 billion. The growth in 1980s in the natural gas business was stymied as it was under regulation "that, affected the rates, accounts, records, the addition of facilities, the abandonment of services and facilities, the extension of services in some cases, in addition to other matters" (Karen Bong), which occured in any industry that was being regulated by public authorities.

Energy Deregulation Fuels Enron's Growth

As a result of constant efforts of businessmen in the energy sector and strong advocacy of laissez–faire economists to open up the sector to competition, the natural gas industry that had been a "regulated monopoly" since 1900s underwent deregulation in the 1990s, that allowed the market to determine energy prices. It was believed that in a competitive market environment, competition would force companies in the energy sector to operate more efficiently in the long run than the so-called regulated monopolies of the past. This, it was argued, would result in lowering the end price of energy to the ultimate consumers. Deregulation further developed in the 1990s under the watchful eye of the Federal Energy Regulatory Commission (FERC) set up in 1977 as part of President Jimmy Carter's response to the energy crisis of 1970s. The FERC, through one of its orders—Order 636—enacted in 1996, ensured the creation of a reseller market for transportation and storage capacity, enabling the marketing of unused or underutilised pipeline capacity. Following the FERC's Order 636, pipeline companies started efforts at consolidation to meet the intense competition and ensure economies of scale. In 2001, there were 14 corporations that included Enron, which accounted for more than 85 per cent of interstate natural gas pipeline capacity in the USA.

Along with natural gas supply deregulation, electricity deregulation also went apace during the 1990s. "The electricity and natural gas industries began to converge as companies with strong ties to the electric power industry acquired natural gas pipelines as natural gas explorers and producers divested themselves of pipeline assets. Natural gas was increasingly used to fuel electricity generation" (Karen Bong). Enron who was into the business of natural gas and electricity became a wholesale supplier of these two energy products along with exploration and production, transportation and distribution, retail energy services, etc. While the growth in all these services was moderate, Enron's revenues from its Wholesale Energy Operations and Services registered a growth of more than 1,200 per cent. The company registered a revenue growth of more than $87 billion between 1995 and 2000 in this sector of its business.

Establishment of GasBank

In the second half of the 1980s, there arose a period of price instability in gas prices due to the operation of market forces. Under a deregulated regime, producers and distributors of natural gas required some means of managing the risk arising from serious market fluctuations in prices. To take advantage of the new environment and to cash on the opportunities that were thrown open, Kenneth Lay hired in 1989 Jeffrey Skilling, an MBA from Harvard, who was then the partner in charge of energy practice with the international consultant, McKinsey in Houston, to be the head of Finance at Enron. Skilling was responsible for the establishment of GasBank, a mechanism for providing funds to small producers of gas with a view to enabling them "to invest more in exploration and development and at the same time, provide Enron with reliable sources of natural gas to feed its pipeline system". Through GasBank, Enron created a market for natural gas commodities that established future prices on long-term supply contracts through the trading of these forward commitments. Through GasBank, Enron became a wholesale trader and marketer of natural gas and electricity both in the US and the United Kingdom.

Enron Becomes a Global Player

In the meanwhile, Enron, with a view to becoming a global player, spread its wings far and wide, under the dynamic leadership of Rebecca Mark, who was placed in charge of international power and pipeline development on her joining Enron. Enron signed the much-controversial contract for the $3 billion Dabhol power project in Maharashtra in 1992. Enron also purchased power plants in Brazil and Bolivia. It also invested substantially in a 4000 mile Argentina pipeline system that supplied two-third of the that country's gas. Rebecca Mark moved on a global expansion spree with a missionary zeal and built more and more such hard assets. Enron wanted to make its presence felt in Europe, South America and Russia. Azurix, Enron's subsidiary, which worked on its water-related assets and activities, bought the United Kingdom's Wessex Water for $1.9 billion to develop and operate water and wastewater assets including distribution systems, treatment facilities and related infrastructures. Azurix pursued such projects in Europe, Asia and Latin America. By 1995, Rebecca Mark had constructed or acquired five plants in the United States and was on her way to buying or building 15 more in Europe, Asia (India and China), South America and the Middle East. It may not be out of context here to mention an incident. Kenneth Lay had arranged to hang a banner in Enron's Corpoate lobby with the legend: "The world's leading energy company." Skilling got it replaced with a new banner: "The world's leading company." Such was the euphoria Enron's executives had with regard to the company's future.

Enron's Unconventional Methods of Adding New Businesses

Just as Enron spread its wings overseas, the company also diversified its businesses into areas other than its core competencies. Executives were encouraged by Lay and Skilling to be innovative entrepreneurs. To make them more committed and involved, Enron offered "phantom equity" to the teams that organised start-up businesses. Once the business began to be profitable, the phantom equity could be swapped for real Enron shares. Once the businesses were firmly established, these were made independent, selecting their own infrastructure, and often, pulling out employees from Enron's other units.

Enron Online Story

It is in this manner that GasBank and online trading of energy products were innovated by company executives. One of Enron's employees, for instance, drove an initiative to set up EnronOnline, an entirely new concept that was put to commercial use successfully. Louise Kitchen, based on her previous experience with Internet trading, began to work on an ad hoc basis, putting together an informal team of commercial, legal and technical personnel drawn from various Enron units. When the team grew to 250 persons, John Sheriff, Louise's boss approached Skilling in November 1999 for sanction to make it a separate business unit. Once skilling approved it, rather hesitantly, EnronOnline was ready to do business in less than a year. Company executives exulted saying that online trading was revolutionary for the company, not only because of its new technology, but more because of the impact it had on its traders. "Since EnronOnline has reduced our transaction time to less than a second, our guys have to manage their businesses by the second—not by the day as in the past". (Economist quoting McCornel. Economist. com, June 28, 2001). Such unconventional methods of promoting entrepreneurial innovations had contributed in no small measure to the initial success of Enron in completely new areas of business.

Broadband Story

Enron's venture into broadband was not a planned affair and developed in the pattern of its other business units. In 1997, Enron had acquired Portland General Electric, an Oregon electricity generator and distributor that owned 1500 miles of fibre-optic cable along its transmission rights of way. Enron, through its new subsidiary, Enron Broadband Services (EBS), making use of *its* own substantial rights of way, started to build its network, with a view to selling capacity to heavy data users, such as Internet providers and telecom companies on long-term contracts, which could then be "marked to market" and to trade bandwidth in a manner similar to gas or electricity adding 4000 miles in 1998 and a further 7000 the following year. The business was developed at a breakneck speed without even a market feasibility study and Enron started competing with established and product-specific companies such as WorldCom and Global Crossing for customers in a market, which had huge over-capacity. Even more bothersome

was the fact that technological improvements were exponentially increasing the amount of data that could be carried by existing cables. With considerably increased overheads, EBS lost $60 million on revenues of $415 million in 2000. The anticipated volumes of traffic did not materialise, which caused great problems, as the only way to generate profits from cable is to get data flowing through it. With high degree of existing capacity and intense competition from more established players it proved impossible to attract enough subscribers to make it pay. But, this did not preclude Enron from booking a "mark-to-market" profit on EBS business based on its predictions of the project's future cash flows.

The novel way Enron created new businesses has been succinctly explained by Brian Cruver, an ex-employee of Enron, in his book *Anatomy of Greed*: *The Unshredded Truth from an Enron Insider*. "Enron's business was essentially creating new commodity markets. Take their weather derivative division as an example—some businesses are particularly vulnerable to the weather, such as tourism and snow plowing. A bumper year for snow might make the snow plow business rich and can spell doom for the local tourist businesses if it keeps customers away. Enron would sell a kind of "weather insurance" to businesses, for which they pay their premium and then, if the weather turned unfavourable, their policy would compensate the loss. Enron dominated the new markets it created—essentially selling a weather policy to both the snowplow and the tourist business—thus ensuring it would achieve some profit no matter what the weather conditions."

Problems of Enron's Unconventional Business Model

Enron's unconventional business model—the way a business was conceived and funded, the haphazard manner in which it was being operated, the lack of proper market feasibility studies, the unrealistic mode of pricing and making provision for adding to Enron's profits from the so-called new business when there was no such profits—brought in too many administrative and financial problems for a public limited company such as Enron.

(a) Inability to follow a viable price strategy: The problems with Enron's business models were many. Cruver has pointed out a few such problems in his book cited above. One such problem was that Enron had no idea how to price business items that did not yet exist, or how to price items in a rapidly-changing regulatory environment such as California's energy market in 2000. Thus, their growth was not built on successes from the past but by booking the largest deals it could. This meant that they became the darlings of Wall Street after booking enormous deals, such as a 15 year deal to supply the San Francisco Giant's stadium with power, despite that, after 2 years, it became obvious their price was well below the cost incurred by Enron. These unprofitable ventures were subsequently spun-off into shell companies to hide the loss. The profit for the entire 15 year deal had already been booked on their balance sheet.

(b) Overstated profits: The other problem with their business model was that even when they did make a profit, it was significantly overstated. In the example of the snow plows and tourists, it was obvious that on any given winter, Enron was liable for paying one of those businesses. But when the deals were closed with each individual business, the estimated profit for the entire transaction was booked. The booked profit had an inherent and in-built liability.

(c) Circumventing anti-trust laws: The illogical nature of its business model showed another problem with Enron—it needed to both be able to commoditise new markets and be the biggest player. That meant using political influence to control the flow of potential competitors and circumvent antitrust laws when necessary. Though this was where Enron truly excelled, it collapsed later because of the unsustainability of such market manipulations.

(d) Lack of risk management: Compounding all these problems was Enron's lack of genuine risk management. Cruver explains in shocking detail how the risk management group was dramatically under-staffed and actively subverted by management and Arthur Andersen. The now defunct accounting firm used its name to help pressure Enron's internal controls to quickly approve new deals.

Cruver's book amply illustrated that complex business models, even once flawed to the core, can survive for a long time if enough people are duped into it. In addition, once duped, stakeholders tend to resist all evidence to the contrary. Literally, Enron's business strategy relied on brainwashing its employees, investors and regulators. The inexorable economic laws of demand and supply were made inoperable for this behemoth. In the aptly put words of Santiago Zorzopulos: "Enron, which had

its Core Values enshrined all over the company, including the parking garage, also illustrates the spectacular failure of American business ethics, and its advocating community. The insistence on epiphenomenal features of good conduct, such as codes and nice little training programs, disguise the incredible weakness of it not having formulated a genuine performance criteria."

The Gathering Storm

In February 2001, Lay appointed Jeff Skilling as the CEO, while he remained Chairman of Enron. Meanwhile, Enron's investment in the broadband business, and its not-so-successful overseas operations severely strained Enron's liquidity position. It was widely held both within Enron and without that Rebecca Mark has overstretched Enron's capability leading to the company's financial difficulties.

Enron financed its growth partly with debt which accounted for more than $13 billion in 2001. But the company, with a view to protecting its credit rating, had to limit its debt and went for additional financing of its ever-climbing requirement for funds through Special Purpose Entities (SPEs).[1] It was reported that Enron had more than 3000 of them in which organisations such as Citigroup, Merril Lynch, JP Morgan Chase, Credit Suisse, First Boston, the MacArthur Foundation were some of the well-known investors. Enron sold ingeniously energy contracts and assets to some of these unsuspecting SPEs, sometimes at prices far above fair market value. "These transactions enabled Enron to move the sold assets off its balance sheet and to show income from the sales on its income statement. While the money Enron received for the sale of its assets obtained by SPEs' borrowing against the transferred assets, the money from these loans was counted as debt on the SPEs' books, but was recorded as income on Enron's books" (Karen Bong).

In the creation of these SPEs, Andrew Fastow, Enron's Chief Financial Officer, played a key role. He created and was running in the year 2000 four partnerships known as the Raptors, which were approved by Enron's Board mainly with a view to hedging Enron's market risk in its portfolio of volatile technology stocks. To finance these SPEs, Enron gave shares in exchange for notes receivable from them, which amounted to Enron selling its shares to itself and being compensated for them by issuing an IOU to itself! This dubious exercise in case of Raptors alone resulted in the shareholders' equity on Enron's balance sheet being inflated by $1 billion and Enron's notes receivable being inflated by $1 billion. The net result was this: Enron's SPEs helped the company to keep debt off its balance sheet, thus protecting Enron's credit rating. The SPEs also kept losses off Enron's income statement, thus helping it to show higher profit than it really earned.

Role of Arthur Andersen in the Enron Collapse

For a reputed and well-established audit firm, the role played by Arthur Andersen was not only passive but also shameful for which it paid a heavy price of getting totally disbanded. Arthur Andersen was both the internal and external auditor of Enron. It also provided several non-audit services to the energy giant. Enron was one of the most important clients to the audit firm and had been its clients since its inception. Enron paid Andersen rather lavishly for the services rendered to it. In 2000, it was reported that Andersen received payments from Enron to the tune of $ 51 billion, $25 million for auditing and $26 million for consulting services. Naturally, for such a hefty compensation paid to the audit firm, Enron extracted its pound of flesh. It made the auditors accomplices in the crime of manipulating and doctoring its accounts. Andersen's audit partners like David Duncan and his team were more than willing to compromise the firm's reputation for honesty, integrity and steadfastness in its unexceptional execution of the audit work, which its founder, Arthur Andersen and his successors followed for a major part of 79 years of its existence. There were many reasons for this downfall of Andersen for compromising its values with clients like Enron. Excessive greed of partners who were a legion in the firm,

1. Special Purpose Entities or asset securitisations are used in various ways to manage risk or as a financing vehicle. Most banks use SPEs to issue debt secured by pools or mortgages. SPEs are widely used for factoring, i.e. for generating cash through selling off receivables. This kind of off-balance sheet financing is used because there may be other reasons to keep assets or special projects off the sponsored company's consolidated balance sheet.

deteriorating standing of auditors vis-à-vis the firm's consulting professionals who earned more for less work which made them follow aggressive accounting in tune with what was dictated by difficult clients like Enron, unprofessionally close relationships that existed between auditors and their clients, inappropriate accounting standards that were not updated to meet the challenges of mega corporations which took liberty with accounts to achieve their ends and the over all deteriorating standards of moral behaviour of those who were at the helm of affairs in corporates.

Once nemesis caught up with both Enron and Andersen when the third quarter of 2001 results were announced, and the audit firm's playing second fiddle to the likes of Jeff Skilling and John Fastow were being probed by Wall Street Journal and analysts, David Duncan and his team started shredding massively Enron-related documents, anticipating an SECs probe. It is part of history that Arthur Andersen was convicted by lower and Appellate Courts for obstruction of justice. Though the US Supreme Court overturned the conviction in May 2005 on appeal by Andersen, it was only a posthumous relief for the firm as all of its clients had deserted it, all of its offices were closed and most of its staff had found employment elsewhere. Andersen paid a huge price for its inability to protect the lofty ideals of its founder and for playing second fiddle to unreliable and difficult clients like Enron.

The Positive Side of Enron

Though in hindsight most observers blame Enron for its failure to observe ethical practices leading to its collapse, Enron's case if analysed objectively one would realise that there were many things that Enron did led to condemnation, there were many things they did, which would place them as innovators and trend-setters in a sort of free in market energy that was just evolving.

(a) Enron's business strategy was legitimate: Though at hindsight one is more than tempted to paint Enron with a black brush, there were many positive sides to Enron which cannot be lost sight off. Enron's failure arose not because of a poor business model but due to several fortuitous circumstances. The collapse of Enron Corporation has been often explained in terms of accounting fraud and greed. Not everything that Enron did, however, was wrong or fraudulent. Fraud contributed to the timing of Enron's failure but was not the root cause of that failure. In analysing Enron, it is critically important to distinguish what Enron did wrong from what it did right. In the words of Christopher Culp and Steve H. Hanker: "Enron's basic business strategy, known as "asset lite," was legitimate and quite beneficial for the marketplace and consumers. By combining a small investment in a capital-intensive industry, such as energy with a derivatives-trading operation and a market-making overlay for that market, Enron was able to transform itself from a small, regional energy market operator into one of America's largest companies."

Enron contributed to the creation of the natural gas derivatives market, and, for a while, it was the sole market maker, entering into price risk management contracts with all other market participants. Its physical market presence as a wholesale merchant of natural gas and electricity, placed Enron in an ideal position to discover and convey to the market relevant knowledge of energy markets and to make those markets more efficient. When Enron applied that same strategy in other markets in which it had no comparative informational advantage or deviated from the asset-lite strategy, it had to incur significant costs to create the physical market presence required to rectify its relative lack of market information. The absence of a financial market overlay in several of those markets further prevented Enron from recovering its costs. It was at that point that Enron abused accounting and disclosure policies to hide debt and cover up the fact that its business model did not work in those other areas. The two learned professors further commented: "For its innovations, Enron should be commended; for their alleged illegal activities, Enron's managers should be prosecuted to the full extent of the law. But under no circumstance should Enron's failure be used as an excuse to enact policies and regulations aimed at eliminating risk taking and economic failure, because unless a firm takes the risk of failure, it will never earn the premium of success. As was demonstrated in the case of Enron, markets—not politicians—are the best judges of success and failure."

(b) Employee development: Enron's top executives believed strongly in building human assets. Skilling, for instance, believed that intelligent, flexible, performance-oriented employees would provide Enron with a competitive advantage, especially when compared to asset-heavy traditional companies. To retain talents Enron compensated executives generously. Lay and

Skilling realised that if they had to compete with investing and consulting firms for talent, they would have to offer competitive compensation packages. High salaries were matched with lavish perks. The company had devised what they termed as "Performance Unit Plan" under which executives were paid one-time bonus if a series of stock price targets were met. Top executives received huge payments based on a calculated combination of dividends and enhancement in stock prices. Andrew Fastow, Enron's CFO received bonus cheques amounting to more than $3.5 million between January and 7 February 2001. Likewise, CEO Jeff Skilling received $7.5 million, while Chairman Lay received $10.6 million. It is not as if excessive payments were the privileges of only top executives. It was reported that a 27 year old energy trader earned an astronomical $8 million bonus on reported profits of $7.50 million in natural gas contracts.

(c) Culture of pride and a deep sense of belonging: The corporate culture at Enron instilled in employees a tremendous sense of confidence and pride in themselves and a deep sense of involvement in the organisation in which they were a part of. They sincerely believed that if you were an Enron employee "You thought you were better. You were smarter than everyone else." This confidence, though often was considered as arrogance and brashness by outsiders, propelled employees to be totally involved and committed to the organisation and helped them scale peaks of achievement hitherto unattained by their counterparts elsewhere.

The Ultimate Collapse

The events leading to the ultimate collapse of Enron, the mammoth energy conveyor of the world, occurred in quick succession. Jeffrey Skilling, the then CEO, unexpectedly put in his papers on 14 August 2001. Expectedly, this triggered a precipitous fall in stock prices. As stock prices plunged, Enron faced huge losses. Sherron Watkins, Enron Vice President wrote a memo to Lay, expressing her concern that Enron would "implode in a wave of accounting scandals." Lay reassured her and other employees that all was well with Enron. At the same time he contacted David Duncan, the Andersen partner in Enron, who concluded that there was nothing to worry about, after a month-long investigation. On October 16, Enron released its third quarter results showing losses amounting to more than $2 billion. Lay removed CFO, Fastow to quell the upheaval in the market. But the announcement of SEC on October 22 of an impending investigation was the last straw. Enron went through a series of hiccups and losses after mounting losses. With more than $37 billion losses, stock price plummeting to less than a dollar, the access to capital markets totally closed, there was no light seen at the end of the tunnel. Enron filed for Chapter 11 bankruptcy on 2 December 2001.

Enron's Growth Rooted in Unethical Practices

Some analysts have underlined the fact that there were several positive aspects in the manner Enron conceived and conducted its business. But several other analysts point out that Enron executives indulged in several activities which could not be justified, both legally and ethically. The company's malpractices easily outnumbered its morally and legally acceptable practices.

(a) Enron' haughty culture: It was said that Enron executives and employees regarded themselves as an elite. Enron's culture was to have tremendous pride that led people to believe that "They could handle increasingly exotic risk without danger." There was an overwhelming pressure to do more and better. The company's highly paid army of MBA's specialised in Finance and encouraged by the CFO, Jeffrey Skilling, sought highly innovative but dubious ways of translating any business deal into a mathematical formula that could then be traded or sold on to Special Purpose Entities (SPE) set up for that purpose. By December 2001, Enron had more than 3000 subsidiaries and unconsolidated associates including 400 registered in the Cayman Islands.

(b) Heavy donations to political parties to curry business favours: Enron and its Chairman, Kenneth Lay, had been generous contributors to political campaigns of both Republicans and Democrats, giving them a reported $2 million. To achieve his goal of the energy markets deregulation from being public utilities so that Enron could cash in on the unregulated market, Lay became heavily involved in state-level political campaigns and spent about $2 million of Enron's money on 700 candidates in 28 states. This did have the desired effect. By 2000, 24 states moved towards energy deregulation in which Califoornia took the lead. Enron officials sought and obtained the support of former President Bill Clinton and Vice-President Al Gore

for the Kyoto treaty, because it would generate immense profits for the company's trendy energy-saving products, though it was subsequently vetoed by President Bush. The company had also close ties with the Bush administration. It was Enron that was at the centre of the energy deregulation scheme that accelerated the electricity crisis in California costing consumers and the State billions of dollars in excess payments. The company and its top executives used every clout they could gather to bring about energy deregulation that brought them enormous profits and enabled them to become the world's largest supplier of energy. Brian Cruver, an Enron employee, has documented how Enron received more than $1 billion in subsidised loans from the US government. Incidentally, Enron, which virtually became an energy company, was filed with the Securities and Exchange Commission as an investment bank, when it commenced its operations.

(c) Influencing public policies for their own benefit: Enron had a corporate culture that encouraged its staff to influence public policy-makers on the deregulation or privatisation of the US (and of the world) energy sector. For instance, the State of California went into energy deregulation in a by-partisan manner that substituted "public monopolies" for "private monopolies." In 1997, before the energy market in California was deregulated, the California Public Utilities Commission unanimously ruled to move ahead to throw open the State's $20 billion electricity market to competition, which in their opinion, would make California the first State to join a world-wide movement to deregulate utilities. Experts and politicians alike joined the bandwagon, which led to deregulation along the laissez–faire model established in the United Kingdom. "Competition should bring down prices and foster a host of new services along with dozens of potential new suppliers" was a resounding chorus of approval. In this whole scheme of things, Enron played a decisive role to influence public policies. When the power utility was deregulated, a representative of Enron exclaimed in a fortuitous manner "We think the Commission took a bold step. This hasn't been done anywhere else in the country."

However, deregulation in the absence of adequate public infrastructure and proper policies in place brought about an energy crisis in 2000. California's flawed deregulation scheme created an energy nightmare, sent electricity prices soaring and led to rolling blackouts. The price for electricity went from an $30 per megawatt to over $1,000 in some cases, averaging about $300 per megawatt, until the governor imposed consumer price caps. The results were that the energy suppliers and marketers sucked $40 billion in excess profit out of California over a two-year period and also forced the state into power-buying business. In 2000 and the first half of 2001, Enron among other market force suppliers, reaped enormous profits from California's deregulated energy market. Records show that the prices paid for power over this period of time were hundreds of percent higher than normal or historical prices during a similar period.

With the political clout they acquired through hefty political contributions, Enron tried to influence public policies, either covertly or overtly, especially in the areas of business they were operating. On 17 April 2001, for example, Kenneth Lay made eight recommendations regarding federal energy policy to Vice President Cheney who headed The Energy Task Force. One of his recommendations hinged on Enron's continued opposition to price caps. When the White House released the final report of its energy task force, seven out of Enron's eight recommendations had been fully adopted by the report. It was also reported later that Enron's staff and senior officers, as well as members of its board had tried to influence the White House during the Clinton administration too and systematically pursued its self interest in states such as California that were then considering deregulation.

(d) Hypocricy pervaded the corridors of Enron: There was a lot of hypocricy in Enron and wide differences in the manner in which they promulgated policies and the way in which they were implemented. There was dichotomy between percepts and practices in Enron. Kenneth Lay was insistent that all staffers should follow faithfully four core values: Communication, respect, integrity and excellence. Banners were put-up in the Company's Corporate lobby proclaiming those values. "I was always in the forefront of trying to make sure that our people did in fact live and honour those values. Integrity and character are incredibly important to me" asserted Lay. But, in actual practice, Enron observed these values only in breach. They hardly communicated the truth of the state of affairs in the company to their shareholders, there was no respect for people who valued truth and it was apparent that integrity was a very rare commodity—from the manner they used Arthur Andersen to commit accounting frauds. Lay himself whom his employees adored

as a father figure and placed their complete trust in him—betrayed them when he painted a rosy picture about the company's performance before its collapse and was instrumental for many of their financial ruin.

(e) Dubious and aggressive accounting practices: Enron had both instructed and led its accounting firm Arthur Andersen into dubious financial transactions which ultimately caused the collapse of Enron as also Anderson as an independent firm, especially in its core business of accounting. Arthur Andersen, which had more than 100 executives and auditors devoted to Enron were misled by David Duncan, the lead audit partner who ordered the rapid destruction of Enron documents after learning that the SEC was looking into Enron's iffy numbers. The unprofessional relationship that was nurtured between Enron and the likes of David Duncan was such that any auditor who found fault or even suggested change in the manner Enron accounts were written was sacked. Though there were serious doubts among Andersen employees about the accounting practices of some of Enron's off-balance sheet activities, they were overruled by Duncan who seemed to be more loyal to Enron than their own employees. In fact, Andersen got an auditor Carl Bass removed from the engagement after Enron complained that he was being deliberately obstructive.

(f) Enron's uncharitable and unethical employee policies: Enron had adopted a policy of "Hire and Fire" in which loyal employees who could not perform as per the company's dubious yardsticks were fired while those indulging in unethical practices were able to make a fast buck. For instance, CEO Skilling had introduced a rigorous employee performance assessment process under which the bottom 10 per cent in performance was dismissed. This created a heavy pressure on executives to meet targets. Remuneration was linked to the deals done and profits booked in the previous quarter. This pressure was particularly acute at the quarter end and gave rise to the expression "Friday Night Specials." These were deals put together at the last moment, which were often poorly conceived and inadequately documented, despite the efforts of 200 or so in-house lawyers that Enron employed. The emphasis was on doing deals and not necessarily bothered about how they were to be implemented or managed in the future. Even internally, its was recognised that project management was not a core competence in Enron.

(g) Poor project implementation: In a short period, Enron showed to the industrial world, too many projects all at one time. However, many of them were poorly conceived and theoretical. Its failure revealed that many such projects could not fructify or could not be funded by Enron's coffers which were being drained due to many such ill-conceived projects.

The Fall-out of the Enron Crisis

(a) A pension double standard: Enron's retirement plan was heavily invested in its own stock. Executives cashed out over a billion dollars, while ordinary employees were locked in. Even when the company's performance was extremely poor causing huge losses, Kenneth Lay and other executives painted a rosy picture to employees and prompted them to invest in Enrons stocks. As a result, almost all the company's employees were ruined financially.

(b) Bogus accounting: Since the great depression, the one form of regulation that even Wall Street had supported was the regulation of stock trades and corporate accounting. Enron's entire game was to make its business plan so complex that neither investors nor regulators nor even its own auditors could penetrate it. While its core energy business made money (at the expense of consumers), it had speculative off-the-books subsidiaries. These borrowed heavily to make risky investments and eventually took the whole company down.

(c) The business press: Enron's breathless cheerleaders included not only its own insiders and stock touts but also a business press that pronounced Enron the epitome of the new economy. The financial press of America which is credited to have a number of investigative journalists were extolling the fantastic success of Enron and had no clue as to what was happening inside the company until one day the Wall Street Journal brought to the open the large number of irregularities at Enron.

(d) Deregulation hiccups: Enron's collapse impeaches the conceit that a market economy can be efficiently self-policing. Enron fleeced consumers by manipulating prices of electricity and gas; it fleeced investors and its own employees. Enron signalled a whole new era of re-regulation-of everything from electricity to pensions to accounting standards.

(e) The spin-off effect on the capital market: Another outcome from the Enron debacle is most significant. Enron had forced the US financial markets into chaos and the need for drastic reforms that most certainly would not have occurred had

the company continued on. The reforms eventually have become international; focusses on standard accounting practices and has impacted the audit functions of all accounting firms.

Nemesis Catches Up with the Culprits

The ongoing investigations of SEC, Federal authorities and other administrators of the government followed Enrons various frauds, malpractices and violations of law. By 2004, many of them ended up in prison.

On 13 January 2004, former Enron chief financial officer Andrew Fastow and his wife Lea Fastow pleaded guilty to charges related to accounting fraud. On 23 January 2004, former Enron chief accountant surrendered to authorities to face federal criminal charges that he served as an "architect" of a wide-ranging scheme to manipulate the company's earnings and improperly boost its stock price. On 20 February 2004, Jeffrey K. Skilling, Enron's former CEO, surrendered to authorities to face nearly three dozen fraud, conspiracy and insider trading charges related to the company's collapse. On 6 May 2004, Lea Fastow was sentenced to 1 year in prison. On 8 July 2004, Kenneth L. Lay surrendered to federal agents, pleading not guilty to criminal charges. The government framed 11 criminal charges against Lay of conspiracy, fraud and making false statements. On 15 July 2004, a Federal judge approved Enron bankruptcy plan, under which it would sell most of its prized assets to repay creditors about 20 cents on the dollar in cash and stock. On 22 July 2004, Federal regulators ordered Enron to repay $32.5 million in energy-trading profits made before and during the West Coast electricity crisis in 2004. On 30 July 2004, Kenneth D. Rice, former chief executive of Enron Internet broadband unit, pleaded guilty to securities fraud and agreed to cooperate with prosecutors. On 21 September 2004, the first criminal trial involving former Enron executives opened with prosecutors charging that the defendants conspired with Wall Street bankers to carry out a sham transaction. A jury convicted a former Enron executive and four ex-Merrill Lynch officials in the first criminal prosecution arising from the accounting fraud that led to the energy a trader's collapse. The 6-week trial in Houston Federal court stemmed from Enron's 1999 sale to Merrill of a $7 million stake in three energy-generating barges. Prosecutors said that the deal was a disguised loan because Enron promised to pay Merrill the money back and that the energy trader committed fraud when it booked the loan as a $12 million profit so it could meet earnings estimates. The trial was "a milestone in bringing both an Enron executive and Merrill Lynch executives who aided and abetted the fraud at Enron to justice," Assistant US Attorney General Christopher A. Wray said in a statement. Prosecutors said Merrill executives helped Enron "cook its books" when in December 1999 the investment bank paid $7 million for a stake in the three energy-generating barges moored off the Nigerian coast. Enron secretly promised to buy back Merrill's investment, with interest, 6 months after the sale, making the deal a loan under accounting rules and Enron's subsequent booking of a profit fraudulently. Enron used the profit to meet earnings estimates, while Merrill agreed to the deal to curry favour with Enron and gain investment-banking business. Five executives of Merrill were convicted of conspiracy, wire fraud and making false statements.

Impact of Enron's Failure

The Enron collapse triggered a chain reaction. Enron left behind $15 billion of debts, its shares became worthless, and 25,000 workers around the world lost their jobs. Many banks were exposed to the firm, from lending money and trading with it. JP Morgan admitted to $900 million of exposure, and Citigroup to nearly $800 million. Former high-ranking Merrill Lynch bankers have been charged with fraud in connection with Enron transactions. Arthur Andersen, who failed to audit the Enron books correctly, collapsed. Enron's collapse in conjunction with the failure of several hitherto popular and famous corporations severely shook investors' confidence, while most people became cynical about accounts of corporates even when audited by big audit firms.

However, the Enron's collapse and the Arthur Andersen fiasco resulted in some positive outcomes too. A number of corrective measures were initiated worldwide to correct corporate frauds. Many corporate governance and accounting reforms have been enacted in the US in the wake of the collapse, followed by such reforms worldwide. The Sarbanes–Oxley Act brought in stiff penalties for violations of US securities laws. CEOs and CFOs of companies required to restate their results due to "material non-compliance" will have to repay bonuses and any profits from share sales over the previous 12 months. Other new rules prohibit loans

from public companies to their directors, Audit firms are prohibited to provide non-audit services to firms they audit. Chief executives of every public American company will have to certify in writing that their results comply fully with the rules and fairly present the group's financial condition; failure to do so or false certification will invite huge fines and imprisonment.

CONCLUSION

The case about the Enron fiasco is an interesting study as to how Enron, one of America's fastest growing companies came to grief because of the greed and duplicity of its top executives. The company was so big that the ramifications of its collapse triggered a chain reaction all over. Its shareholders lost their investments, and more than 25,000 workers around the world lost their jobs. Many banks that dealt with the company lost millions of dollars. However, the Enron fiasco brought about a positive outcome in as much as corrective measures were initiated by governments worldwide to correct such corporate frauds. Auditors too came for public scrutiny and governments started initiating a number of steps not only to arrest frauds but also to anticipate them and thwart such developments.

DISCUSSION QUESTIONS

1. How was Enron, considered once the darling of American industry, turned into a company that caused terrible damage to the investments by investors?
2. Trace Enron's growth as a powerhouse of the technological, fast-tracked "new economy" company.
3. Explain Enron's unconventional methods of adding new businesses to its portfolio. How did the company branch into areas that were not its core competency business?
4. What role did Arthur Andersen play in bringing about the ultimate collapse of Enron?
5. Would you agree with the view that Enron's growth was rooted in unethical practices? Substantiate your answer.

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Case Study 10

TVS Group of Companies: Commitment Far Beyond a Sense of Corporate Social Responsibility

(This case is based on reports in the print and electronic media. The case is meant for academic purpose only).

Introduction

TV Sundaram Iyengar & Sons, popularly known as TVS, is a household name in South India, especially in Tamil Nadu. Hailing from a small hamlet, Thirukkurungudi in Tirunelveli District, one of the southernmost regions of Tamil Nadu, TV Sundaram Iyengar became a doyen of the automobile industry. Prior to the nationalisation of the transport sector, TVS & Sons used to run buses connecting major metropolitan cities of Tamil Nadu and the neighbouring states. Honesty, integrity and commitment to public welfare were the hallmarks of TVS & Sons, which was the hub from which several closely held public limited companies emerged. The buses they ran in the first-half of the Twentieth Century set benchmarks in punctuality. It used to be said that if a TVS bus were to enter a depot at 10 a.m., one could adjust his watch to that time. Such was the company's adherence to values including punctuality in a region where such values were followed mostly in breach and not in observance.

The TVS group of companies which are now diversified, and closely held, are professionally managed profit-earning enterprises. They have been recipients of many awards for quality including the famous Deming Prize, instituted by the union of Japanese scientists and engineers, and is the ultimate confirmation of commitment to quality control. The TVS group is also known for its social consciousness and commitment to the promotion of the welfare of the poor and the underprivileged.

Profile of TVS Group of Companies

TVS & Sons was founded in 1911 by the late Shri T. V. Sundram Iyengar at Madurai, Tamil Nadu. The proprietary concern was set up to engage in the dealership of automotives and their components. In 1929, TVS & Sons was converted into a private limited company. Two of its subsidiaries, viz. Sundaram Motors (P) Limited and Madras Auto Service, were amalgamated with TVS & Sons in 1970 and currently operate as its divisions. TVS & Sons became a public limited company in 1979. Its shares are closely held by the descendants of Iyengar in their individual capacities and through family trusts.

T.V. Sundaram Iyengar & Sons Ltd (TVSL) has played a pivotal role in the growth of the TVS Group by providing seed capital to a multitude of ventures. The TVS Group's core competence is mostly in two wheelers, automotive spares, components, automobile-related activities such as tyres, bus body building, precision products relating to the industry, auto electrical components and related products. They have a textile unit and a sewing needle unit. There is one unit that manufactures computer peripherals while another produces switches for computers and telephones. The group owns a couple of non-banking finance companies that provide finance chiefly to the transport sector. They are also into freight service and logistics. The group owns three software units. While most of their facilities and production units are in India, especially Tamil Nadu, they have their presence in the USA, the UK, China, Malaysia, and Sri Lanka. The TVS group is a well-diversified, professionally managed, though closely-held, industrial conglomerate. Some of the prominent companies within the Group include Sundram Fasteners Limited, Lucas-TVS Limited, Sundaram Clayton Limited, TVS Motor Company Limited and Sundaram Finance Limited, Brakes India and Wheels India.

TVSL is the holding company for some of the companies in the group, and its investments are therefore strategic in nature. TVSL also has substantial real estate in major cities whose market value is much higher than book value. Building on its experience in the automotive and automotive components business, TVSL is currently the largest automotive and automotive component dealer in India. Its presence is especially strong in South India. The company is the main dealer for Ashok Leyland (ALL) and one of the prime dealers in the South for Mahindra and Mahindra (M&M), Fiat, Ford, Honda, GM and Daimler-Chrysler. TVSL also provides comprehensive service facilities for vehicles. TVSL has a presence in Madhya Pradesh, Chattisgarh, Maharashtra, Goa, Uttar Pradesh and Gujarat, although it is currently a marginal player in these States. During 2003–04, the company achieved a turnover and profit after tax of Rs. 26.08 billion and Rs. 428 million, respectively.

Srinivasan Services Trust (SST)

The TVS Group of Companies, especially TVS Motor Company Ltd and Sundaram Clayton Ltd have together formed a Trust to carry out their social commitments. Srinivasan Services Trust (SST), an NGO, is the organisation that carries out social service activities of TVS group Companies. Both Sundaram Clayton and TVS Motor Company contribute 1% of their annual profits to the SST, which no "shareholder should grudge" seeing the excellent work the NGO is doing. The SST employs 45 people to carry out the welfare activities, 35 of whom are on the rolls of TVS Motor and salaries paid by the company. "We don't have to pay for the employees out of the NGOs grant" says Joshi, Chairman of the Trust. The SST spends about Rs. 3 crore a year on CSR activities in various regions but "the total value of work could, be five times that," according to Joshi. However, as Joshi points out, it's not the men and the money which matter as much to the movement as the involvement of companies like the TVS group which has brought in TQM practices into monitoring projects run by the NGO. Both TVS Motor and Sundaram Clayton have won the Deming award for quality and the managerial inputs they bring to their role as a good corporate citizen is what makes the difference.

The Srinivasan Services Trust (SST), provides a classic example of an Indian corporate which moved from philanthropy-welfare mode to a broader agenda in congruence with current development approaches worldwide. Deeply concerned with the widespread deforestation and degradation in Tamil Nadu, the Trust nurtures a vision of re-greening the State in years to come. This has led to the integration of SST's decade old community development activities with the ongoing regeneration and conservation efforts of the Tamil Nadu Forest Department (TNFD). The Tata Energy Research Institute (TERI), New Delhi is providing advisory and technical guidance to SST in undertaking Joint Forest Management (JFM).

SST's Commitment to Broad Spectrum Community Welfare

Since its inception, SST, has been actively engaging itself in community development work. The rural development project attempts to achieve its aim by improving the socio-economic status of the people through a multi-sector approach of strengthening the education system, providing access to better economic improvement, water and irrigation facilities, improving health services and sanitation facilities, developing community infrastructure, and creating a clean and green environment. The organisation is presently engaged in several activities for the development of the rural communities in several districts. The main aim of the Trust is self-sustainable development of countries with a holistic perspective to make the communities self-reliant.

The focus areas of the Trust are as vast as they are crucial for the rejuvenation of the rural economy and include the following:

- Healthcare
- Education, literacy promotion
- Improving rural infrastructure
- Rural/community development: welfare programmes, economic empowerment of women, income generating programmes, child welfare
- Community relations: involving employees in community development, providing social amenities, assisting community groups in micro financing and credit assistance
- Environment
- Tribal development

The Mission statement of the Community Development Programme of the Trust reads as follows: "We strive to facilitate the process of sustainable community development through active involvement of local communities, leading towards the goal of self-reliant rural communities, and a disease-free society, by providing primary health care and quality education, opportunities for the development of women and providing eco friendly environment."

Administration of the Trust

The Community Development Programme of the Trust is headed by the chairman, Mr.Ashoke Joshi I.A.S (Retd.) and director, Mr. R. Seshadri. Implementing a professional approach to create a sustainable development model, professional social workers facilitate and coordinate the activities both at managerial and ground level in all locations. Interested and dedicated individuals from the local community are appointed as animators to work at the grass-root level. In the project areas, Civil Engineers also form part of the team. The Personnel and Civil departments are entrusted with the responsibility to co-ordinate community development at the factory areas.

Providing Training for Employment

The Trust runs a number of welfare activities alone by itself or in collaboration with other like-minded NGOs. For instance, at a hamlet, Santhavasal in Tamil Nadu, SST offers a training programme in collaboration with the Hyderabad-based Dr. Reddy's Labs. The Livelihood Advancement Business School (ABS) a programme undertaken by LABS offers training in different vocational streams. At this village, students of both sexes are being trained in two streams—customer and sales relations and hospitality. While the trainers are offered by the LABS, the rest of the facilities is provided by the SST. All the students come from families with agricultural backgrounds or children of daily wage earners seeking a better deal in life. The LABS training programme in Padavedu is just one of the multifarious activities carried out by the SST since it began its work in this region in 1996.

While in Padavedu itself TVS group companies do not have any business activities, the SST has taken up development activities in regions around where its factories are located. Today it does work across five districts of Tamil Nadu; in Mysore where it has a factory, at Bhuj in Gujarat and at Dok Sangivi in Pune district of Maharasthra. The Padavedu region, where the SST has been operating for at least 7 years, has been the touchstone for the NGO's activities in other areas, where it has taken up development work.

Rural Development Activities

The major thrust areas for rural development work undertaken by SST are:

- Economic development
- Health
- Education
- Infrastructure facilities
- Eco-friendly environment

The rural development activities are integrated with spiritual development. Temple, Trees and Tanks are the hub of the whole rural development programmes. Another notable feature is the holistic approach aimed at making people self-reliant through active involvement of local communities. The Namakku Naame Thittam/Village Self Sufficiency Scheme in partnership with the local community, Rural Development Department and the Trust is a maiden initiative leading towards sustainable community development.

The community development programmes of the SST are executed in the following locations:

* Padavedu - Tiruvannamalai
* Tirukurungudi - Tirunelveli
* Nava Tirupathi - Thuthukudi
* Hosur - Dharmapuri
* Padi, Vanagaram, Mappedu - Tiruvallur
* Sindhuvalli Panchayat & Kembal - Mysore, Karnataka
* Dok Sangivi - Pune, Maharashtra
* Goyersama - Kutch, Gujarat

Major projects executed so far:

Economic Development

SST has helped the formation of Self-help groups (SHG) in the following locations:

131 SHGs in Padavedu

93 SHGs in Tirukurungudi

24 SHGs in Nava Tirupathi

49 SHGs in Mysore

41 SHGs in Hosur

(a) ***Income Generation Programmes*** using locally available raw materials from agriculture, viz., Banana fibre extraction and value-added products, Agarbathi and Chapathi making, Mushroom cultivation, Apiculture (Honey bee), Dairying, Sheep rearing, Appalam's and Masala powder have been started. There are 231 Self Help Groups that are coordinated and involved in income generating activities.

(b) ***Vocational Training*** for Educated Unemployed youth in collaboration with Dr. Reddy's Foundation under LABS programme has been initiated in Padavedu and Hosur.

(c) ***Appropriate Technology*** such as drip irrigation and quality seeds are being provided for enhancing the agricultural output of the farmers. This is done through the Farmers Association that has been formed at the community level.

(d) ***University–Industry Partnership for Rural Development*** has been forged with Tamil Nadu Agriculture University, Coimbatore, towards preparing techno-economic feasibility study utilising agro-based materials to start income generation programmes. These are some of the activities planned for income generation programmes. Academic-Industry partnership has been created with the Indian Institute of Technology (IIT) in the areas of Rainwater harvesting, environmental sanitation, etc. SST also proposes to establish partnership with Tamil Nadu University for Veterinary and Animal Sciences.

Health Services

(a) ***Major Eye Camps*** conducted in all locations in co-ordination with Aravind Eye Hospital. So far 12,000 cataract surgeries were performed in collaboration with Indian Oil Ltd. (IOL) since 1996 in all locations.

(b) ***Dental Check-up*** including extraction and filling, and paediatric health programmes for school children was conducted in all government schools, as for example, in Nava Tirupathi (Thuthukudi) where 10,000 children in 33 schools in Padavedu (Tiruvannamalai) were covered.

(c) ***Alcoholism Treatment Residential Camp*** was conducted at Padavedu through T.T.K Hospital, Chennai. Remarkable improvements have been notified in the quality of life of 100 families.

(d) ***Support Services*** for 'Varumun Kappom Programme', Pulse polio, etc. has been extended to Public Health department in all locations.

(e) ***Veterinary Camps*** have also been conducted.

(f) ***9 PHC's are run by SST*** and 5 Government PHC's have been adopted by SST in sequel to the appeal from the Government of Tamil Nadu. Also one Government Taluk Hospital in Hosur has been adopted.

(g) ***Individual and collective toilets*** have been constructed to stop open defecation and maintain health and hygiene standards in the village.

(h) ***School toilets*** have been constructed to improve the personal hygiene standards of the children.

Education—General and Vocational

(a) ***Schools Improvement Facilities*** include construction of toilets with running water, balwadi construction, fencing, drinking water, partition to of class rooms, additional buildings, sports and cultural programmes, upgradation of the High School at Tirukurungudi, supply of science and audio-visual equipment, scholarship to poor students, etc.

(b) ***SST also runs Schools*** at Hosur and Tumkur, based on child–focussed and project–oriented education, with an integrated approach to 'learning by doing' and hands on experience. The same methodology is also followed at T. S. Srinivasan Centre for Advanced Vocational Training, situated at Vanagaram, near Chennai. The National Apprentice Board – approved courses offered are industrial machinist, mechanical and electronics for a period of 3 years. Annually 60 students (boys and girls), are selected and imparted theoretical training at the centre and sent to various industries for practical training at the shop floor.

(c) ***Adult Education*** in collaboration with Tata Consultancy Services has been initiated in all the operational sites.

(d) TVS Academy and SST have been creating an interface between Government School Teachers for activity-based learning techniques.

Infrastructure Facilities

Infrastructure Facilities such as roads and drains, drinking water, street lights, public library, health sub-centre, desilting of village water ponds, public toilets, community hall, etc. have been provided by the Trust directly, as well as in partnership under "Namakku Naame Thittam I Village Self Sufficiency Scheme" during the year 1999 – 2002 for the total value of Rs. 400 lakhs at Padavedu (Tiruvannamalai), Tirukurungudi (Tirunelveli), Nava Tirupathi (Thuthukudi), Hosur (Dharmapuri) and Padi, Vanagaram, Mappedu (Tiruvallur).

Eco-Friendly Environment

(a) With a view to increasing green coverage and protecting forests, Joint Forest Management (JFM) programme has been undertaken at Padavedu and Tirukkurungudi in co-ordination with the Tamil Nadu Forest Department, The Energy Research Institute (TERI), New Delhi, and TVS group companies. Nearly 2400 hectares have been covered under this programme for which buffer zone activities comprising alternate sources of livelihood for forest dependants and other community development activities have been executed by the Trust. Due to this strong social fencing the result has been growth of rootstocks and absence of forest fire, and grazing inside the forest. There has also been increase in the water table by 10 feet in the surrounding wells in JFM villages due to various water conservation measures such as construction of checkdams, percolation ponds by the Forest Department.

(b) Social forestry, Horticultural and Wasteland development programmes are being executed in all locations.

(c) A Comprehensive Plan has been prepared for sustainable water sources by adopting rainwater

harvesting and artificial recharge, which is planned to carry out over a period of 5 years.

(d) A Comprehensive Watershed Development Plan in coordination with various line departments are being prepared towards increasing the agriculture producitivy by adopting various water management techniques viz., drip irrigation, traditional waterbodies viz., lakes, tanks and ponds are being identified and rejunevated in all locations in a phased manner. This watershed development plan is envisaged to be a sustainable, replicable and cost effective model.

Eco-Tourism

Eco-tourism is being encouraged by SST in Reserved Forests of Javadi Hills along with Tamil Nadu Forest Department and Care Earth. A trail of 4 kms has been identified that has seven distinct ecological zones. A number of species of animals, birds and insects are spotted in along the trail that runs through southern Indian mixed dry deciduous forests. This initiative will also help the local youth to be employed as forest guides.

Tribal Development

(a) SST has also initiated various tribal development activities in Kanamalai Panchayat comprising 32 hamlets and intensive work has been carried out in Elanthampattu Senbagathoppu, Erulamparai, Thanjan Parai, Neerthumbai and Kanamalai and the remaining hamlets will be covered in the next 5 years. This has been done in partnership with the Department of Anthropology, University of Madras.

(b) Another unique project of Environment Management Plan, Community-based model on rejunevation of river Nambi at Thirukurungudi has been planned, for which a pilot project viz., individual toilets, oxidation pond, solid liquid waste management has been completed in Levenjipuram ward. It is also proposed to continue this initiative in all other wards with support from National River Conservation Directorate, under the Ministry of Environment and Forest.

(c) Organic farming and low economic input and sustainable agriculture (L E I SA technique), has been initiated in all locations. The T. S. Srinivasan Centre for Rural Training at Hosur offers a 10-month course on the above subject.

This first phase of rural development activities was initiated in 1996 and so far approximately Rs. 535 lakhs has been incurred for the above projects.

Forest Management

Before we analyse the contribution of SST in forest management, it is appropriate to know how this activity is important in terms of the national perspective.

Forest management in India underwent a dramatic change in 1990 when the Union Ministry of Environment and Forests issued policy guidelines for the Joint Forest Management (JFM) to combat deforestation and degradation in the country. The JFM is a system of governance that devolves the responsibility of forest protection and management on ecosystem people[1] in partnership with the concerned State Forest Department for regeneration, efficient use and sustainable conservation. People are organised into Village Forest Cornmittees (VFCs) at the village(s) level with the Executive Committee (EC) elected by the VFC members. The EC takes the role of the regulator in monitoring the access to forests and also in regulating utilisation of forest products such as grasses, NTFPS, and a portion of the proceeds from the sale of trees when they mature.

In the Joint Forest Management project in Renukondapuram village, for instance, the SST works closely with the TN Forest Department. The hills in the region fall under the Vallimalai reserved forest area and it was found that the denudation of the hills led to soil erosion and depletion of water sources. The area was brought under the Tamil Nadu Afforestation Project while the SST acted as a bridge between the local community and the forest department in creating awareness about what needed to be done. There were four objectives: reforestation of denuded lands soil and moisture conservation measures, increasing incomes for those dependent on the forests for a living, and better infrastructure in the village. The village has 652 households and a population of nearly 3,000. In the year 2000, a Village Forest Committee (VFC) was formed with 24 members.

Intensive plantation was carried out across hillocks around the village that year. Nelli, neem and bamboo were among the 1.27 lakh seedlings that were planted as part of the first phase of the afforestation programme. Earlier, villagers used to cut the tall grass on these hillocks and then burn the entire grass cover so that there would be a fresh yield immediately after the rains.

Afforestation and Conservation Efforts

The Tamil Nadu Forest Department (TNFD) has been implementing JFM programme, known as Tamil Nadu Afforestation Programme (TAP), since 1997 with the financial assistance from Japan Bank of International Cooperation to re-green the Eastern Ghats. The eco-development programme supported by the World Bank is the other programme going on in the Kalakad–Mundanthurai Tiger Reserve (KMTR) in Western Ghats for biodiversity conservation. SSTs pilot effort is concentrated in two locations at Pedavedu-Renugondapuram (under TAP) in Triruvannamalai district and at Tirukurungudi (under EcoDevelopment project) in Tirunelveli district.

Plethora of Other Services Rendered by SST in Forest Management

The innovative interventions by the SST in forest regeneration has been supplementing and facilitating the initiatives taken by the TNFD in the following ways:

(a) Providing Professional Expertise : Providing professional expertise in developmental interventions to strengthen the initiatives of the Forest Department for JFM has been one of SST's major contributions in rural development. The SST has appointed professional social workers for the Rural Training Centre (RTC) and Field Officers at Thirukkunmgudi and Padavedu–Renugondapuram to coordinate ongoing JFM activities. They, along with FD staff, organise people into VFC, conduct training programmes and capacity building workshops for the villagers on various operational activities. The women volunteers appointed at the RTC are responsible for the formation of self help groups, and capacity building of the women on micro-bank management etc.

(b) Creating Partnerships : Another contribution of SST is creating partnerships with various ongoing government rural development schemes/ projects on poverty reduction and environmental conservation for mobilising resources. The SST has created partnership with ongoing rural development schemes such as Namakku Naamme Thittam (NNT) to source funds to successfully execute entry point development programmes such as repairing of roads, ponds or creation of community assets such as building of schools etc. Under NNT, the state government provides three- fourths of the financial support, one-fourth is contributed by the community either in the form of cash or kind or labour. The SST has been tying up with NNT since 1999 and undertook various infrastructure developments such as rebuilding village roads, constructing, new concrete room for creche (at Vattakulam) etc. The local village community, volunteered their labour for construction and supervision.

(c) Liaising with Local Administration to Execute Development Work : The constant *liaisoning* of SST staff with district administration brings myriad benefits to the local community. In Padavedu, a 32-km stretch of metalled road has repaired under the National Bank for Agricultural and Rural Development scheme as a result of constant communication by SST staff. In another instance, SST's persuasion with District Collector enabled 29 families of Vattakulam to get *patta fr*om the administration.

(d) Adoption, Reconstruction and Maintenance of Existing Infrastructure : The SST has identified the existing non-functional resources (silted pond for irrigation or non-functional tubewell) and undertook restoration and reconstruction, as for example, providing better health facilities to the people. SST adopted the local Primary Health Centre (PHC) at Thirukkurungudi in 1999 and rendered better facilitates. The Outdoor Patient Department (OPD) building of the PHC has been completely renovated and a generator set has been installed at the Centre for uninterrupted power supply. Besides these, SST is providing the salary of the newly appointed lady Doctor at the PHC. Similarly, desilting and by construction of two new sluice gates on existing ponds at Thirukkurungudi has brought 750 acres of lands under increased irrigation which has boosted agricultural productivity.

(e) Providing Livelihood Through Imparting Training to Local Youth : Around 50 educated unemployed youth of the project areas have received training on two- wheeler servicing. The training programme includes a practical training conducted at the service stations of TVS Motor Company. Besides arranging instructors for imparting training, the SST also bears all costs including that of transportation for trainees travelling between their villages and service stations. Some of them have already started the repairing work on a small scale.

(f) Empowerment of Women Through Self-Help Groups (SHGs) : Formation of women's self-help groups (SHGS) is one of the most significant interventions in the area for poverty reduction and economic empowerment of women. Each SHG consists of 20 women contribute Rs. 50 per month who each to the common fund. More than 100 SHGs have been formed under the SST's initiative. Numbers of training programmes have been organised for the women to develop technical skills (such as pickle making or banana-fibre craft or tailoring). The common fund accumulated through regular savings is loaned to members. The SHGs at Thirukkurungudi charge only two percent interest compared to 10 % charged by the local money lenders.

(g) Income Generation Projects : Under the guidance of SST workers, villagers also get loans to buy cattle and materials for pot making, basket weaving, floriculture, to set up an apiary, and pursuing other professions. The forest department has disbursed over Rs. 7 lakh under this and the loan amount keeps rotating. Over 250 villagers have availed themselves of this opportunity.

The SST has helped form six self-help groups. Its role is weighty: it assesses the causes for groups, then joins together and form a federation. The strength of scale present in the federation helps them get loans, which are then disbursed according to the needs of the members. SST also helps the groups find markets. Baskets made from banana fibre, for, instance, are exported to Bangalore; meanwhile SST wants to find alternative markets.

Earlier, the agricultural economy lay in shambles with little rain fall. There are alternatives now; 100–250 people are engaged either part-time or full-time with the banana fibre business and the full-timers manage to make Rs 50. a day. SST initially provided the equipment, which costs Rs. 1500 per unit. The fibre itself fetches 20 paise per metre.

Another example is vermiculture. SST urged villagers to take it up, and helped provide training too. A group started off with a loan of Rs 25,000. They chose the fatter African hybrid earthworms. Till now, the output of the unit has been three tonnes, of which two tonnes have been sold. To get a steady supply of manure, another group has bought five cows. Though the output now is good enough for the local market, the group is now scouting for outside markets. For every one tonne of sale, the expenditure is Rs.1000 while the revenue is Rs. 4000.

The involvement of SST has also helped raise loans. The local bankers say a total of Rs. 7 lakh has been disbursed, including for sanitation projects, which have no direct monetary benefit. For up to Rs. 50,000, the bankers charge an interest rate of 8.5 % for self-help groups. SST acts as a link between the beneficiaries and the source of help.

Accent on Health and Education

The accent is also on health and education. The villagers had to go to the nearest town even for a medical emergency. Now, SST has created a health sub-centre, which government doctors visit 3 days a week. During those days, 150–200 patients checked in daily. SST is working with government schools in the area too to improve the infrastructure there, as also in improving the quality of education. It has helped build toilets, compound wall, a classroom, enable supply of water and install computers. It also organises health camps. SST has helped the teachers of the Padavedu school get trained in computers in Chennai.

Ten years ago, there were 185 students and four teachers. Now, it is 563 students and 16 teachers. As TVS' Srinivasan points out, often, there are enough schemes to assist rural development, but the money doesnot find its way to the beneficiaries and funds could lie unused in government coffers. NGOs like the SST play the role of a facilitator or catalyst in utilising the funds.

For example, the tribal village of Irulamparai near Padavedu had a problem with its roads. Their demand was for an all-weather road which would connect their hamlet to the main village. While the government put in 75 % of the fund for the roads, the SST chipped in with the remaining to complete the road. SST's volunteers have also started a literacy movement in this remote hamlet. Using a TCS software, 67 women have become literate in 3 months. As each letter in the monitor flashes, the women shout it out and then the entire word. Seeing the women folk progress, men in that area have also started seeking literacy classes while parents' have now have started sending their kids to schools.

Funding Is No Constraint

Meanwhile, given its track record, the SST had applied for a grant from the Ford Foundation, and the latter sent a team to assess the opportunity of a micro-watershed project at Padavedu. What resulted was a $2,00,00 grant. The project aims to generate economic activity from water conservation.

Afforestation and soil conservation are also on the agenda of the project to be completed in 3 years. This, along which is an expected aid of Rs. 60 lakh from Nabard for the Irumbilli watershed project in the region is extremely important for the local, in the water-starved region, many of whom still depend on agriculture for their livelihood, Since 1999, SST, along with the department of rural development, has spent around Rs. 2 crore to develop infrastructure such as roads, bridges, drainage systems, drinking water and school buildings.

Padavedu has been the model for the SST's activities, Says Joshi: "When the local community empowers itself, we can withdraw to a certain extent though we will still need to intervene, to give them suitable managerial inputs." He sees this happening in the next 3 years when the village would have acquired a certain level of development. SST's work has also gained momentum in other parts of Tamil Nadu. In Thirukkurungudi in Tirunelveli, where the TVS family hails from, the NGO revived self-help groups among the local community and re-started traditional occupations' like *appalam* making. Now, through the efforts of the SST, SHGs from there have bagged an order to supply one tonne of *appalams* to SEWA.

Further north in Hosur, around TVS Motor's factory, SST has helped local women's groups to invest and grow a business in supplying chapathis to factories around Hosur. The NGO helped set up three SHGs of l5–18 people each and together they produce 14,000 chapathis a day to supply to various factories in the area; the plan is to scale it up to 1 lakh a week. The business has become self-sustaining now and each person is able to earn roughly Rs. 1400 a month. Earlier, they were all agricultural labourers.

Rehabilitation of Earthquake Affected Village

With a view to responding during crisis and disaster situations, the Trust has always taken a lead. The Gujarat rehabilitation project at Goyersama village has been completed with a holistic approach. It is not only building bricks and mortar, but also putting people on the rails of livelihood has been the focus of the Trust.

Relief Land Rehabilitation Works to the Tsunami Affected Areas

SST was one of the earliest NGOs to provide succour and support to fisherfolk when the killer waves of Tsunami hit ferociously the unsuspecting people who lived by the sea, on December 26, 2004.

1. 48,000 food packets were supplied in Chennai, Colachel and Radhapuram from December 26 to December 30, 2004.
2. A population of 15,000 have benefited in Cuddalore, Nagapattinam, Colachel and Radhapuram by receiving clothing, utensils, stoves, blankets etc. These were donated by the employees of Sundaram-Clayton Limited and TVS Motor Company Limited.
3. A team of 74 persons led by 4 doctors were deployed to the 4 districts. Medical attention and medicines were provided to over 18,000 people. Prevention against cholera and tetanus had been administered.
4. Around 655 temporary shelters were completed and handed over in Chennai (200), Keelmoovarkarai (155) and in Poompuhar (300) villages of Nagapattinam district.
5. About 50 Community toilets were constructed in Keelmoovarkarai and Poompuhar.
6. An expenditure of Rs. 60 lakhs has been incurred in the relief work.
7. The SST has a plan to adopt a cluster of villages around Keelmoovarkarai village in Sirkazhi block of Nagapattinam district for holistic development. The total population expected to be covered is around 26,000.

CONCLUSION

The above analysis of the multidimensional work carried out by the Srinivasan Services Trust exemplify clearly how corporates can do wonders if they pool their material and human resources to promote the welfare of the community. In this case, TVS Motor Company Ltd, and Sundaram Clayton Ltd, by forming a Trust, motivating its workers, funding their activities, and helping them join hands with other NGOs and government departments, have helped to rejuvenate a sizeable part of Tamil Nadu's rural economy. The Trust has adopted a multi pronged approach and has been trying to address various issues and problems which the rural economy faces. They have found that if there is a strong will, desire and commitment to uplift the poor, resources are not a constraint and an unstinted co-operation of the rural folk can be taken for granted. The excellent work done by the Srinivasan Services Trust of TVS Group Companies is a model of Corporate Social Responsibility worth emulation by other Indian corproates. In recognition of the excellent humanitarian work rendered by the TVS Motor Company Ltd and for being a role model to other corporates and the community at large by showing exemplary commitment and involvement in the welfare of the underprivileged sections of society, far beyond the call of its duty and responsibility, the Loyola Institute of Business Administration (LIBA) conferred on the company the prestigious Mother Teresa Award for Corporate Citizen on March 31, 2004, in a glittering function presided over by M. Damodaran, Chairman, the Securities and Exchange Board of India, the Indian capital market regulator.

DISCUSSION QUESTIONS

1. Discuss the growth and the current profile of the TVS group of companies.
2. Explain the formation of the Srinivasan Services Trust. What are the multifarious CSR activities the trust is engaged in with what kind of outcome?
3. What are the different and diverse kinds of CSR activities the Srinivasan Services Trust is engaged in? Have they all contributed to the rural rejuvenation of the areas they are serving?
4. What are the various kinds of rural development activities the Srinivasan Services Trust is engaged in and with what outcome? Give suitable examples.
5. Evaluate critically the overall CSR activities of the TVS Group of Companies. To what extent are they relevant in establishing the reputation of the group?

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Case Study 11

World's Worst Man-made Disasters

(I) CHERNOBYL NUCLEAR DISASTER

The Unfolding of the Tragedy

At 1.23 a.m. on 25–26 April 1986, the world's worst nuclear power accident occurred at Chernobyl in the former USSR. The Chernobyl nuclear power plant, located 80 miles north of Kiev, had four reactors and whilst testing reactor number 4, several safety procedures were disregarded by the workers. This caused a chain reaction in the reactor that went out of control creating explosions and a fireball blowing off the reactor's heavy steel and concrete lid. The accident killed more than 30 people immediately, and as a result of the high radiation levels in the surrounding 20-mile radius caused by the accident, 13,500 people had to be evacuated. The spread of radiation from the plant damaged the Eastern European agriculture. This resulted in the Soviet Union to take the responsibility to pay for all the damage done to the EE agriculture, as the European Community banned their produce for 90 days.

The main factor that caused a lot of contamination and most of the European Countries to be concerned was the cloud of smoke and debris that travelled through Europe, affecting especially the eastern parts of Poland as well as parts of the Federal Republic of Germany. Most of the contamination was caused by the fallout from the plume as it went over Eastern Europe.

What Caused the Disaster?

The Chernobyl disaster was caused by a combination of several unfortunate factors such as: (i) the lack of a safety culture amongst those who organised and administered the plant, (ii) a communication breakdown between those who carried out the test and those who operated the nuclear reactor, (iii) the inherent design fault in the RBMK Reactor and (iv) violation of safety procedures—while running a test of the reactor, numerous safety procedures were violated by the station technicians.

The Damages Caused by the Disaster

The Chernobyl tragedy caused terrible damages such as: (i) Disastrous impact on population inasmuch as the birth rate in many of the affected regions began to decline rapidly following the Chernobyl accident. In the Gomel region in Belarus, the birth rate fell by 44%, mortality rate increased by over 60% and natural population growth was so badly affected that it came down from +8% to –5%; (ii) Various studies conducted by international welfare organisations found that the affected population in Belarus, Ukraine and Russia suffered from several health disabilities, and the situation had been *worsening* at frightening speed. In 1991, the Ukrainian government had registered around 2000 individuals with "disabilities connected with the Chernobyl disaster," but their number had risen to almost 100,000 by January 2003. (iii) Studies also showed "children developing severe depression and suicidal tendencies" and were treated by the mobile team of psychologists. There was also a dramatic increase in thyroid cancers. (iv) Beyond the devastating consequences for the living, the impact of Chernobyl has had adverse hereditary effects with a significant increase in Down's syndrome and other diseases. (v) After the Chernobyl accident, radioactive material was widely dispersed and its adverse effects were practically felt all over the northern hemisphere.

Call for More Compensation

Hundreds of survivors of the Chernobyl nuclear disaster marched in April 2005 in the Ukrainian capital, Kiev, demanding greater compensation from the government. As described earlier, 19 years ago, reactor No. 4 at the power station exploded sending radioactive fallout across Ukraine, Belarus, Russia and northern Europe. At least 3.3 million Ukrainians were affected by the blast, 100 km north of Kiev. The average monthly compensation for those directly affected rarely exceeded the equivalent of $50. About 700 persons joined the march, organised by the Ukrainian Chernobyl Union, a pressure group for survivors. Some bore placards with the slogans "Chernobyl is closed.

Are the problems of Chernobyl forgotten?" The group is to ask Parliament for a 10-fold increase in payments, yet doubts its request will be heeded. "We are already tired of hoping for better ... it seems the Government does not have such money", one victim Tamara Tikhonova (68) said. The move is the first serious effort to force Ukraine's newly elected President, Viktor Yushchenko, to tackle the disaster's legacy. It comes amid growing financial problems at the plant, which owes $6 millions in unpaid wages and electricity bills.

The Chernobyl disaster was a landmark in the history of nuclear power generation and its use for peaceful purposes. The widespread damage that was caused by the disaster prompted Soviet Russia and other countries including India to put in place adequate safety measures, rectify design faults that led to such accidents and improve the internal communication systems to avoid the confusion and the resultant calamity when accidents do take place.

(II) EXXON VALDEZ

How did it occur?

On 24 March 1989, a 987-foot oil-tanker called the Exxon Valdez, carrying about 11.48 million barrels of crude oil was on its way to California. Shortly after leaving the Port of Valdez, the Exxon Valdez ran aground on Bligh Reef. As a result, on 26 March, 10.8 million gallons of the crude oil was spilled into the harbour, making it the largest tanker spill in the American history. The oil did not burn and it proved to be very difficult to remove the same from the surface of the sea. The oil spill swept ashore along a 750-km trajectory that ran from Prince William Sound to the southern Kodiak Archipelago and Alaska Peninsula.

The spill severely affected several species of sea born animals, Alaska's fisheries, national forests and parks and caused a major decline in tourism, and had severe psychological effects on the human population who lived there. The death toll in terms of wildlife was staggering, the full impact of which could never be assessed.

What Caused the Disaster?

The spill was said to have been caused due to the Exxon Shipping Company not providing a rested and sufficient crew for the Exxon Valdez. It was found that there was inadequate equipment, poor personnel training and lack of effective pilotage services. The grounding of the Exxon Valdez oil tanker was due to the failure of the third mate to maneuver the vessel properly because of fatigue and excessive workload, and the failure of the master to provide a proper navigation watch due to heavy drinking. The combined results of all these failures was an enormous tragic oil spill that had a huge impact on not only all living creatures, but also the entire region.

Impacts of Exxon Oil Spill

The Exxon Valdez oil spill had great impact on trade, the Alaskan fishing industry and on the lives of the fishermen and native Alaskans who lost together more than an estimated $1 billion. The native fishermen are said to have lost a total of $580.4 million since the oil spill tainted the reputation of Alaskan salmon and $154.8 million more due to damage to the ecosystem and depleted fish stocks.

The Alaskan tourism industry was also adversely affected significantly by the spill, reporting substantial financial losses. The business segments most negatively affected by the spill included lodges and resorts, Alaska-based package tour companies, guided outdoor activities, charter and sightseeing boats. As for long term effects, many in the industry opined that Alaska's reputation for a pristine natural environment is tarnished for ever.

What Happened to the Spilt Oil?

According to American researchers who made a detailed study of the oil spill: (i) approximately 14% of the oil was recovered or disposed off by clean-up processes, (ii) the largest proportion of the oil-between 70–85%—either evaporated or broke up by photolysis or biodegradation in water. But, many of the heavier organic compounds remain as solid residues on the beaches and (iii) this still leaves 15–20% of the oil being around Prince William Sound and the Gulf of Alaska untraced.

The "Recovery" Settlement

The initial cleanup of the spill took three years, and the cost was over $2.1 billion to the US Government. On 8 October 1991, an agreement was reached between the State of Alaska, the Federal Government, and Exxon on both claims of criminal charges and civil damage. In settlement of civil charges, Exxon was asked to pay the State of Alaska and the Federal Government $900 million over a 10-year period for restoration purposes. The amount is to be administered by six government trustees; three federal, three state. In settlement of criminal charges, Exxon was asked to pay a fine of $250 million. Two "restitution funds" of $50 million each were established, one under state control and the other under federal authority. Against strong opposition from many Alaskans, $125 million of the balance was forgiven due to Exxon's cooperation during the cleanup, and upgraded safety procedures to prevent a reoccurrence. The remaining $50 million was divided between the Victims of Crime Act account ($13 million) and the North American Wetlands Conservation Fund ($12 million).

(III) TOKIAMURA ACCIDENT

Accident in a Nuclear Fuel Factory

On 30 September 1999, a severe accident occurred at a nuclear fuel factory run by JCO, a subsidiary of Sumitomo Metals and Mining in the village of Tokiamura, 130 km northeast of Tokyo. A total of 119 people received a radiation dose over 1 msv from the accident, but three operators' doses were above permissible limits. Of the three workers who received high doses of radiation in the plant preparing fuel for an experimental reactor, two of the doses proved fatal.

The Cause of the Accident

The accident was caused by bringing together too much uranium enriched to a relatively high level, causing a "criticality" (a limited uncontrolled nuclear chain reaction), which continued intermittently for 20 hours. According to the United Nation's monitoring body, the International Atomic Energy Agency (IAEA), the accident "seems to have resulted primarily from human error and serious breaches of safety principles, which together led to a criticality event". The company conceded that it violated both normal safety standards and legal requirements. Criminal charges were filed against the company.

The Occurrence of the Accident

On the fateful day of 30 September 1999, three workers were preparing a small batch of fuel for the JOYO experimental fast breeder reactor, using uranium enriched to 18.8% U-235. It was JCO's first batch of fuel for that reactor in 3 years, and no proper qualification and training requirements appear to have been established to prepare those workers for the job. At around 10:35, when the volume of solution in the precipitation tank reached about 40 litres, containing about 16 kg of uranium, a critical mass was reached.

The accident occurred when workers preparing nuclear fuels mixed uranium oxide with nitric acid using a stainless steel container instead of a mixing apparatus. This shortcut was described as an illegal act by the operating manual drafted by the company. The shortcut had been used for 7 or 8 years before the accident occurred, to save costs and to be more competitive with foreign fuel suppliers. The three workers were performing this task for the first time and were wearing t-shirts instead of protective clothing and the required film badges to measure radioactive exposure.

The Impact of the Accident

The company did not have any emergency plans in place for handling such critical accidents. Families living near the plant were temporarily evacuated and 300,000 people were asked to stay indoors for more than a day. Afterwards, employees and people living around the facility were tested for radioactive contamination; which showed that 63 people as having been exposed, amongst them 14 workers of JCO (who poured boron into the reaction vessel to help put out the nuclear chain reaction) and the two victims who later died. The three workers concerned were hospitalised, two in a critical condition. One died 12 weeks later, another 7 months later. The three had apparently received full-body radiation doses.

Those who were exposed to the radiation may be affected badly because it could cause a range of cancers, particularly leukaemia; genetic damage, particularly to an embryo or foetus; and damage to the immune and nervous systems.

Case Study 12

Bhopal Tragedy: Mother of All Industrial Disasters

The Unfolding of the Tragedy

On the night of 3 December 1984, the greatest industrial disaster in the history of the world unfolded itself in a dangerous chemical reaction that occurred in the Union Carbide factory when a large amount of water (500 litres) got into the MIC storage tank 610. The poisonous gas methyl isocyanate (MIC), used in producing the pesticide, Sevin, leaked from the plant. The leakage was first detected by workers by about 11:30 p.m. when their eyes began to tear and burn. They informed their supervisor who failed to take action until it was too late. The factory alarm meant for workers was sounded by a desperate worker at 12.50 p.m. The management not only turned it off, but also delayed the sounding of the public siren until as late as 2 p.m. by which time, about 40 tonnes of MIC, poured out of the tank and escaped into the air, spreading over the city of nearly 900,000 people. More than 3500 people were killed in their sleep or as they fled in terror, and about 400,000 remain injured or affected to this day. The most seriously affected areas were the "squatter settlements" and the densely populated shanty towns surrounding the plant. The victims were almost entirely the poorest members of the population.

The Enormous Human Tragedy

This poisonous gas caused death and left the survivors with lingering disability and diseases. Not much is known about the future medical damage of MIC, but according to an international medical commission, the victims suffered from serious health problems that were being misdiagnosed or ignored by local doctors.

Exposure to MIC resulted in a variety of problems among the victims. These include damage to the eyes and lungs causing respiratory ailments such as chronic bronchitis and emphysema; gastrointestinal problems such as hyperacidity and chronic gastritis; ophthalmic problems such as chronic conjunctivitis, early cataracts and vision problems; neurological disorders such as memory and motor skills; psychiatric problems of various types including varying grades of anxiety and depression; musculoskeletal problems and gynecological. It is estimated that children born in Bhopal after the disaster face twice the risk of dying as do children elsewhere, partly because parents cannot care for them adequately. Surprisingly enough, despite the serious health problems and the deaths that had occurred, Union Carbide claimed that the MIC was merely a "mild throat and ear irritant".

The Genesis of the Problem

The Bhopal facility was set up as a means to promote India's Green Revolution that aimed to increase the productivity of crops. Considered an essential input in the effort to achieve self-sufficiency in agricultural production, pesticide manufacture and use increased dramatically during the late 1960s and early 1970s. The decision to manufacture pesticides in India, as opposed to relying on imports, was based on India's policy of preserving foreign exchange through import substitution.

Until 1979, the Indian subsidiary of the American Union Carbide Corporation (UCC) used to import methyl isocyanate from the parent company. In 1969, UCC, the parent company, set up a small plant through its subsidiary, Union Carbide India Ltd. (UCIL), in Bhopal, the capital city of Madhya Pradesh, to produce pesticides. Bhopal was chosen as the site for the Carbide plant because of its central location in India, a railway system that spanned the country, a large lake which provided a reliable source of water, and sufficient electricity and labour to sustain a large-scale industrial plant. The MIC facility was located in the existing Carbide plant to the north of the city, adjacent to an existing residential neighbourhood, barely two kilometres from the railway station. After 1979, UCIL started to manufacture its own MIC, which is one of many "intermediates" used in pesticide production and is a dangerous chemical. It is a little lighter than water but twice as heavy as air, implying that when it escapes into the atmosphere it remains close to the ground. It has the ability to react with many substances: water, acids, metals, and the small deposits of corrosive materials that accumulate in pipes, tanks and valves. The MIC produced in the Bhopal factory was used for the production of various pesticides, mainly Sevin brand carbaryl insecticide and Temik brand aldicarb pesticide. All the pesticides produced at UCIL were sold in the Indian market.

A Tragedy of Errors

The Bhopal disaster was the result of a combination of legal, technological, organisational and human errors. The immediate cause of the chemical reaction, as mentioned earlier, was the seepage of water into the MIC storage tank. The results of this reaction were exacerbated by the failure of containment and safety measures and by a complete absence of community information and emergency procedures. Ironically, in Bhopal, people living around the Union Carbide plant were warned of potential hazards in a series of local newspaper articles, but residents ignored these warnings because they did not know how to react to them, while local officials dismissed them as sensational reporting. The long-term effects were made worse by the absence of systems to care for and compensate the victims.

Tragedy That Was Waiting to Happen

Though the disaster occurred suddenly and without immediate warning, it was not totally unexpected. There is evidence which supports the view that Carbide (both the parent company and its Indian subsidiary) was a negligent company that failed to improve its deteriorating plant. A report (May 1982) of the Indian subsidiary conducted by a three-member safety team from the Union Carbide headquarters in the US mentioned there was "a serious potential for sizeable releases of toxic materials in the MIC unit either due to equipment failure, operating problems, or maintenance problems thus requiring various changes to reduce the danger of the plant; there is no evidence the recommendations were ever implemented".

Furthermore, "Carbide persistently shows 'wanton and willful disregard for the health and safety of its workers and the communities in which it operates" (New Statesman and Society, "Surviving..." p.5). A scientific report published by two US organisations, the National Toxic Campaign and the International Council on Public Affairs, asserted that Union Carbide continued to be "a major discharger of toxic substances into the environment, and a major generator of hazardous waste'. In 1988, the company generated more than 300 million pounds of hazardous waste—an increase of 70 million compared with 1987". Safety standards and maintenance procedures at the plant had been deteriorating and being ignored for months. There were five safety devices installed in the plant to prevent a mishap like the one that happened in December, 1984: a vent gas scrubber, a flare tower, a water curtain, a refrigeration system, and a spare tank. All of these devices were under repair, or failed to operate on that fateful day. The following defects of the MIC unit were unearthed by various investigations on the tragedy.

- Gauges measuring temperature and pressure in the various parts of the unit, including the crucial MIC storage tanks, were so notoriously unreliable that workers ignored early signs of trouble.
- The refrigeration unit for keeping MIC at low temperatures (and therefore less likely to undergo overheating and expansion should a contaminant enter the tank) had been shut off for sometime as part of the company's economy drive to save about Rs. 700 per day. Had the refrigeration unit been working, a runaway reaction in the MIC tank could have been delayed or even prevented.
- Another cost-cutting measure included substantial reduction in the workforce at the factory. By 1984, the size of workers was brought down by half from that of 1980. The work crew for the MIC plant was cut by half by then. The maintenance crew was brought down to 2 from the initial 6 workers. In the control room, there was only one operator who was expected to monitor 70 odd panels, indicators and controllers on the console. Worse still, the period of safety training to workers in the MIC plant was brought down from 6 months to 15 days.
- The gas scrubber, designed to neutralise any escaping MIC, had been shut off for maintenance. Post-disaster inquiries revealed that even if it had been operative, the maximum pressure it could handle was only one-quarter of what actually reached during the accident.
- The flare tower, designed to bum off MIC escaping from the scrubber was also turned off, waiting for replacement of a corroded piece of pipe. The tower, however, was inadequately designed for its task, as it was capable of handling only a quarter of the volume of gas released during the accident.
- The water curtain, designed to neutralise any remaining gas, was too short to reach the top of the flare tower, from where the MIC was billowing.

- The alarm on the storage tank failed to signal the increase in temperature on the night of the disaster showing the lack of effective warning systems.
- MIC storage tank number 610 was filled far beyond the recommended capacity.
- The maximum permissible storage limit for MIC is only half a tonne in US and Europe. But the management of US Carbide overruled the advice of the managers of its Indian subsidiary and kept the storage capacity hazardously high at over 90 tonnes. On the night of the disaster, 67 tonnes of MIC were stored in the company's two tanks.
- A storage tank which was supposed to be held in reserve for excess MIC, already contained too much MIC;
- The Union Carbide Corporation adopted double standards with reference to the Bhopal factory. At its Western Virginia plant at Institute, all the vital systems had back-ups and were automatically linked to computerised alarms and crises control systems. The Bhopal unit not only lacked these precautionary measures, but the sole manual alarm was also switched off so as not to 'unduly' alarm people.
- Notwithstanding all these problems that existed, Carbide was able to operate its deteriorating plant because industrial safety and environmental laws and regulations were either lacking or were not strictly enforced by the state of Madhya Pradesh making it indirectly responsible for the tragedy in Bhopal.

Carbide's Refusal to Take the Blame

Interestingly enough, Carbide tried to hide its poor safety and maintenance record along with the other faults mentioned already, by claiming publicly that the company was the victim of sabotage by a 'disgruntled employee'. Yet, Carbide did not release the name of this employee or bring charges against him/her till today. The comments made by Carbide officials rubbed salt to the wound. Dr. Loya, Union Carbide's resident official doctor, commenting on MIC after the tragedy, said: "It is not a deadly gas, just irritating, a sort of tear gas". "The numerous safety systems with which this type of plant is equipped enable us to control any of the MIC's potentially dangerous reactions", observed another company official, making a mockery of the tragedy. The Union Carbide Corporation also tried to wriggle out of the situation by saying that it controlled only 50.9 per cent stake in UCIL, that the Bhopal Plant was exclusively manned by Indians and that the day-to-day functioning of the Indian company was independent of the parent company, and such being the case, it could not be held responsible for the gas leak. The company also charged the government of India and the state of Madhya Pradesh with "contributory responsibility" for the gas leak, since they knew fully well the toxicity of MIC, and yet failed to take adequate precautions to prevent the disaster.

The Legal Wrangling

International law at present plays almost no role in a Bhopal tragedy type of event in which the perpetrator company's headquarters is located in one country and the victims belong to another. Moreover, substantive international law remains weak in the area of pollution, industrial hazards, and multinational business regulation.

The Bhopal disaster gave rise to the world's largest lawsuit, one that spanned half-way around the world and dragged on for more than seven years to settle basic issues. Lawsuits were filed in both US and Indian courts, but ultimately it was decided that the case should be tried only in an Indian court. Lawsuits filed in US courts were refused on the grounds that the immediate location of the accident was in India, the victims were all Indians, and the US connection with its Indian affiliate did not appear to give it an unusual degree of control.

Following the disaster, the government of India passed the Bhopal Gas Leak Disaster (Processing of Claims) Act 1985, which authorised the central government to represent all claimants in appropriate forums, to appoint a Welfare Commissioner and other staff and to discharge duties connected with hearing of the claims and distribution of compensation. Under this Act, the government formulated a scheme known as the Bhopal Gas Leak Disaster Scheme, for registration, processing, and determination of compensation to each claim and appeals arising therefrom.

Since the tragedy, the victims have waged an "unrequited struggle for justice, but they have been ill-served by the Indian government, which failed to pursue the victims' cases aggressively in the Indian courts, opting instead to go easy on Union Carbide and maintain a favourable investment climate". By deflecting responsibility for the disaster to the

Indian government, Union Carbide managed to escape its obligations. By constantly downplaying the damage to limit its liability, it has shown its ethical and moral bankruptcy. Union Carbide has now merged with Dow Chemicals, resulting in the creation of the world's biggest chemical company. Dow showed no sign of taking responsibility for the Bhopal legacy.

An important aspect in this case is the apparent difference in behaviour of a company in a rich "Western" country which has relatively strict rules protecting people and the environment, and the disappointing behaviour of the same company in "poor" countries where the laws are lax and hardly enforced. The case shows that the global markets make it possible for corporations to practise double standards, misusing lax standards in poorer countries to save on costs and to maximise profits.

Issues of jurisdiction were central to the legal battle that followed the tragedy. These centered around the relationship of the parent Union Carbide Corporation to its Indian subsidiary and the appropriateness of the place where litigation was being conducted. Union Carbide Corporation maintained that its subsidiary was separate from the parent company and so only the subs should be liable instead of the parent corporation. The Indian government's petition argued that insofar as Union Carbide designed, constructed, owned, and operated the plant from which the chemical escaped, the company should be held absolutely liable for all the resulting damage. It was further argued that the company, in undertaking an activity that it knew was ultra-hazardous to the public at large, was strictly liable for the harm which was the material consequence of such activity, regardless of whether the harm that resulted was through the fault of another or its own negligence. It was also pointed out that the company was negligent in designing, constructing, operating and maintaining its plant and thus failed to exercise its duty of care to protect the public from the dangers inherent in its plant and processes.

With regard to process standards, it was apparent that Union Carbide adopted double standards when operating its plant in India and in West Virginia. An investigation of both the UCIL plant in Bhopal and its counterpart in Institute, West Virginia revealed that "while the latter plant had computerized warning and monitoring system, the former relied on manual gauges and the human senses to detect gas leaks. The capacity of the storage tanks, gas scrubbers and flare tower was greater at the Institute plant. Finally, emergency evacuation plans were in place in Institute, but nonexistent in Bhopal".

The Aftermath of Bhopal Disaster

More than twenty years after this tragic disaster, the legacy of poisoning continues. Even today chronically-ill survivors remain in desperate need of medical attention. Thousands of survivors and the children born since the disaster continue to suffer debilitating health problems. Many are unable to work. The now abandoned chemical plant is a toxic hotspot, strewn with toxic wastes and materials that have been either dumped or haphazardly stored in rotting sacks and barrels. A survey conducted by Greenpeace International revealed substantial, and in some locations, severe contamination of land and drinking water supplies with heavy metals and persistent organic contaminants in and around the plant. There is evidence that the residual contaminants have migrated off-site, creating new problems, including contamination of groundwater used by families living near the site for their daily drinking and washing needs.

The Settlement

The delay lasting more than twenty years in delivering final compensation to the victims has further aggravated the suffering of the victims. Other elements of relief ordered by the Supreme Court of India such as the medical surveillance programme, the contingency insurance and the establishment of a new hospital have not been implemented. There has been much dissent, and several organisations have voiced that the settlement with Union Carbide for a paltry sum made on behalf of the victims by the Indian government should be voided.

By the end of 2004, Union Carbide, now a fully-owned subsidiary of Dow Chemicals, agreed to pay $470 million to the Government of India as settlement against the $3 billion damage sought by the government of India, thus avoiding any damaging legal precedent or liability. In return, Supreme Court of India ordered the dismissal of all civil and criminal charges against Carbide and its officers, and gave them immunity from future prosecution. The Supreme Court felt that in this case, the victims needed immediate relief. Although the final settlement ($470 million) satisfied the imperatives of the company and the Government

of India, it was condemned by the victims. Activists in Bhopal denounced the settlement as a betrayal of the 20,000 victims who still suffer from exposure to the deadly gas that escaped from the pesticide plant. More than 500,000 claims for compensation have been filed. The government itself has spent more than $70 million on relief and health care for victims. "Justice delayed is justice denied." It is well-known that India has one of the world's slowest judicial systems. But for more than half a million victims of the Bhopal Union Carbide chemical tragedy, it is better late than never. It has taken them nearly 20 years to get partially compensated.

The petitioners representing the Bhopal tragedy victims argued that the Indian court had no authority to dismiss criminal charges or grant immunity against future charges to Union Carbide since pleas bargaining is not permitted under the Indian law. The petitioners also argued that while the settlement amount was based on an estimated 40,000 severely injured victims, medical studies suggested the number may be closer to 400,000. Also, many medical experts believe that liability to provide adequate compensation and facilities for the handicapped victims requiring long-term follow-up and treatment should rest with Union Carbide Corporation and not with the Indian Government. Moreover, more than 250,000 claims were never documented or classified, making it hard for these victims to obtain compensation. Much to the anger and outrage of these groups and victims and to the relief of Union Carbide, the Supreme Court of India upheld the Bhopal settlement of $470 million dollars in October 1991. Many feel that this is a clear signal from the Indian government that MNC's investing in the country will receive only a "slap on the wrist" in the event that something like this happens again.

The Supreme Court ordered $325 million to be paid to more than 566,000 survivors and dependents, who still had not received compensation 20 years after methyl isocyanate gas began leaking from the Carbide pesticide plant.

After the initial relief was paid out, the Supreme Court directed the government to hold the balance of the money in the Reserve Bank. That fund has earned interest and increased the value of the original deposit, which would be distributed to the victims on the basis of the formula worked out by the government. Dow chemicals, which owns Union Carbide, has been criticised by activists for doing little to clean up the contaminated site, failing to release information about the gas to the doctors who need to provide patients with better treatment, and providing inadequate compensation to survivors and their families. "When Dow Chemical bought Union Carbide two years ago, it inherited not only its assets but the liability and karma attached to Carbide's lack of accountability for the Bhopal chemical disaster," said Gary Cohen of Environmental Health Fund in a statement about the shareholder resolution released by International Campaign for Justice in Bhopal. A $470 million compensation package provided by Union Carbide amounts to approximately nine cents per day per person over the 19 years since the incident occurred, "a pathetically inadequate amount, given the economic and health needs of the survivors," says the campaign's Tim Edwards. If the compensation amount was to be equally distributed, it would work out to be a paltry sum of Rs. 10,000 per victim. Contrast this with what the US spent on the rehabilitation of the Alaska Oil Spill. According to a report in the Times of India, the US spent approximately $40,000 on the rehabilitation of each sea otter, besides giving rations of lobsters worth $500 per day. Besides, the compensation package does not include money to clean up the contaminated site, nor does it include compensation for the tens of thousands of 'second generation victims' who were born after the disaster but suffer severe birth problems.

More Time for Compensation

The Supreme Court on 25 April 2005 extended the time limit till 30 April 2006 for the Welfare Commissioner, Bhopal, to disburse the compensation amount of Rs. 1,503 crore to over five lakh victims of the Bhopal gas tragedy.

The court by an order on 15 November 2004 had directed that the money deposited by the Union Carbide, following a settlement with the Union Government should be disbursed to 5,72,000 claimants within three months by the Welfare Commissioner, In February, the time limit was extended till 30 April 2005.

In his fresh application, the Welfare Commissioner submitted that in the three months up to 11 February, the amount had been disbursed only to 78,938 claimants to the tune of Rs. 224 crores in view of the complex nature of the identification process. He said due to shortage of judges, only 25 could be entrusted with the disbursement of compensation.

The commissioner pointed out that initially the payment of compensation to 5,72,029 gas victims

was carried out in a span of more than 12 years. In the action plan submitted, it was stated that the pro rata amount could be disbursed to the claimants within six months. He agreed that "some tall claims were made, but due to practical difficulties the target that was proposed could not be achieved." He further said more than 20 to 30 per cent of the claimants were not available, as their whereabouts are not known. Despite efforts none was appearing for those claimants, and therefore, he sought one more year to settle the compensation amount. A bench of the Supreme Court, comprising the chief justice, accepted the request of the Commissioner.

CONCLUSION

Even as society appears to be getting increasingly corrupt and criminal, many are beginning to realise that one can not aspire to create value without deeply cherishing a sense of values. To add a lot of interest to one's principles, one needs to stick to one's principles. To sustain one's competitive advantage in an increasingly competitive corporate world, one needs character. Morals are more important than money, materials, marketing and management.

Capitalism is still the most promising and working economic system, but surely every thinking individual would have already questioned its rapacious destruction of the environment and of the individual by generating and fulfilling an endless amount of human wants. Capitalism is dominated by the profit motive and promotes "Mammon-worship". This is an amoral motive, which allows one to hire and fire workers to suit one's convenience, big corporations to swallow smaller companies, to send one's toxic waste into Third World countries, to patent nature's bounty, to overprice one's product, to destroy the environment, and so on.

The victims of this tragedy, and their international support groups, continue to strive for justice. They believe that this is not the final judgment on Bhopal and are determined not to give up. The International Campaign for Justice in Bhopal (ICJB) has decided on having "hope" and "rebuilding" as their motto for the 20th anniversary of the gas disaster with hope for a safer world — a world with no more Bhopals.

DISCUSSION QUESTIONS

1. What were the factors that caused the Chernobyl Nuclear Disaster? What were the consequences of the nuclear tragedy?
2. Explain the Exxon Valdez disaster. What happened to the spilt oil? How was it retrieved?
3. Discuss the occurence of Tokiamara Accident. Also explain the impact of the accident.
4. Why was the Bhopal gas tragedy nicknamed as the mother of all industrial disasters? Also trace the genesis of the problem and the ultimate consequence.
5. Discuss the aftermath of the Bhopal disaster and the issues relating to compensation to victims.

Case Study 13

Ketan Played Around with Others' Money

(This case is based on print and electronic reports and is meant for class room discussion only. The author has no intention to tarnish the reputations of corporates or individuals).

Ketan Parikh is a notorious name in the annals of India's securities market. He used an ingenious technique to get public funds for his price-rigging operations. As the *Indian Express* reported, Ketan Parekh had close to Rs. 2000 crore to play around with during the month prior to his arrest in 2001. Securities and Exchange Board of India's (SEBI) preliminary enquiry unearthed the fact that Ketan got around Rs. 670 crore from corporations such as Zee and HFCL whose shares he was ramping up. Both Zee and HFCL had raised this money for business purposes but diverted it to Ketan unauthorisedly. Though Zee reported that it gave funds to Ketan to buy a stake in entertainment firm ABCL and television channel B4U, both these firms denied that they were selling their stakes to Zee. Ketan had also borrowed Rs. 250 crore from Global Trust Bank, against the Reserve Bank of India's (RBI) norms. He was ramping up GTB's shares too with a view to getting a good deal at the time of its expected merger with UTI Bank. Ketan and his associates got another Rs.1000 crore from the Madhavpura Mercantile Co-operative Bank despite the fact that RBI regulations ruled that a broker could get a maximum loan of Rs.15 crore only.

SEBI also found that the Foreign Institutional Investor Credit Suisse First Boston was funding Ketan Parikh's operations disguising these loans by creating false records of transactions. It then charged Ketan *brokerage* fees which was actually nothing but the interest on the loans it gave him. SEBI even found evidence of how brokers acting for Ketan placed dubious sell-orders to complete the paperwork to cover their illegal operations. SEBI also found out evidence that there was a big bear cartel in the market and that one of them, Shankar Sharma, was closely linked with Tehelka.com—he owned a large part of the dotcom. The allegation was that Sharma was short-selling shares since he knew there was going to be a major expose that would shake the government and hence the country's stock markets.

Ketan's Modus Operandi

Ketan's *modus operandi* was to ramp up shares of select firms in collusion with their promoters. In the Ketan 2001 Scam case, SEBI found *prima facie* evidence of price rigging in the scrips of Global Trust Bank, Zee Telefilms, HFCL, Lupin Laboratories, Aftek Infosys and Padmini Polymer. Though UTI denied any link with Ketan, it was found that UTI's purchases almost aligned with Ketan's buying in what are called the K-10 stocks, or those stocks that Ketan had been buying. UTI also purchased hitherto unknown stocks such as Arvind Johri's Cyberspace Infosys—Cyberspace interestingly, was the erstwhile Century Finance, which changed its name like many others, to sound infotech in order to take advantage of the boom in infotech stocks. Market rigging was found to be so obvious that the Bombay Stock Exchange (BSE) began investigating the sudden rise in prices of Cyberspace which sky-rocketed to Rs. 1450 within a few weeks of its launching. However, its value fell below par as the investigation had started.

The Scam's Impact on the Market

The most frightening aspect of the entire scam, of course, was how long it had been going on unsuspected and unchecked, and how long it took to discover the fraud. More damaging was the fact that SEBI's Regional Chief in charge of surveillance cautioned BSE's officials about Johri's powerful connections and asked them to go slow on the investigations. If the markets had not crashed after the budget, the then Finance Minister Yashwant Sinha would not have insisted on a thorough probe, and chances were that life would have continued the way it was.

CONCLUSION

In almost all such scams, the public were told that it was a "system failure", that it was not just individuals who erred, it was the system that failed. While that sounds like the classic rogue's defence, it remains sadly true. For every possible system that could fail did so in this particular case, either by design or by default. Moreover, as usual, the cautious investigation and the long legal procedures, even when the entire market was aware of Ketan Parikh's and his accomplices' wrongdoings, proved that "delayed justice meant denied justice" to the hapless investors whose confidence in the securities market was rudely shaken once again.

DISCUSSION QUESTIONS

1. Explain in your own words how Ketan Parikh used other people's money to play his game of speculation.
2. Discuss briefly Ketan Parikh's modus operandi to ramp up shares of select companies. What was the impact of the scam on the market?

Case Study 14

Problems and Issues of Corporate Governance in Emerging Economies: Russian Example

The Russian Economy in Transition

The early 1990s witnessed a dramatic transformation of the Russian economy. It started with the dismantling of the command (centrally planned) economy, which was a hallmark of the erstwhile Soviet Union. This was gradually replaced by a market-driven economy operating on the basis of market forces and private property. With the collapse of the Soviet Union in 1991, the Russian Federation became an independent country. Russia that was the largest of the fifteen republics, which made up of the pre-1991 Soviet Union accounting for over 60per cent of the GDP and half of the Soviet population, had to ensure the transition from socialism to a Laisez–Faire type of economy through a process of trial and error. Some of the former Socialist States of Central Europe began to experiment with a free market system, 2 years before Russia that has provided some insight into the effects of transition from Socialism to a free market economy but their experience could not be replicated fully in Russia as there were a number of differences between them and Russia in terms of political structure, economic institutions and cultural values. Even while experimenting with free market forces, Russia could not shake itself completely from the political culture and social structure with its Soviet past. The question of how well Russia's fragile democratic and federal institutions would fare during the transition was a question mark all through since the Russian Presidents under the free regime were unwilling to loosen the tight control they exercised over parliament, regional office holders, mass media, courts and the civil society.

Soviet Economy in Retrospect

For nearly 60 years, the economy of the Soviet Union operated on the basis of central planning—state control over virtually all means of production and investment, production, and consumption decisions throughout the economy. Economic policy was made according to directives from the communist party, which controlled all aspects of economic activity. The central planning system left a number of legacies with which the Russian economy had to deal with in its transition to a market economy.

Much of the structure of the Soviet economy that operated until 1987 originated from the time of Stalin, with only few slight changes having been made between 1953 and 1987. Centralised plans were the chief mechanisms the Soviet government used to convert economic policies into programmes. According to these policies, the State Planning Committee (*Gosplan)* formulated countrywide output targets for stipulated planning periods. Regional planning bodies then adopted these targets for economic units such as state industrial enterprises, state farms (*sovkhoz*) and collective farms (*kolkhoz*), each of which had its own specific output plan. Central planning operated on the assumption that if each unit met or exceeded its plan, then equilibrium between demand and supply could be achieved. The role of government was to ensure that the plans were fulfilled. Responsibility for production flowed from the top to the bottom. At the national level, some 70 government ministries and state committees, each responsible for a production sector or subsector, supervised the economic production activities of units within their areas of responsibility. Regional ministerial bodies reported to the national-level ministries and controlled economic units in their respective geographical areas.

The plans incorporated output targets for raw materials and intermediate goods as well as final goods and services. In theory, though not in practice, the central planning system ensured a balance among the sectors throughout the economy. Under this kind of command economy, the state performed the allocation functions that prices perform in a market system. In the Soviet economy, prices were only an accounting mechanism. The government established prices for all goods and services based on the role of the product in the plan and on other non-economic criteria. This kind of administered pricing system produced anomalies. For example, the price of bread, a traditional staple of the Russian diet, was below the price of the wheat used to produce it. In some cases, farmers fed their livestock with bread rather than grain because bread cost less. In yet another such situation, rents for apartments were set very low to achieve social equity, yet housing was in extremely short supply. Soviet industries obtained raw materials such as oil, natural gas, and coal at prices below world market levels, encouraging waste.

However, the central planning system allowed Soviet leaders to marshal resources quickly in times of crisis, such as the Nazi invasion, and to reindustrialise the country during the postwar period. The rapid development of its defence and industrial base after the war permitted the Soviet Union to become a superpower, though this was achieved at the cost of the consumer who had to do with an extremely constricted choice of goods and services and stood as a poor cousin compared to his compatriots in the capitalist countries of the West.

The old socialist system was ineffective because the economy was centrally controlled. Power was concentrated in the hands of the elite of the communist party. The ultimate goal of ***Peristroika***, introduced by Gorbachav was to increase the efficiency of material production while maintaining the essential elements of socialist society in the Soviet Union, the success of which depended on the success of glasnost. Secondly, it depended upon improved international cooperation. ***Glasnost***, or openness, has been heralded by western leaders as signifying the death of socialism. However, according to Professor Rakos, Glasnost merely signified the recognition that people must be directly involved in that which they own (for example, the country's resources). Rakos pointed out that under the old socialist system the Soviet Union's bureaucratic interests resisted changes that would have had widespread benefits, if those were potentially disadvantageous to a sub-group, say, a ministry. Thus, technology was underutilised, efficiency was meaningless because an enterprise that lost money or produced useless goods was bailed out by the state, and workers got paid independent of the quantity and quality of output. These conditions resulted in a cycle of shortages of much-wanted consumer goods, lackadaisical management in work forces, money as a facilitator weak reinforcer and of little value in work. Glasnost represented an effort to enhance worker's self-management so as to produce feelings of ownership. One example of that is the election of managers on Soviet collectives, in contrast to its western use to elect political leaders.

The second requirement for the success of Peristroika was increased international cooperation. Till its adoption, the Soviet Union's isolation has resulted in too much resources being allocated to armament production and too little international cooperation. More international cooperation could produce hard currency, raw materials, scientific knowledge, technological sophistication, and other factors that would enhance benefits for individual citizens in ways that tended to keep them working, producing high quality consumer and social goods.

Shock Therapy

To convert the worlds' largest state-controlled economy into a market-oriented system would have been extraordinarily difficult whatever the types of policies chosen. The policies chosen for this herculean task consisted of three major constituents, namely, (i) liberalisation (ii) stabilisation and (iii) privatisation.

The programmes of liberalisation and stabilisation were designed by Yeltsin's deputy prime minister Yegor Gaidar, a 35-year-old liberal economist, inclined toward radical reform, and widely known as an advocate of "shock therapy." Shock Therapy began days after the dissolution of the Soviet Union, when on 2 January 1992, Russian President Boris Yeltsin ordered the liberalisation of foreign trade, prices, and currency. This required removal of Soviet-era price controls in order to lure goods back into understocked Russian stores, removing legal barriers to private trade and manufacture, and cutting subsidies to state farms and industries while allowing foreign imports into the Russian market in order to break the power of state-owned local monopolies. The immediate results of liberalisation were hyper-inflation and the near bankruptcy of much of Russian industry.

The process of liberalisation would obviously create winners and losers, Among the winners were the new class of entrepreneurs and black marketers that had emerged under Mikhail Gorbachev's *perestroika*. But liberalising prices meant that the elderly and others on fixed incomes suffered a steep fall in living standards, and people saw a lifetime of savings wiped out.

With inflation at double-digit rates per month as a result of sudden price liberalisation, macroeconomic stabilisation was enacted to curb this trend. Stabilisation, also called structural adjustment, is a harsh austerity regime—owing to tight monetary policy and fiscal policy—for the economy in which the government sought to control inflation. Under the Russian stabilisation programme, the government let most prices float, raised interest rates to record highs to as much as 250per cent, imposed heavy new taxes, sharply cut back on government subsidies to industry and construction, and made massive cuts in state welfare spending.

The rationale of the programme was to squeeze the built-in inflationary pressure out of the economy so that producers would begin making sensible decisions about production, pricing and investment instead of chronically overusing resources as was done in the Soviet Union in the 1980s that resulted in shortages of consumer goods by letting the market rather than central planners determine prices, product mixes, output levels, and the like, the reformers intended to create an incentive structure in the economy where efficiency and risk would be rewarded, and waste and carelessness punished. According to the reformers, removing the causes of chronic inflation, was a precondition for all other reforms: Hyper-inflation would wreck both democracy and economic growth, and only by stabilising the state budget could the government proceed to dismantle the Soviet planned economy and create a new capitalist Russia. However, these policies caused widespread hardship as many state enterprises found themselves without orders or working capital. A deep credit crunch shut down many industries and brought about a protracted depression.

Obstacles to the Smooth Transition to Capitalism in Russia

A major reason why Russia's transition has been painful to a large extent is that the country launched a mammoth task of remaking both its Soviet-era political and economic institutions at one go. Equally daunting was the task of Russia in building a new national state following the disintegration of the Soviet Union. Russia faced a number of unique obstacles during the post-Soviet transition. These obstacles have left Russia on a far worse footing than other former Soviet Russia's satellite countries of the west that were also going through dual economic and political transitions, such as Poland, Hungary, and the Czech Republic. These countries, however, have fared better since the collapse of the Soviet bloc between 1989 and 1991.

In its efforts to transform itself as a capitalist economy, Russia faces the following problems:

(i) One major problem facing Russia is the legacy of the Soviet Union's enormous commitment to the Cold War. In the late 1980s, the Soviet Union was estimated to have allocated a quarter of its gross economic output to the defence sector. At least one out of every five adults in the Soviet Union was employed in the military-industrial complex in some regions of Russia, while as much as half of the workforce was employed in defence plants. The end of the Cold War and the cutback in military spending hit such plants very hard, and it was often impossible for them to quickly retool equipment, retrain workers, and find new markets to adjust to the new post-cold war realities and post-Soviet era. In the process of converting a sort of "wartime" industry into a peace-time industry, an enormous body of experience, qualified specialists and know-how has been lost, as the plants were sometimes switching from producing hi-tech military equipment to making kitchen utensils and the like.

(ii) Another obstacle, partly related to the sheer vastness and geographical diversity of the Russian landmass, was the sizeable number of "mono-industrial" regional economies dominated by a single industrial employer that Russia inherited from the Soviet Union. The concentration of production in a relatively small number of big state enterprises meant that many local governments were entirely dependent on the economic health of a single employer; when the Soviet Union collapsed and the economic ties between Soviet republics and even regions were severed, the production in the whole country dropped by more than 50 per cent. Roughly half of Russia's cities had only one large industrial enterprise, and three- fourths had no more than four. Consequently, the decrease in production caused tremendous unemployment and underemployment, creating traumatic problems to dependent families.

(iii) Post-1991 Russia did not inherit a functioning system of social security and welfare provided by the government. Since Russian industrial firms were traditionally responsible for a broad range of social welfare functions—building and main-taining housing for their workforces, and managing health, recreational, educational, and similar facilities—the towns possessing few industrial employers were left heavily dependent on these firms, which were the mainstay of employment, for the provision of basic social services. Thus, economic transformation that brought

about privatisation of industries created severe problems in maintaining social welfare, since local governments were unable to assume financial responsibility for these functions.

(iv) Finally, there was the problem of human capital. The problem was not that the Soviet population was uneducated. Literacy was nearly universal, and the educational attainment level of the Soviet population was among the highest in the world with respect to science, engineering, and technical specialities. The former Soviet Union's state enterprise managers were indeed highly skilled at coping with the demands on them under the Soviet system of planned production targets. But the incentive system built into state and social institutions of the Soviet era encouraged skill in coping with an intensely hierarchical, state-centered economy, but discouraged the kind of competitive risk-and-reward centered behaviour of market capitalism. For example, the directors of Soviet state firms were rewarded for meeting output targets under difficult conditions, such as uncertainty about whether, needed inputs would be delivered in time and in the right assortment. As seen earlier, they were also responsible for a slew of social welfare functions for their employees, their families, and the population of the towns and regions where they were located. Profitability and efficiency were well down the list of priorities of Soviet managers. Thus, almost no Soviet employees or managers had first-hand experience with decision-making in the conditions of a market economy. This lack of expertise and experience in the changed economic scenario for the managers brought in a host of human resource management problems.

In short, turning the cold war-era Soviet economy into a market-based peacetime economy without wrenching problems was simply impossible.

Economic Reform in the 1990s

The economic reforms of Russia in the 1990s were characterised by two fundamental and interdependent goals—macroeconomic stabilisation and economic restructuring. The transition from central planning to a market-based economy was sought to be ensured through these instruments of the country's economic policy. Macroeconomic stabilisation involved the implementation of fiscal and monetary policies that promoted economic growth in an environment of stable prices and exchange rates. The latter called for establishing the commercial, legal, and institutional entities—private property, banks, and commercial legal codes—that would permit the economy to operate efficiently. Throwing open domestic markets to foreign trade and investment, and linking the economy with the rest of the world, was an important tool in realising these goals. The new government of the Russian Republic under Yeltsin had begun to address the problems of macroeconomic stabilisation and economic restructuring. But the results were mixed by mid-1996, as in the given circumstances, the goals of these measures seemed to be unrealistically high.

Macroeconomic Stabilisation Measures

The macroeconomic stabilisation programme had set out a number of policy measures to achieve stabilisation, such as sharp reductions in government spending, targeting outlays for public investment projects, defence, and producer and consumer subsidies; and also aimed at reducing the government budget deficit from its 1991 level of 20per cent of GDP to 9per cent of GDP by the second half of 1992 and to 3per cent by 1993. Government imposed new taxes and upgraded tax collection to increase state revenues. In the monetary sphere, the economic programme required the Russian Central Bank (RCB) to cut subsidised credits to enterprises and to restrict money supply growth. The programme aimed at reducing inflation from 12per cent per month in 1991 to 3per cent per month in mid-1993.

Economic Restructuring Measures

The government lifted price controls on 90per cent of consumer goods and 80per cent of intermediate goods immediately after the dissolution of the Soviet Union. In order to establish a realistic relationship between production and consumption that had been lacking in the central planning system, it raised administered prices on energy and food staples such as bread, sugar, vodka and dairy products.

Many fundamental changes were made in the economy mainly with a view to encouraging the development of the private sector, in the tax system, including introduction of a value-added tax (VAT) of 28per cent on most transactions, a progressive income tax and a tax on business income; revisions in the system of import tariffs and export taxes; new taxes on state controlled domestic energy use to encourage conservation and new taxes on oil and natural gas exports to narrow the gap between subsidised domestic prices and world prices and to prevent domestic energy shortages. A fixed exchange rate was established for the rouble, with the ultimate objective of making it convertible. Many restrictions on foreign trade and investment also were sought to be lifted to expose Russia to the discipline of world prices.

Monetary and Fiscal Policies Leading to Galloping Inflation

In 1992, the first year of economic reform, retail prices in Russia increased by 2520 per cent, mainly due to the sudden decontrol of most prices. The sharp increase in the money supply which had increased by 18 times within 3 quarters in 1992, was influenced by large foreign currency deposits that state-run enterprises and individuals had built up and by the depreciation of the rouble. Enterprises drew on these deposits to pay wages and other expenses after the government had tightened restrictions on monetary emissions. Commercial banks monetised enterprise debts by drawing down accounts in foreign banks and drawing on privileged access to accounts in the Central Bank. Government efforts to control credit expansion also were short-lived in the early years of the transition. Domestic credit increased about nine times during this period. To support continued production under these circumstances, enterprises relied on loans from other enterprises. The government failed to curtail its own expenditures in this period, due to the influence of the conservative Supreme Soviet, which encouraged the Soviet-style financing of favoured industries. By the end of 1992, the Russian budget deficit was 20per cent of GDP, as against the 5per cent projected under the economic programme and stipulated under the International Monetary Fund (IMF) conditions for international funding. This budget deficit was financed largely by expanding the money supply. These monetary and fiscal policies along with price liberalisation contributed to the inflation rate of over 2000per cent in 1992.

By October 1994, inflation, which had been reduced by tighter fiscal and monetary policies early in 1994, began to soar once again to dangerous levels. On October 11, a day that became known as Black Tuesday, the value of the rouble on interbank exchange markets plunged by 27per cent. The loosening of credit and monetary controls clearly was a significant cause of declining confidence in the Russian economy and its currency. After tightening the flow of money early in 1994, the government loosened its restrictions in response to demands for credits by agriculture, industries in the far north, and some favoured large enterprises. In 1995 the pattern was avoided more successfully by maintaining the tight monetary policy adopted early in the year and by passing a relatively stringent budget. Thus, the monthly inflation rate held virtually steady below 5per cent in the last quarter of the year. For the first half of 1996, the inflation rate was 16.5per cent. However, experts noted that control of inflation was aided substantially by the failure to pay wages to workers in state enterprises, a policy that kept prices low by depressing demand.

Shuttle Trading

A significant but unconventional model of solving Russia's serious problem of non-availability of consumer goods to cater to the needs of people in Russia's economy is "shuttle trading"—the transport and sale of consumer goods by 5–10 million individual entrepreneurs. Traders buy goods in foreign countries such as China, Turkey and the United Arab Emirates and in Russian cities, then sell them on the domestic market where demand is highest. Yevgeniy Yasin, Minister of Economics, estimated that some $11 billion worth of goods entered Russia in this way in 1995. Shuttle traders have been vital in maintaining the standard of living of Russians who cannot afford consumer goods on the conventional market. However, domestic industries such as textiles suffered from this infusion of competing merchandise, whose movement is unmonitored, untaxed and often mafia-controlled.

Privatisation

The essence of economic restructuring, and a critical consideration for foreign loans and investment

in Russia's economy, was the privatisation programme. In most respects, between 1992 and 1995, Russia kept pace with or exceeded the rate established in the original privatisation programme of October 1991. In 1992, privatisation of small enterprises began through employee buyouts and public auctions. By the end of 1993, more than 85 per cent of Russian small enterprises and more than 82,000 Russian state enterprises, or about one-third of the total in existence, had been privatised.

On 1 October 1992, vouchers, each with a nominal value of 10,000 roubles (about $63), were distributed to 144 million Russian citizens for purchase of shares in medium-sized and large enterprises that officials had designated and reorganised for this type of privatisation. By the end of June 1994, the voucher privatisation programme had completed its first phase, and has succeeded in transferring ownership of 70 per centof Russia's large and medium-sized enterprises to private hands and in privatising about 90 per centof small enterprises. By that time, 96 per cent of the vouchers issued in 1992 had been used by their owners to buy shares in firms directly, invest in investment funds or sell on the secondary markets. According to the organisers of the voucher system, 14,000 firms employing about two-thirds of the industrial labour force had moved into private hands.

The next phase of the privatisation programme called for direct cash sales of shares in remaining state enterprises. That phase completed the transfer of state enterprises and added to government revenues. Notwithstanding periodic delays, the inefficient administration of the programme's successive phases, and allegations of favouritism and corrupt transactions in the enterprise and financial structures, international experts judged Russia's privatisation effort a "qualified success." The movement of capital assets from State to private hands has progressed without serious reversal of direction-despite periodic calls by disgruntled people for re-establishing state control of certain assets. And the process has contributed to the creation of a new class of private entrepreneurs.

By mid-1996, four and a half years after the launching of Russia's post-Soviet economic reform, experts found the results promising, but mixed. The Russian economy has passed through a long and wrenching depression. Official Russian economic statistics indicate that from 1990 to the end of 1995, Russian GDP declined by roughly 50per cent, far greater than the decline that the United States experienced during the Great Depression. Some analysts concluded that such a decline was to be expected in an economy going through the transition from central planning to a free market structure. Much of the decline in production has occurred in the military-industrial complex and other heavy industries that benefited most from the skewed economic priorities of Soviet planners but have much less demand in a free market.

The Insider Buyout

Sovietologist Marshall Goldman, Nobel Lawreate in Economics (2001) Joseph Stiglitz, and other critics of Russia's implementation of privatisation generally argue that "insider buyout," which supposedly induced employee dominant ownership, inevitably leading to the tendency for the stockholders, who are managers or employees themselves, to vote for increased wages, reduced investments and fewer layoffs. Such a situation did not facilitate the growth of market economy and allowed state managers to wound up with the controlling share of the stock, which in turn accounted for Russia's poor implementation of economic restructuring.

Compared to the former Czechoslovakia, Hungary, and Poland, a far higher share of state-owned assets were sold to managers and workers, or "insiders" in Russia. In this sense, it is more precise to describe Russia's privatisation as "insider privatisation" and "***Oligarch Privatisation***," and thus distinct from the general pattern of privatisation in other, more successful countries in Eastern Europe. Many analysts of Russian economic reform, therefore, argue that it would be more accurate to say that real economic reform was never tried, given that it was quickly subverted by actors outside the government's control, such as the Central Bank, ministries, regional governments and industrial managers.

Aside from the distortions associated with the lack of competition, employee ownership in general keeps wages and employment at too high levels. The impact of "insider buyout" in Russia can be seen from the abnormally low unemployment rates and very high underemployment levels in privatised industries. Generally speaking, large-scale privatisation of moribund, money-losing state owned enterprises should *increase* unemployment. Sixteen percent of the workforce became unemployed in both the former East Germany and Poland. Most Soviet industries, after all, were not even value adding, with cost of inputs exceeding the cost of outputs and yet the skewed privatisation process saw to it that there was no shedding of

surplus labour. Even in China, where organised, large-scale privatisation has not taken place, the unemployment rate in 1998 was conservatively placed at 8–9 per cent. But in Russia, during 1994, in the most radical stage of privatisation, only 6.3 per cent of the economically active population was unemployed though a far larger share of the population remained underemployed.

According to Stiglitz, the key economic mistakes of the transition were the emphasis on privatisation over competition and on restructuring existing enterprises over creation of new jobs and enterprises. With emphasis on just transferring ownership to private hands in order to create a lobby for private enterprise with a view to preventing a Soviet comeback and push for creation of institutions to govern the market instead of competition, price controls were lifted without dismantling key Soviet-era monopolies. Prices thus were not able to properly equilibrate according to levels dictated by supply and demand since private profit-seeking monopolies lacked the incentives provided by competition to lower prices.

Asset Stripping and Barter

According to the "Washington Consensus," privatisation would lead to incentives to improve productivity of Soviet-era state enterprises. However, privatised enterprises found it difficult to revitalise, given the high interest rates and lack of financial institutions to provide capital. With inflation at double-digit rates per month as a result of instantaneous price liberalisation, the macroeconomic stabilisation programme enacted to curb this trend entailed tightening the money supply and raising interest rates. During the early 1990s the focus on macrostabilisation led to interest rates rising between 20 per cent and 250 per cent. With interest rates so high, "non-insiders" were left largely incapable of borrowing the capital to invest in Russian enterprises, a major factor leaving privatised industries starved of cash. In addition, shock therapy had wiped out the savings of most Russians, leaving ordinary Russians largely incapable of investing in enterprises left up for auction. Moreover, until around 1996–1997, many enterprises did not have enough working capital due partly to the lack of competition, to pay the wages and taxes on time, and traded with one another using barter. Not able to pay wages, upgrading and modernising their facilities was out of the question. The high interest rates and shortage of working capital forced some industries to barter, leading to a new system of distorted prices as a system of exchange under barter created unreal values. By 1998, at least half of enterprise output was being "sold" through barter or trade. The Federal government has effectively allowed them to avoid paying much of their federal taxes in return for keeping key customers, such as military bases and major industrial enterprises, supplied with energy and power.

Capital Flight

"Insider privatisation," accompanied by the opening of the capital markets, led to incentives for capital flight in addition to barter, leading to large scale movements of capital estimated between $2 billion and $3 billion per month. According to Stiglitz, "Anyone smart enough to be a winner in the privatisation sweepstakes would be smart enough to put their money in the booming US stock market, or into the safe haven of secretive offshore bank accounts. It was not even a close call; and not surprisingly, billions poured out of the country." Capital flight continues uninterrupted until present day.

Emergence of Oligarchs

The new capitalist opportunities presented by the opening of the Russian economy in the late 1980s and early 1990s affected many people's interests. As the Soviet system was being dismantled, well-placed bosses and technocrats in the Communist Party, the KGB, and the Komsomol (Soviet Youth League) were cashing in on their Soviet-era power and privileges. Some quietly liquidated the assets of their organisation and secreted the proceeds in overseas accounts and investments. Others created banks and businesses in Russia, taking advantage of their insider positions to win exclusive government contracts and licenses and to acquire financial credits and supplies at artificially low, state-subsidised prices in order to transact business at high, market-value prices. Many made fortunes almost overnight. Privatisation of state enterprises subsequently gave many who had gained wealth in the early 1990s an opportunity to convert it into shares of privatised enterprises. The Yeltsin government hoped to use privatisation to spread ownership of shares in former state enterprises as widely as possible to create political support for his government and his reforms.

The privatisation programme was deeply corrupt from the beginning. The western world generally advocated a quick dismantling of the Soviet planned economy to make way for "free-market reforms," but later expressed disappointment over the newfound power and corruption of the "oligarchs." Some called this wave of plundering "***nomenklatura capitalism***." By the time Yeltsin's government launched radical reforms, the "nomenklatura capitalists" had already entrenched themselves as powerful players.

As mentioned earlier, the government used a system of free vouchers as a means to provide a quantum - leap to mass privatisation. But it also allowed people to purchase shares of stock in privatised enterprises with cash. As the government ended the voucher privatisation phase and launched cash privatisation, it devised a programme that it thought would simultaneously speed-up privatisation and yield the government a much-needed infusion of cash for its operating needs. Under the scheme, which quickly became known in the west as "loans for shares," the Yeltsin regime auctioned off substantial packages of stock shares in some of its most desirable enterprises, such as energy, telecommunications, and metallurgical firms, as collateral for bank loans.

In exchange for the loans, Yeltsin handed over assets worth many times as much. Under the terms of the deals, if the Yeltsin government did not repay the loans by September 1996, the lender automatically acquired the title to the stock and could then resell it or get equity shares in the enterprise. The first auctions were held in the fall of 1995. The auctions themselves were usually held in such a way as to limit the number of banks bidding for shares and thus to keep the auction prices extremely low. By summer 1996, major packages of shares in some of Russia's largest firms had been transferred to a small number of major banks, thus allowing a handful of powerful banks acquire substantial ownership shares over major firms at shockingly low prices. These deals were effectively giveaways of valuable state assets to a few powerful, well-connected, and wealthy financial groups.

The concentration of immense financial and industrial power, which loans for shares had assisted, extended to the mass media. One of the most prominent of the financial barons, Boris Berezovsky, who controlled major stakes in several banks and companies, exerted enormous influence over state television programming for a while. Berezovsky and other ultra-wealthy, well-connected tycoons who controlled these great empires of finance, industry, energy, telecommunications, and media became known as the "Russian oligarchs." Along with Berezovsky, several other rich and influential men emerged as Russia's most powerful and prominent oligarchs. Corruption covered the entire span of social relations in the new Russia. Currently, the bottom end consists of drug lords and leaders in organised crime. Between them is a small army of civil servants turned petty extortionists that emerged from the ruins of the socialist system. A tiny clique who used their connections built up during the last days of the Soviet years to plunder Russia's vast resources during the rampant privatisations of the Yeltsin years, the oligarchs emerged as the most hated men in the nation. In Russia today, the oligarchs control up to 85per cent of the value of the country's leading private companies.

Efforts at Ravamping the Weak Legal System

It is important to a market economy to have a well-settled legal system and a rigorous enforcement machinery to enable the system of contracts work smoothly. This is very essential for the effective functioning of a market oriented economy.

In the new Russian economy's lack of legislation and more importantly lack of effective law enforcement, in many areas of economic activity is a pressing issue. During 2000 and 2001, changes in government administration increased the power of the central government to compel local administrations to enforce laws. Taxation and business regulations are unpredictable, and legal enforcement of private business agreements is weak. Attitudes left over from the Soviet period may take many years to overcome. Government decisions affecting business have often been arbitrary and inconsistent. Crime has increased costs for both local and foreign businesses. On the positive side, Russian businesses are increasingly turning to the courts to resolve disputes. The passage of an improved bankruptcy code in January 1998 was one of the first steps. In 2001, Duma, the Russian Parliament, passed legislation for positive changes within the business and investment sector; the most critical legislation was a deregulation package. This trend in legislation continued through 2002, with the new corporate tax code going into effect.

Investment in Industry

Russia is one of the most industrialised of the former Soviet republics. However, years of very low investment have left much of Russian industry outdated and highly inefficient. Besides its resource-based industries, it has developed large manufacturing capacities, notably in machinery. Russia inherited most of the defence industrial base of the Soviet Union, so armaments are the single-largest manufactured goods export category for Russia. Efforts have been made with varying success over the past few years to convert defence industries to civilian use.

Foreign investment in Russia is very low. Cumulative investment from US sources of about $4 billion are about the same as US investment in Costa Rica. In 1999, investment increased by 4.5 per cent, the first such growth since 1990. Investment growth has continued at high rates from a very low base, with an almost 30 per cent increase in total foreign investments in 2001 compared to 2000. Higher retained earnings, increased cash transactions, the positive outlook for sales, and political stability have contributed to these favourable trends.

Foreign direct investment, which includes contributions to starting capital and credits extended by foreign co-owners of enterprises, rose slightly in 1999 and 2000, but decreased in 2001 by about 10 per cent. Foreign portfolio investment, which includes shares and securities, decreased dramatically in 1999, but has experienced significant growth since then. In 2001, foreign portfolio investment was $451 million, more than twice the amount from the previous year. Inward foreign investment during the 1990s was more than offset by capital flight from Russia, estimated at about $15 billion annually. During the years of recovery following the 1998 debt crisis, capital flight seems to have slowed. Inward investment from Cyprus and Gibraltar, two important channels for capital flight from Russia in recent years, suggest that some Russian money is returning home.

The poorly developed banking system makes it difficult for entrepreneurs to raise capital and to diversify risk. Banks in Russia still perceive commercial lending as risky, and some banks are inexperienced with assessing credit risk. The Russian banking sector lacks resources, capability and the trust of the population, with the result it is unable to attract substantial savings so that it can direct it toward productive investments. Russia's banks contribute only about 3 per cent of overall investment in Russia. While rouble lending has increased since the October 1998 financial crisis, loans are still only 40 per cent of total bank assets. The Central Bank of Russia reduced its refinancing rate five times in 2000, from 55 per cent to 25 per cent, signalling its interest in lower lending rates. Interests on deposits and loans are often below the inflation rate. Money on deposit with Russian banks represents only 7 per cent of GDP. Sberbank receives preferential treatment from the State and holds 73 per cent of all bank deposits. It is also the only Russian bank that has a federal deposit insurance guarantee. Chairman of the Russian Central Bank, Sergei Ignatiev, has initiated necessary banking reforms, including stricter accounting procedures and federal deposit insurance, and these are expected to be implemented in course of time.

Institutional Problems

The pro-reform leaders of Russia, in their enthusiasm to promote fast-track capitalism abandoned existing pre-Reform Soviet institutions even before the legal structures of a market economy that govern private property, oversee the financial market, and enforce taxation were put in place and made functional. Yet, the two major components that are required to manage a macroeconomy are banking system and the state budgetary system. A vibrant free market economy requires strong contract enforcement, accepted customs and practices, and financial and regulatory institutions. But Russia was left with Soviet-era institutions with their lackadaisical ways of functioning. Privatised enterprises thus found it difficult to move forward given the lack of financial institutions to provide capital. Moreover, several devastating blows were dealt to the potential capital market. First the savings of the people in state-owned Sberbank were frozen and effectively destroyed by hyper-inflation. Second, a large number of financial pyramids extracted huge amounts of money from unsuspecting public. Third, the government has successfully repeated the scheme with their short-term government obligations, extracting tens of billions of dollars from unsuspecting investors and then defaulting on domestic obligations. As a result, the Russian stock market remains almost irrelevant. As of 2004, there have been only two IPOs in Russia and the investment activity in money markets remains abysmally low.

Financial Collapse of 1998

The global recession of 1998, which started with the Asian financial crisis in July 1997, exacerbated Russia's economic crisis. Given the ensuing decline in world commodity prices, countries heavily dependent on the export of raw materials, such as oil, were among those most severely hit. Russia whose exports of petroleum, natural gas, metals, and timber constituted more than 80 per cent left the country vulnerable to swings in world prices. Oil is also a major source of government tax revenue. The sharp decline in the price of oil had severe consequences for Russia. The pressures on the rouble, reflecting the weakness of the economy, resulted in a disastrous fall in the value of the currency. Massive tax evasion also continued, and the government found itself unable to service the massive debts it had incurred or even to pay its employees. The government stopped making timely payment of wages, pensions and debts to suppliers; and when workers were paid, it was often with bartered goods rather than roubles. Coal miners were hard hit, and for several weeks in the summer they blocked sections of the Trans-Siberian railroad, effectively cutting the country into two. As time wore on, they added call for the resignation of Yeltsin and his government to their wage demands. The crisis management efforts of Yeltsin by reshuffling his cabinet also did not yield the desired result.

The Russian crisis caused alarm in the West. Pouring more money into the Russian economy would not be a long-term solution, but the US in particular feared that Yeltsin's government would not survive a looming financial crisis without IMF help. The US President Bill Clinton's treasury secretary, Robert Rubin, also feared that a Russian collapse could create a panic on world money markets. The IMF approved a $22.6 billion emergency loan on July 13. Despite the bailout, Russia's monthly interest payments still well exceeded its monthly tax revenues. Realising that this situation was unsustainable, investors continued to flee Russia despite the IMF bailout. Weeks later the financial crisis recommenced as the value of the rouble resumed its fall, and the government fell into a self-perpetuating trap. To pay off the interest on the loans it had taken, it needed to raise still more money, which it did through foreign borrowing. As lenders became increasingly certain that the government could not make good on its obligations, they demanded ever-higher interest rates, deepening the trap. Ultimately the bubble burst.

On August 17, 1998, Yeltsin-appointed Prime Minister Kiriyenko's government and the Central Bank were forced to suspend payment on Russia's foreign debt for 90 days, restructure the nation's entire debt, and devalue the rouble. The rouble went into free fall as Russians sought frantically to buy dollars. Western creditors lost heavily, and a large part of Russia's fledgling banking sector was destroyed, since many banks had substantial dollar borrowings. Foreign investment rushed out of the country, and financial crisis triggered an unprecedented flight of capital from Russia.

Russians' Total Disillusion with Reforms

Since 1991, under the leadership of Boris Yeltsin, the country made great strides toward developing a market economy by implanting basic tenets such as market-determined prices. Critical elements such as privatisation of state enterprises and extensive foreign investment went into place in the first few years of the post-Soviet period. But other fundamental parts of the economic infrastructure, such as commercial banking and authoritative, comprehensive commercial laws, were absent or only partly in place by 1996 and the configuration of the post-transition economy remained unpredictable.

Increasingly impoverished and marginalised, elderly pensioners and fixed income earners have grown more and more disillusioned with economic reforms, contributing to growing nostalgia for Soviet days. Structural reform lowered the standard of living for most groups of the population, and created powerful political opposition. Democratisation opened the political channels for venting these frustrations, thus translating into votes for anti-reform candidates, especially those of the Communist Party and its allies in the Duma. Russian voters, able to vote for opposition parties in the 1990s, often rejected economic reforms and yearned for the stability and personal security of the Soviet era. These were the groups that had enjoyed the benefits of Soviet-era state-controlled wages and prices, high state spending to subsidise priority sectors of the economy, protection from competition with foreign

industries, and welfare entitlement programmes. During the Yeltsin years in the 1990s, these groups were well organised, voicing their opposition to reform through strong trade unions, associations of directors of state-owned firms, and political parties in the popularly elected parliament whose primary constituencies were among those vulnerable to reform. A constant theme of Russian history in the 1990s was the conflict between economic reformers and those hostile to the new capitalism.

The "Brain Drain"

Among other things destroyed during the transition to market economy were Soviet educational and science systems. Teachers and scientists, together with doctors were hit by the transition the strongest. As the government was unwilling to index their fixed salaries according to inflation or even to pay them on time, their income quickly dropped below the level of subsistence, ridding the schools, universities and research institutes of qualified specialists in a record time. Some of the scientists fled to the West, attracting some attention to the problem of "brain drain," but nothing was done. As of 2004, more than half of the school graduates are functionally illiterate, the professional and higher education is almost useless and the amount of fundamental and applied research is minuscule, compared with the Soviet potential.

CONCLUSION

In recent times things seem to have improved. However, Russia's corporate and credit culture appears weak and immature. Bank and bond markets are vulunerable to shocks due to investment and lending decisions being based on relationships, reputations or other extraneous considerations rather than on proper market and risk analysis. However, since 2002–03, large Russian companies are able to have easy access to the international bond and bank loan markets, supported by solid Russian economic growth and a strong international demand for emerging market debt. Russia's several eurobond placements in late 2003–early 2004 have been very successful. Russia's ability to service all its debt in the short term remains relatively strong and the risk of a sovereign default is minimised by the country's very strong external liquidity position and the government's short-term fiscal flexibility. Meanwhile, domestic bank credit and capital markets have been growing fast, albeit from a low level, so that Russia now has the largest bond market in Eastern Europe. Oil revenues have created a liquidity cushion on the domestic financial market and provided funding opportunities for midsize companies. These factors have improved corporate liquidity in the short term, but Russia's corporate sector would still benefit greatly from a strengthening of the domestic banking system.

SUGGESTED READINGS

- Economy of Russia : Information from Answers.com
- (http://www.timesonline.co.uk/article/0,,630-334118,00.html)
- (http://www.pbs.org/frontlineworld/stories/moscow/billionaires.html)
- (http://www.cia.gov/cia/publications/factbook/geos/rs.html))
- (http://www.pbs.org/newshour/bb/europe/july-dec98/russia_10-27.html)
- (http://www.pbs.org/newshour/bb/europe/jan-june98/russia_3-23.html)
- (http://www.cnn.com/WORLD/europe/9804/24/russia.duma.vote/index.html)
- (http://www.cnn.com/WORLD/europe/9804/24/duma.vote.results/)
- (http://www.worldbank.org/transitionnewsletter/mayjune2002/pgs14-17.htm)
- (http://www.answers.com/main/ntquery;jsessionid_History of Post_Soviet Russia Information from Answers.com)

Case Study 15

Insider Trading: HLL–BBLIL Merger

(This case is based on print and electronic media and is meant for classroom discussion only. The author has no intention to tarnish the reputataion of either the corporates or the individuals involved).

Statement of the Case

The Indian capital market has witnessed several price-rigging and insider-trading activities both of which are considered unlawful by the Securities and Exchange Board of India (SEBI). Price rigging occurs when persons acting in concert with each other collude to increase or decrease artificially the price of a security. Insider trading refers to a situation when a person having unpublished price-sensitive information such as financial results, expansion plans, take-over bids etc. by virtue of his association with a company, trades its shares to make undue profits. This is a case that studies one such instance of alleged insider trading by officials of Hindustan Lever Limited (HLL) when the company wanted a merger with its sister concern Brooke Bond Lipton India Limited (BBLIL). This is the first ever case of insider trading in India which was taken up by SEBI to scrutinise the manner of the involvement of a big company, HLL. It also exposes the major flaws in SEBI's insider-trading regulations and the need to plug the loopholes in them. Although SEBI was investigating the case from May 1996, the final verdict was passed 2 years thereafter by the market regulator which took the whole of corporate India by storm.

Establishing the Case

SEBI in its order that tried to establish an insider trading case against HLL management observed that it could be conclusively stated that while entering into the transaction for the purchase of 8 lakh shares of BBLIL from the Unit Trust of India (UTI), HLL was acting on the basis of the privileged information in its possession, regarding the impending merger of BBLIL with HLL. "It also may be stated that, by its very nature, when it comes to motives and intentions, there may not always be any direct evidence. However, the chain of circumstances, the timing of the transaction, and other related factors demonstrates beyond doubt that the transaction was founded upon and effected on the basis of unpublished price sensitive information about the impending merger."

On 4 August 1997, SEBI issued a show cause notice to HLL claiming that there was *prima facie* evidence of the company indulging in insider trading, through the use of "unpublished price sensitive information" prior to its merger with Brooke Bond Lipton India Ltd. (BBLIL). In March 1998, SEBI passed an exhaustive order, which sent shock waves through the country's corporate sector. SEBI found HLL guilty of insider trading because it bought shares of BBLIL from Unit Trust of India with the full knowledge that the two sister concerns were going to merge. Since it bought the shares before the merger was formally announced, SEBI held that HLL was using unpublished, price-sensitive information to trade, and was therefore, guilty of insider trading. SEBI directed HLL to pay UTI Rs 3.4 crore in compensation, and also initiated criminal proceedings against the five common directors of HLL and BBLIL: S. M. Datta, K. V. Dadiseth, R. Gopalakrishnan, A. Lahiri and M. K. Sharma, who were on the core team which discussed the merger.

The History of the Case

The case dates back to 1996 when the FMCG giant, Hindustan Lever, had decided to merge with its sister concern, Brooke Bond Lipton India Limited, so as to enable their parent company, Uniliver have a major stake in the merged entity. Both the companies informed the concerned stock exchanges of their desire to become a single entity by entering into a merger on 19 April 1996. However, much before the merger move became public, the share price and the volumes of BBLIL traded on the stock exchanges witnessed a steep hike. On 12 May 1996 SEBI, the market regulator, in an uncharacteristically swift move launched an investigation on HLL and on 4 August 1997 charged the company of indulging in insider trading. SEBI did not accuse any individual for the wrongdoing, but the company itself was accused of it. The culmination of the proceedings of the case took place on 11 March 1998 in the form of SEBI holding HLL guilty and prosecuting the five above cited HLL directors for the offence of insider trading.

Questions of Law and Its Interpretations in the Case

Naturally enough, Hindustan Lever decided to appeal against SEBI's verdict to the Union Ministry of Finance, the appellate authority in such cases. The questions which were in everyone's mind were two-fold: (i) is HLL guilty of insider trading and (ii) would SEBI's charges stand legal scrutiny when contested, as there were several questions of law and its interpretations which would have to be settled.

SEBI took the stand that only HLL knew about the forthcoming merger and it acted on the basis of such unpublished information it was privileged to know. According to SEBI, HLL and its directors misused such information. HLL was an "Insider" and by buying 800,000 shares of BBLIL from UTI (pre-merger), it violated the insider trading regulation. Shares were purchased from the UTI to ensure 51% stake to Unilever in the post-merger company with the prior knowledge of share-swap ratio. On 17 January 1996 the merger decision made by the parent company, Unilever, was communicated to the core team of directors by C. M. Jemmett, the parent company's represen-tative. In March 1996, HLL bought the shares from UTI. HLL announced the merger with BBLIL in April 1996.

SEBI also charged HLL of acting in a manner inimical to the interests of thousands of ordinary shareholders. Besides, Hindustan Lever depleted its own resources by helping its holding company, Unilever obtain major stake in the merged entity. "The funds that were shelled out by HLL to purchase BBLIL's shares were to be extinguished and that too for the holding company", As per SEBI's contention, this was against the interest of the ordinary shareholders. Further, SEBI charged that HLL deprived the country of precious foreign exchange, as Unilever would have invested nearly Rs. 45–50 crores to raise its holding to 51% in the post-merger consolidated company.

Arguments For and Against SEBI's Ruling

SEBI's notice to Hindustan Lever, the penalty the market regulator imposed on the company and its indictment of the directors of the company not only created a storm in the Indian corporate sector, but also raised a number of legal issues relating to SEBI's penal action and its sustainability by appellate authorities when contested by the company. These issues were: (i) whether HLL was an "insider" or not, (ii) whether or not the premerger information HLL had access to was "unpublished", (iii) whether or not HLL had any price-sensitive information with regard to the merger (iv) whether or not HLL had gained any unfair advantage out of the deal.

The first and most debated issue was concerning whether HLL was an insider at all. According to Clause 2(e) of SEBI's regulations: "Insider means any person who is or was connected with the company or is deemed to have been connected with the company, and who is reasonably expected to have access, by virtue of such connection, to unpublished price-sensitive information in respect of securities of the company, or who has received or has had access to such unpublished price-sensitive information."

To rebut this allegation of SEBI, Hindustan Lever countered that though it was deemed to be connected to BBLIL, and though it knew about the merger before it bought BBLIL's shares, it received the information only because it was one of the parties to the merger itself and not merely because of its connection to BBLIL. HLL stressed this distinction because, to be an "insider", HLL should have received the information "by virtue of such connection" with the other company. HLL's defense centred around the fact that as an initiator and also as the transferee, it was the "primary party" to the merger. the legal Director of Hindustan Lever argued: "Nowhere in the world is the primary party to a merger considered to be an insider from the point of view of insider-trading."

SEBI refused to accept the company's interpretation of the clause. It argued: "The phrase 'by virtue of such connection' applied only to one kind of insider, 'the connected' or 'deemed connected person' who was expected to have access to information because of his connection." SEBI underscored the point that HLL also fell under the definition of someone "who was reasonably expected to have access by virtue of such connection", as the core team of five common directors discussed the merger, and Unilever, the common parent, granted the "in principle" approval, and besides, HLL was free to use the information to further the merger, but not to buy shares. There is a second part of the clause, argued SEBI, that defined another kind of insider, who might not be connected to the company at all, but "who had received or has had access to

such unpublished price sensitive information". Therefore, SEBI argued that even if BBLIL was construed to be unconnected, HLL could still be an insider of the second type. Its order said, "If we were to accept HLL's argument...it would permit a 'connected' or 'deemed connected' person to misuse the price-sensitive information because he has received the information independently".

The second issue raised in the case was whether or not the information, which HLL had access to, was "unpublished". According to clause 2(k) of SEBI's regulation on Insider Trading: "Unpublished price-sensitive information means any information which is of concern, directly or indirectly, to a company, and is not generally known or published by such company for general information, but which if published or known, is likely to materially affect the price of securities of that company in the market."

While SEBI argued that Hindustan Lever has gone against this regulation, HLL contended that before the transaction, the merger was the subject of wide market and media speculation. After the formal announcement, press reports highlighted the fact that the merger caused no surprise at all to anyone as it was part of the market grapevine for long. HLL pointed out that before the transaction, the share price of BBLIL moved up from Rs. 242 to Rs. 320 between January and March 1996, showing that the merger was "a generally known information".

HLL also pointed out that the public sector mutual fund, UTI was a large enough institutional player and, given the speculation, how could UTI had remained unaware that the merger was forthcoming? Inspite of its being the second largest shareholder in both BBLIL and HLL, UTI did not complain against the transaction either formally to SEBI, or informally to HLL after the formal merger announcement. Moreover, Hindustan Lever had, between the transaction and the formal announcement, privately told UTI of the merger. UTI also hosted an inter-institutional meeting to discuss it. UTI even sold HLL some more shares 9 months later, though at a higher price.

SEBI tried to show as proof that the information was not generally known to people at large by relying on an UTI official's testimony that he was unaware of the merger, though he was, in his official capacity, concerned with the company. Though it had not defined either "unpublished" or "generally known information", SEBI officials were of the view that these could include press reports, even if unconfirmed by the company. "Since these reports were speculative, technically HLL's knowledge was qualitatively better." SEBI also claimed that one of the press reports carried a denial by the company.

The third legal issue concerned the price-sensitive nature of the information regarding the merger. Section 2(k) of SEBI's regulation laid down eight examples of price-sensitive information which included *inter alia* "amalgamations, *mergers*, or takeovers".

Hindustan Lever asserted that it was unaware of the swap ratio when the company bought BBLIL shares in March 1996. Further, it was not privy to any special price-sensitive information on the merger, as it had been highlighted by the media even before the official announcement. Hindustan Lever also argued that both the companies, namely, itself and BBLIL involved in the deal were sister concerns and subsidiaries of Uniliver; operated in the same industry, and were large profit making enterprises with common recruitment of personnel. They had some common directors on their boards and were listed in several of the country's stock exchanges, and their securities were actively traded. HLL argued that such being the case, information of the merger by itself was not enough to induce a reasonably knowledgeable investor to buy its shares until the share-swap ratio was known. The company thus argued that the merger information *per se* had little relevance to the issue. The only thing that was price sensitive was the swap ratio, and HLL was not aware of it when it purchased BBLIL shares from UTI.

However SEBI, emphasised that the regulation cited explicitly defined "mergers" as price-sensitive information. It said, "(the) swap ratio may be price -sensitive information, but that does not mean that information of the overall fact of merger is not price-sensitive".

The fourth issue, that was debated between the contending parties was whether HLL had profited from the deal or gained any unfair advantage. In regard to this, neither the Act nor the regulations stated that SEBI must prove that a profit was made or a loss was avoided. However, Section 15 of the Act prescribed that the regulator should consider "the amount of disproportionate gain or unfair advantage wherever quantifiable", when levying penalties.

With regard to this issue, Hindustan Lever contended that the onus of proof of insider trading and the resultant gain by the concerned party rested with SEBI. The company also argued that it made no gain out of the deal: (i) after

the merger, the company cancelled its BBLIL shareholding, and so financially there was no gain; (ii) HLL bought 80,0000 shares from UTI at Rs. 350 per share at a premium of almost 10 per cent over the market price of Rs. 318 and (iii) HLL also contended that its intentions were only to consolidate Uniliver's shareholdings, and to achieve this, it had cheaper options which it did not resort to, such as the issue of preferential shares either to Uniliver or to HLL.

SEBI maintained that the provisions HLL quoted helped the regulator to determine the penalty, not the violation itself. SEBl's order said: "Making profit or avoiding loss is not a legal requirement under the regulation to establish the charge of insider trading. Section 15...(is) only applicable in cases of levy of monetary penalties (and) has no bearing on determination of the contravention." SEBI's contention was that HLL did benefit from the deal inasmuch as the company could not predict how prices would move after the merger announcement, it might well have had to pay more for the BBLIL shares then. In support of its argument, it cited the instance that immediately after the merger announcement, BBLIL's share price closed at Rs. 405, though it fell subsequently. Alternatively, if UTI had not sold, it would have got shares worth Rs. 48.83 crore in the merged HLL, Rs. 20.83 crore more than its sale price.

Was SEBI's Stand Justified?

Experts maintain that SEBI as a market regulator has erred in its decision by favouring UTI and imposing a fine on HLL to pay 3.04 crores as compensation to the public sector mutual fund. But being a regulator also calls for protection of the interests of all market players which essentially includes investors, both small ordinary and large institutional shareholders. Therefore, SEBI argued that it was justified in awarding compensation to UTI. But this line of argument also was countered by Hindustan Lever when it explained that it had paid UTI Rs. 350 per share as against the then market price of Rs. 318. The interest for Rs. 28 crore for 9 months at the rate of 18 per cent works out to 3.78 crores which is far more than the compensation set by SEBI.

CONCLUSION

The charge against HLL had brought to the fore the debate over SEBI's role as a watchdog of the Indian capital market and its ability to control financial crimes such as insider trading. It also highlighted the inability of its legal machinery to handle such cases. The case has also triggered the need for an urgent rehaul of SEBI's regulations. With the changing scenario in the capital market, there is a pressing need to finetune various policies and regulations guiding the transactions in the securities market. With tremendous growth in the capital market, and the diverse nature of transactions in a multiple product range, all of which have been impacted by technology-driven operations and explosion in communications, there is an urgent need for a system and structure of market regulation that will respond speedily, adequately and efficiently to challenges such as price-rigging and insider trading.

Glossary

Advanced Countries Countries having high national and per capita income that ensure high rate of capital formation. These countries possess highly developed infrastructure and apply most updated and advanced technical know-how in their productive activities. A strong and well-organised financial structure is the characteristic of advanced countries.

Ad Valorem Tax A type of indirect tax in which goods are taxed by their values. In the case of ad volorem tax, the tax amount is calculated as the proportion of the price of the goods. Value Added Tax (VAT) is an ad volorem tax.

Arbitrage When the middle-man buys and sells goods at a particular time to cash the price difference of two markets, then this action is termed as arbitrage. Purchases are done when prices are low in one market and then sold in another market where the prices are high in order to earn the profit due to the price difference in the two markets.

Arbitration Settlement of claims, differences or disputes between one member and another and between a member and his clients, authorities, clerk's sub-brokers, etc, through appointed arbitrators. It is a quasi-judicial process that is faster and is an inexpensive way of resolving a dispute. The stock exchange facilitates the process of arbitration between the members and their clients. The disputes between the parties are resolved through arbitration in accordance with the bye-laws of the exchange.

Auction It is a mechanism utilised by the exchange to fulfill its obligation to a counter party member when a member fails to deliver good securities or make the payment. Through auction, the exchange arranges to buy good securities and deliver them to the buying broker or arranges to realise the cash and pay it to the selling broker.

Bad Delivery Delivery of a share certificate together with a deed of transfer, which does not meet the requirements of title transfer from seller to buyer, is called a bad delivery in the market.

Bad Delivery Cell When a delivery of shares turns out to be bad because of company objection etc., the investor can approach the bad delivery cell of the stock exchange through his broker for correction or replacement with good delivery.

Balance Sheet A statement showing the assets and liabilities of a business at a certain date. Balance sheet helps in estimating the real financial situation of a firm.

Balanced Budget When the total revenue of the government exactly equals the total expenditure incurred by the government, the budget becomes a balanced budget. It is a conservative viewpoint, as most of the times, a welfare government has to regulate a number of economic and social activities; this increases the expenditure burden on the government and results in deficit budget.

Balanced Business Score Card A system of corporate performance evaluation based on identified key performance areas.

Balanced Growth It refers to a programme of coordinated growth of all sectors of the economy. Generally speaking, developing nations plan a balanced growth of their economies.

Bank A financial institution that accepts funds on saving, current and fixed deposit accounts, and lends money. The bank pays cheques drawn by customers against their accounts. It can be termed as a trader that deals in money and credit.

Bank Draft A negotiable claim drawn upon a bank. Drafts are as good as cash. The drafts cannot be returned unpaid. A draft is issued when a customer shows his unwillingness to accept cheque in payment for his services or mercantile goods. A bank draft is safer than a cheque.

Bank Rate The rate of discount at which the central bank of the country discounts first-class bills. It is the rate of interest at which the central bank lends money to the lower banking institutions. Bank rate is a direct quantitative method of credit control in the economy.

Barter System It is a primitive system of transaction involving exchange of 'goods for goods'.

Base Year Reference year in the past, i.e. a year chosen to be the basis for comparison of the value of a particular variable with the value of that variable in another year. For example, if we are comparing the price level in 2005 with that in 2004, then 2004 is the base year. A base year should be a normal year in terms of economic performance.

Bearer of Options Money is a bearer of options, as it gives the freedom to its possessor to either keep it or to spend it on any commodity that is for sale.

Bid and Offer Bid is the price of a share a prospective buyer is prepared to pay for a particular scrip. Offer is the price at which a share is offered for sale.

Bilateral Monopoly It refers to that market situation where there is only one buyer of a commodity or service as exists in a nationalised industry. This buyer is the sole employer of a particular type of labour, the suppliers of which are all members of a trade union. The bargaining between employers and employees then would be between two monopolists.

Bills of Exchange A document acknowledging an amount of money owned in consideration for goods received.

Blue Chip Equity shares whose purchase is very safe. It is a safe investment as it does not involve any risk.

Bond A negotiable certificate evidencing indebtedness. It is normally unsecured. A debt security is generally issued by a company, municipality or government agency. A bond investor lends money to the issuer and in exchange the issuer promises to repay the loan amount on a specified maturity date. The issuer usually pays the bond holder periodic interest payments over the life of the loan.

Bonus Shares Shares issued by companies to their shareholders free of cost by capitalisation of accumulated reserves from the profits earned in the earlier years.

Break-even Price The price at which firms make zero abnormal profits.

Bridge Loan Loan made by a bank for a short period to make up for a temporary shortage of cash. Bridge loan covers the period between the buying of a new company/equipment and disposing of the old one.

Brokerage Brokerage is the commission charged by the broker for purchase/sale

transaction done through him. The maximum brokerage chargeable as stipulated by SEBI is at present 2.5 per cent of the trade value.

Budget A document containing a preliminary approved plan of public revenue and public expenditure. It is a statement of the estimated receipts and expenses during a given period, normally one year. In India, the union budget is presented during the last day of February every year, preceded by the railway budget and the tabling of economic survey.

Budget Deficit It is the difference between the total expenditure on one hand, and current revenue and net internal and external capital receipts of the government. It has to be financed by net internal and external capital receipts.

Bull A bull is the speculator who gains with the rise in prices of shares and stocks. He buys shares or commodities in anticipation of rising prices and sells them later at a profit.

Bull Market A market where the speculators buy shares or commodities in anticipation of rising prices. This market enables speculators to resell such shares and make a profit.

Business Cycle Also known as Trade Cycle, it refers to an alternate expansion and contraction in overall business activity in a wave-like rythmic cycle in a capitalist economy. The four phases of the business cycles are recovery, prosperity, recession and depression.

Call Money It is a form of loans and advances which is payable on demand or within the number of days specified for the purpose.

Capacity Building Programmes to create awareness and impart skills to make persons, groups or organisations capable of undertaking targeted initiatives.

Capital Budgeting The process of preparing the budget for a period of a year or more than one year allocating capital outlays for various investment projects. In other words, it is the process of budgeting capital expenditure by means of an annual or longer period capital budget.

Capital Consumption Allowance Monetary value assigned to the rate of depreciation of a physical asset in one year.

Capital Expenditure It consists mainly of expenditure on acquisition of assets such as land, buildings, machinery, equipment, investments in shares, etc. and loans and advances granted by the central government to the state and the union territory governments, government companies, corporations and other parties.

Capital Formation It is also known as capital accumulation. It means increasing the additions to the existing supply of capital goods in a country. It represents the addition of new capital stock to existing stock after deducting depreciation, damage and other physical deterioration of the existing capital stock. Economic progress in a country depends upon its rate of capital formation. India's capital formation at 28 per cent (2004) is one of the highest among developing economies and higher than those of the USA and U.K.

Capital Market It is a market for long-term debt and equity shares. In the capital market the capital funds of both equity and debt are issued and traded. This also includes private placement sources of debt and equity as well as organised markets like stock exchanges. Capital market can be further divided into primary and secondary markets.

Capital Receipts Items included in capital receipts are loans raised by the government from the public (also called market loans), borrowings by the government from the Reserve Bank of India and other parties through the sale of treasury bills, loans received from foreign governments and other international bodies (for example, World Bank, Asian Development Bank etc.), recoveries of loans granted to state and union territory governments and other parties, small savings and deposits in the public provident fund (PPF), etc.

Capital-intensive Industry It refers to that industry which uses large amounts of capital equipment in relation to its labour force for its output.

Capitalism It is an economic system in which all the means of production are owned by private individuals. Profit motive is the guiding feature for all economic activities under capitalism. Under pure capitalism, economic conditions are regulated solely by free market forces. This system is based on 'Laissez-faire', i.e. no state intervention. Sovereignty of consumer is a feature of this system. Consumer is considered a king under capitalism.

Carry Forward Trading Carry forward trading has evolved in response to local needs in India and it refers to the trading in which the settlement is postponed to the next account period on payment of contango charges (known as vyaj badla) in which the buyer pays interest on borrowed funds or the backwardation charges (known as undha badla) in which the short seller pays a charge for borrowing securities.

Cartel It is a monopolistic organisation established for the purpose of restricting the output of member-firms in order to keep up the price of their products. The cartels first made their appearance in Germany.

Cash Reserve Ratio (CRR) The portion of net demand and time liabilities every bank is required to deposit with the Reserve Bank of India.

Central Bank The apex banking and monetary institution whose main function is to control, regulate and stabilise the banking and the monetary system of the country in the national interest. The Indian central bank is the Reserve Bank of India.

Central Planning It refers to that system of economic planning where the state determines what shall be produced, how much shall be produced and how shall it be produced. It is the state which allocates factors of production to the various industries for productive purposes. Socialism and central planning often go hand in hand. Central planning is now being increasingly followed even in non-socialist societies.

Cheque A cheque is an order in writing issued by the drawer to a bank. If the customer has sufficient funds in his account, the cheque is paid by the bank. Cheques are used in place of cash.

Circuit Breakers It is a mechanism by which a stock exchange temporarily suspends the trading in a security when its prices are volatile and tend to breach the price band.

Clearing A clearing refers to the process by which all transactions between members are settled through multilateral netting.

Clearing Bank A clearing bank is one which settles the debits and credits of commercial banks.

Clearing House A Clearing House is an institution which helps to settle the mutual indebtedness that occurs among the members of its organisation.

Closed Economy A closed economy refers to an economy having no foreign trade (i.e. export and import). Such economies depend exclusively on their own internal domestic resources and have no dependence on outside world.

Collective Bargaining It refers to negotiations between employers' association and workers' trade union in an industry. The workers can bargain more effectively if they combine together into a powerful trade union. Employers too prefer collective bargaining, as individual bargaining with each worker is a cumbersome process.

Collusion Producers of an industry reduce competition among themselves to raise their profits. They fix the price themselves with a clear mutual understanding. This understanding among different firms is called collusion.

Command and Control Regime An economic system in which all economic activities are based on inflexible regulations, directions, rigorous monitoring and verification.

Commercial Bank A commercial bank is an institution of finance. It deals in banking services through its branches in the entire country. Operation of current accounts, deposits, granting of loans to individuals and companies etc. are the various functions of the commercial bank.

Commercial Paper A short-term promise to repay a fixed amount that is placed on the market either directly or through a specialised intermediary. It is usually issued by companies with a high credit standing in the form of a promissory note redeemable at par to the holder on maturity and therefore does not require any guarantee. Commercial paper is a money market instrument issued for a tenure of 90 days.

Commercial Revenue The revenue received by the government in the form of prices paid for government-supplied commodities and services, i.e. revenues derived from the government from their public enterprises.

Company Objection When an investor sends the certificate along with the transfer deed to the company for transfer, and the registration is rejected because of signature difference or if the shares are fake, forged or stolen etc., the company returns the shares along with a letter, which is termed as a company objection.

Competition It refers to that market situation in which rival firms try to increase their profits at one another's expense.

Complementarity It is a relationship between the demands for two goods, which are in joint demand. The extent of this complementarity varies from commodities, which will always be demanded in the same proportion to goods where they can be varied to some extent.

Compliance Acting within the requirements of laws and regulations.

Constant Returns to Scale These are present when a proportionate increase in all inputs leads to the same proportionate increase in the output.

Consumer's Equilibrium Consumer's equilibrium with respect to the purchase of one good is attained when the difference between total utility in terms of money and the total expenditure on it is maximised.

Consumers' Sovereignty This concept means that in a capitalist society, it is the consumer who decides what goods shall be produced and in what quantities. Every time a consumer buys a commodity, he is, in fact, voting for the continued production of that commodity. But in an abnormal time, consumers' sovereignty becomes a myth.

Consumption Function The relationship between consumption and income.

Convertible Bond A bond giving the investor the option to convert the bond into equity at a fixed conversion price.

Core Sector An economy needs basic infrastructure for accelerating development. Development of infrastructure industries such as cement, iron and steel, petroleum, heavy machinery etc. can only ensure the development of the economy as a whole. Such industries are core sector industries.

Corporate Citizen A corporate is likened to a resident of a country, and is presumed to have rights as also obligations towards the nation.

Corporate Social Responsibility It refers to corporates engaging in pursuits of rendering services to the welfare of the community at large, apart from enhancing long-term shareholder value. In recent times, CSR has become an important and integral part of corporate activities.

Corporate Volunteering Permitting and facilitating employees to undertake social service for brief periods or intermittently.

Corporation Tax It is a tax on company's profit. It is a direct tax which is calculated on profits after interest payments and allowance (i.e. capital allowance) have been deducted but before dividends are allowed for.

Corporatisation of Stock Exchanges Corporatisation is the process of converting the organisational structure of the stock exchange from non-corporate to a corporate structure. Traditionally, some of the stock exchanges in India were established as "Association of Persons", e.g. BSE, ASE and MPSE. Corporatisation of such exchanges is the process of converting them into incorporated companies.

Cost-Benefit Analysis It refers to that analysis with the help of which we allocate scarce resources among competing uses in an efficient manner by equating marginal social cost with marginal social benefits.

Coupons Tokens for payment of interest attached to bearer securities.

Credit Money This refers to money, whose value is greater than the commodity value of the material from which the money is made.

Credit Rationing It takes place when the banks discriminate between the borrowers. It empowers the bank to lend to some and to refuse to lend to others. In this way, credit rationing restricts lending on the part of the bank.

Credit Squeeze Monetary authorities restrict credit as and when required. This credit restriction is called credit squeeze. Monetary authorities adopt the policy of credit squeeze to control inflationary pressure on the economy.

Cum-bonus The share is described as cum-bonus when a purchaser is entitled to receive the current bonus.

Cum-rights The share is described as cum-rights when a purchaser is entitled to receive the current rights.

Cumulative Convertible Preference Shares A type of preference shares where the dividend payable on the same accumulates, if not paid. After a specified date, these shares will be converted into equity capital of the company.

Cumulative Preference Shares A type of preference shares on which dividend accumulates if remains unpaid. All arrears of preference dividend have to be paid out before paying dividend on equity shares.

Currency Appreciation A situation in which there is a decrease in the domestic currency price of the foreign currency.

Currency Depreciation A situation in which there is an increase in the domestic currency price of the foreign currency.

Customs Duty A duty that is imposed on the products received from exporting nations

of the world. It is also called protective duty as it protects the home industries.

Cut-throat Competition It refers to discriminatory and unfair price-cuts made by a large firm in order to injure the interest of smaller firms. The large firm may resort to price reductions only in those areas where rival firms are operating while maintaining the normal price elsewhere.

Day Order A day order is an order which is valid for the day on which it is entered. If the order is not matched during the day, at the end of the trading day, the order gets cancelled automatically.

Dear Money Dear money is that money which can only be borrowed at a high rate of interest. In dear money policy, bank rate and other rates of interest are high and, as a result, borrowing becomes expensive. Dear money policy is a deliberate policy adopted by monetary authorities to check inflation in the economy.

Debentures Bonds issued by a company bearing a fixed rate of interest usually payable half-yearly on specific dates and principal amount repayable on particular date on redemption are known as debentures. Debentures are normally secured/charged against the asset of the company in favour of the debenture holder.

Deficit Financing It is a practice resorted to by modern governments, of spending more money than they receive in revenue, by deliberately budgeting for a deficit. The government incurs the deficit budget, either to deal with a depression and serious unemployment as in Western capitalist countries or to break the vicious circle of poverty and underdevelopment as in underdeveloped countries.

Deflation Deflation is the opposite of inflation. Deflation is that state of falling prices which occurs at the time when the output of goods and services increases more rapidly than the volume of money in the economy. During deflation, the general price level falls and the value of money rises.

Deflationary Gap It is the difference between the actual level of aggregate demand and the level of aggregate demand required to establish the full-employment equilibrium. It is a measure of the amount of aggregate demand deficiency.

Delisting of Securities The term "delisting" of securities means permanent removal of securities of a listed company from a stock exchange. As a consequence of delisting, the securities of that company would no longer be traded at that stock exchange.

Dematerialisation Dematerialisation is the process by which shares in the physical paper form are cancelled and credit in the form of electronic balances are maintained on highly secure systems at the depository.

Demutualisation of Stock Exchange Demutualisation refers to the transition process of an exchange from a "mutually-owned" association to a company "owned by shareholders". In other words, transforming the legal structure of an exchange from a mutual form to a business corporation form is referred to as demutualisation. The above, in effect, means that after demutualisation, the ownership, the management and the trading rights at the exchange are segregated from one another.

Denationalsation It means returning a nationalised industry back to private enterprise as occurred in Great Britain in the case of iron and steel industry.

Depreciation The value of the existing capital stock that has been consumed or used up in the process of producing output.

Devaluation It means reducing the value of a nation's currency relative to gold or to the value of a hard currency like the US dollar which would increase a country's physical exports and decrease its physical imports, provided other countries do not devalue their currencies.

Direct Tax Those taxes that are levied on the property and income of persons and those that are paid directly by the consumers to the state. Income tax, interest tax, wealth tax, corporation tax are all examples of direct taxes.

Disinvestment Also known as negative investment, this term was coined by Lord Keynes to refer to the sale of investment. Britain sold off her overseas investments during the Second World War to secure foreign currency to pay for her imports. National output expands only when fresh investment exceeds disinvestments.

Dividend A dividend is the amount which the company distributes to shareholders when profits of the company are calculated by the board of directors.

Dominant Firm A business concern so powerful that smaller concerns in the industry are afraid of taking independent action in trade policy.

Double Counting Counting a product two or more times is called double counting. Double counting will over-estimate the value of a country's income.

Double-entry Accounting An accounting principle requiring funds that come in to be entered in an account that shows where they came from and also in an account that shows where they are put. Funds that go out are entered in an account that shows for what they are spent and also in an account that shows where they came from.

Dumping It means selling goods abroad at a lower price than is charged for them in the home market; it is an example of discriminating monopoly.

Economic Issues Economic issues include, for example, wages and benefits, labour productivity, job creation, expenditures on outsourcing, expenditures on research and development, and investment in training and other forms of human capital. Economic issues include, but are not limited to, financial information.

Economic Planning It refers to government direction of the economic growth of a country. Modern economic planning is of two types: (i) partial economic planning and (ii) total economic planning. The former is designed to smoothen economic fluctuations in a capitalistic economy and is resorted to in private enterprise countries, such as the UK and USA The latter refers to the determination by a supreme government authority (say the Planning Commission) of the quantity and quality of goods to be produced by the country. This type of planning is resorted to in socialist countries.

Edifar "Electronic Date Information Filing and Retrieval System" (EDIFAR) is a web site launched by SEBI in association with National Informatics Center (NIC) in July 2002 to facilitate filing of certain material information/documents/statements by the listed companies on line in the EDIFAR web site–www.sebiedifar.nic.in. EDIFAR would enable electronic filling of information in a standard format by the companies and expedite dissemination of information to various classes of market participants like investors, regulatory organisation, research institutions, etc.

Environment The living and non-living surroundings, natural or man-made, which make life on earth possible. Environmental issues include, for example, impacts of processes, products and services on air, water, land, biodiversity and human health.

Environmental Audit An investigation of processes and procedures of a company or site with respect to its compliance with applicable laws and regulations and impacts on environment conditions.

Environmental Impact Assessment An assessment of the impacts on the natural or human environment of a proposed project or development, usually performed by an environmental consultant.

Environmental Management System The combination of arrangements for assessing, monitoring and recording a company's environmental impact.

Environmental Reporting Internal or external reporting of environmental performance. Can take the form of an addition to a company's annual report, or form part of a separate document.

Equilibrium The equilibrium between aggregate demand and aggregate supply occurs, when at a particular price level, the aggregate demand is equal to the aggregate supply. It is the point at which the total output of goods and services produced equals the total demand for those goods and services.

Equity Shares An equity share, commonly referred to as ordinary share, also represents the form of fractional ownership in which a shareholder, as a fractional owner, undertakes the maximum entrepreneurial risk associated with a business venture. The holders of such shares are members of the company and have voting rights. A company may issue such shares with differential rights as to voting, payment of dividend etc.

Ex-bonus The share is described as exbonus when a purchaser is not entitled to receive the current bonus, the right to which remains with the seller.

Excise Duty It is a tax imposed on total cost incurred by a firm. It is a tax which is imposed on certain indigenous production (e.g., soft drinks, matches, cigarettes, etc.) of the country. Excise duty may be imposed either to raise revenue or to check the consumption of the commodities on which they are imposed. Excise duty is progressive in nature.

Ex-rights The share is described as exrights when a purchaser is not entitled to receive the current rights, the right to which remains with the seller.

Final Goods Those that are meant for final use by consumers or firms. These goods are not required to enter into further stages of production or resale to change their form and content. They are finished goods meant only for final consumption or investment.

Financial Intermediaries Institutions that receive funds from savers and lend them to borrowers. These include depository institutions such as banks and non-depository institutions such as mutual funds, pension funds, etc.

Fiscal Deficit The difference between the total expenditure of the government and the revenue receipts plus those capital receipts which are not in the nature of borrowing, but which finally accrue to the government.

Fiscal Discipline It is realised when the government exercises control over expenditures, given the quantum of revenues.

Fiscal Policy It is that part of government economic policy which deals with taxation, expenditure, borrowing, and the management of public debt in the economy. Fiscal policy primarily concerns itself with the flow of funds in the economy. It exerts a very powerful influence on the working of economy as a whole.

Fixed Deposits These are deposits for a fixed term varying from a few days to a few years. The rate of interest will vary, with a small rate for a minimum period to a higher rate for a longer period.

Forfeitures Penalties imposed by courts for non-compliance with orders or non-fulfillment of contract, agreements etc.

Forward Trading Forward trading refers to trading where contracts traded today are settled at some future date at prices decided today.

Good Delivery A share certificate together with its transfer form which meet all the requirements of title transfer from seller to buyer is called good delivery in the market.

Gross Domestic Product (GDP) It is the money value of all final goods and services produced within the geographical boundaries of the country during a given period of time (usually a year). GDP can be calculated both at current prices and at constant prices. If we add net factor income from abroad to the GDP, we get 'Gross National Product' (GNP).

Health and Safety The set of issues that are concerned with the welfare of employees, both with regard to occupational health and accidents at work. Management of health and safety and environment issues is often combined.

Hedging Activity that is designed to minimise risk of loss.

Imperfect Competition It refers to that market situation in which one or more buyers or sellers are large enough to influence the price of the goods sold in the market. This is also referred to as monopolistic competition.

Imperfect Market It is a market characterised by the existence of imperfect competition. In such a market the following conditions of perfect competition are not fulfilled: (i) the commodity is homogeneous, (ii) there is a large number of both buyers and sellers; (iii) buyers and sellers are in close touch with each other, (iv) the commodity must be transferable, and (v) there must be no favourable treatment of some buyers or discrimination against others. Only a few markets are perfect in actual practice. Most of the markets are imperfect but retail markets are always imperfect. In the commodity too, market is not homogeneous.

Independent Directors As per Clause 49 of the Listing Agreement, 'independent directors' means directors who, apart from receiving director's remuneration, do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the judgement of the board may affect the independence of the judgement of the director.

Indirect Taxes These taxes are levied on goods and services. They only affect the income and property of persons indirectly, through their consumption of goods and services.

Inflation Inflation is a persistent upward movement in the general price-level leading to a decline in the purchasing power of the monetary unit. Inflation invariably takes place when the money supply rises faster than the increase in the output.

Infrastructure It is also referred to as social overhead capital. Infrastructure implies the foundation underlying a nation's economy and includes such things as transport and communications, power, irrigational facilities, etc. The level of economic activity in a country depends upon its infrastructure. The more developed the infrastructure in a country, the greater and more variegated is the economic activity in that country.

Insider Trading Trading in a company's shares by a connected person having non-public price sensitive information such as expansion plans, financial results, take-over bids, etc, by virtue of his association with that company is called insider trading.

Interested Parties All parties concerned involved with a stake that either impacts a business or are impacted by the business.

Intermediate Goods Intermediate goods are those goods which are used to produce other goods and therefore they always move from one stage of production to another in the manufacture of a final product.

ISO International Standards Organisation, which has its headquarters in Geneva and coordinates conferment of standards by standards organisations in countries such as the Bureau of Indian Standards (BIS).

ISO 14000 Series of standards for environment management produced by the International Standards Organisation.

Jumbo Certificate A jumbo share certificate is a single composite share certificate issued by consolidating/aggregating a large number of market lots.

Labour Union Labour union represents that organisation of workers which works for improving working conditions of labour and also for raising their wages by adopting 'collective bargaining' measures with the management of the industry.

Laissez faire It is a French word meaning 'non-interference'. This doctrine was popularised by Classical Economists led by Adam Smith who gave the view that government should interfere as little as possible in the economic activities of individuals. 'That government is the best that governs the least' is their motto.

Liquidity Assets which can easily be converted into cash are said to have liquidity. Land does not possess liquidity as it takes longer time to get converted into cash.

Lock-out It refers to a situation when the management does not permit the workers to work unless they agree to accept the employer's term. Lock-out is the closing of work by the management for an uncertain period of time to put pressure on the labour union. It is an action by the employer equivalent to a strike by employees.

Management System This includes policy, strategy, objectives and targets, programmes, resources, organisational structure, reporting and control mechanisms, audit and review mechanisms pertaining to management.

Market Lot A market lot is the minimum number of shares of a particular security that must be transacted on the exchange. Multiples of the market lots may also be transacted. In dematscrips, the market lot is one share.

Mature Economy It refers to that capitalist economy which has reached the final stage of growth.

Merger The joining together of two or more independent firms into one single combined firm is known as merger.

Merit Goods These goods refer to those goods that are very essential to the society as a whole and hence the government ensures their availability to all consumers, regardless of their ability to pay a reasonable price.

Mixed Economy It refers to an economy in which characteristics of both capitalism and socialism are found. In such an economy, some planning of production is undertaken by the state directly or through its nationalised industries and some is left to private enterprise. India offers an example of mixed economy. However, under the policy of economic liberalisation, many of the mixed economic characteristics are being diluted, and the country is moving gradually towards a market-driven economy.

Monetary Policy Monetary policy comprises all measures applied by monetary authorities with a view to creating a deliberate impact on the nature and volume of money so as to achieve the objectives of general economic policy. It aims at regulating the flow of currency, credit and other money substitutes in an economy with a view to affecting the total stock of such assets as well as to influence the demand of the community for such assets.

Money Market Money market is a market for debt securities that pay off in the short term, usually less than one year; for example, the market for 90-days treasury bills. This market encompasses the trading and issuance of short-term non-equity debt instruments including treasury bills, commercial papers, banker's acceptance, certificates of deposits, etc.

Monopolistic Competition It is a market structure in which there are many sellers, who produce a differentiated product with free entry and exit.

Monopoly It refers to that market structure where there is only one producer of a commodity for which there is no substitute. This is sometimes referred to as absolute monopoly. This type of monopoly is very uncommon. It is rare to find only a single producer of a commodity for which there is no substitute. Actual conditions vary between the two extremes of near monopoly and near perfect competition. These conditions have been termed imperfect competition. The term monopoly is extensively used to mean near monopoly or very imperfect competition. Although neither absolute monopoly power nor perfect competition actually exist, economists find it useful to study each of these extremes, the reason being that the theoretical conditions for each are simple and clear and they provide a basis for the more difficult study of the many different varieties of imperfect competition.

Monopsony It refers to the market structure with a single buyer of a commodity. Pure monopsony or buyer's monopoly is characterised by the ability of the single buyer to set the buying price. It is not very common, but it may occur, as in the case of the demand for labour in a company town. In the case of monopsony, the buying price and the quantity bought are lower than they would be in a competitive situation.

National Income It can be regarded either as the money value of the total volume of production of goods and services, or the total of all incomes derived from economic activity during a specified period, generally one year. Calculation of the national income by either method gives the same total.

Nationalisation An act by which a government takes over the ownership and operations of companies or an entire industry which were hitherto in the hands of the private sector.

Natural Monopoly Monopoly of goods enjoyed by a country due to the bounty of nature.

Neo-classical School An alternative name applied to the Cambridge School of Economists. Members of this school reconstructed the classical economic theory to take into account the changes that had occurred since the early nineteenth century.

Net National Product Gross national product minus allowance for depreciation and maintenance of capital equipment.

No-delivery period When a book closure or record date is announced by a company, the exchange sets a no-delivery period for that security. During this period trading is

permitted in that security. However, these trades are settled only after the no-delivery period is over. This is done to ensure that investor entitlement for corporate benefits is clearly determined.

Non-discrimination Equal Opportunity No discrimination on account of gender, age religion, race or creed providing equal opportunity to all irrespective of gender, age, religion, race, or creed.

Odd Lot A number of shares that is less than the market lot is known as odd lot. Under the scrip-based delivery system, these shares are normally traded at a discount to the prevailing price for the marketable lot of an industry or a business previously in the hands of private capitalists.

Oligopoly It is that form of imperfect competition in which there are only a few firms in the industry (or group) producing either homogeneous products or goods having product differentiation in a given line of production.

Open Economy It is that economy which is left free and the government imposes no restrictions on trade.

Open Market Operations Buying and selling of securities by the central bank of a country in the open market. This is a tool of the monetary authority for effecting monetary control.

Opportunity Cost It is defined with respect to a particular choice. It is equal to the value of the next best alternative.

Optimum Firm This is a firm which has reached its most efficient size, at which its cost of production per unit of output will be at a minimum so that the firm has no motive to expand or reduce its scale of operations. Thus as the firm expands towards the optimum size, it will enjoy increasing returns to scale but if it goes beyond the optimum size, diminishing returns will set in.

Order-driven Trading It is a trading initiated by buy/sell orders from investors/brokers to the members by the clearing house of the exchange.

Over the Counter Trading Trading in those stocks, which are not listed on a stock exchange.

Overdraft An advance given by a bank allowing a customer to overdraw his current account upto an agreed limit.

Participating Preference Share The right of certain preference shareholders to participate in profits after a specified fixed dividend contracted for is paid. Participation rights is linked with the quantum of dividend paid on the equity shares over and above a particular specified level.

Passive Philanthropy Inert inactive giving, when asked for, without actively participating in programmes.

Pay-in Pay-in day is the designated day on which the securities or funds are delivered paid in by the members to the clearing house of the exchange.

Pay-out Pay-out is the designated day on which securities and funds are delivered paid.

Perfect Competition It is the market situation, in which there are a large number of buyers and sellers; firms sell a homogenous product with one price prevailing. There is free entry and exit.

Permit Allowance Trade Regime Negotiable permits and allowances which may be traded to meet regulatory requirements.

Preferred Stock/Preference Shares Owners of this kind of shares are entitled to a fixed dividend or dividend calculated at a fixed rate to be paid regularly before dividend can be paid in respect of equity share. They also enjoy priority over the equity shareholders in payment of surplus. But in the event of liquidation, their claims rank below the claims of the company's creditors, bond holders/debenture holders.

Price Band The daily/weekly price limits within which price of a security is allowed to rise or fall.

Price Mechanism It signifies the working of those market forces which establish equilibrium in the economy. Laissez faire policy is the basis for the working of price mechanism.

Price Rigging When a person or person acting in concert with each other colludes to artificially increase or decrease the price of a security, that process is called price rigging.

Price Ring It is an unofficial syndicate in which the prices are controlled with the prior understanding among the traders. These dealers under a price ring decide not to over-bid one another at a public auction to keep the prices low. This will discourage outsiders from coming to the auctions.

Private Sector It is that part of the economy which is not owned by the government and is in the hands of private enterprise. In other words, private sector is not under direct government control and includes the personal as well as the corporate sector.

Privatisation Privatisation is the antithesis of nationalisation. When the government-owned public industries are denationalised and the disinvestment process is initiated, it is called privatisation.

Public Debt It represents borrowing by the state and public authorities. All loans taken by public authorities constitute public debt.

Public Sector It signifies those undertakings which are owned, managed and run by public authorities. Public sector includes direct government enterprises, the nationalised industries and public corporations. In this sector of the economy, the government acts as an entrepreneur.

Public Utilities This term refers to such services as local passenger transport, gas and electricity undertakings.

Quote Driven Trading Trading, where brokers/market markers give, buy/sell, quote for scrip simultaneously.

Recession It refers to a temporary falling off in business activity. It is one of the four segments of a business or trade cycle.

Record Date Record date is the date on which the beneficial ownership of an investor is entered into the register of members. Such a member is entitled to get all the corporate benefits.

Rematerialisation of Shares It is the process through which shares held in electronic form in a depository are converted into physical exchange computer.

Rights Issue/Rights Shares The issue of new securities to existing shareholders at a ratio to those already held.

Savings Account Deposits These deposits combine the features of both current account deposits and fixed deposits. They are payable on demand and also with-drawable by cheque, but with certain restrictions on the number of cheques issued in a period of time. Interest is paid on the deposits in these accounts.

Secondary Markets Secondary market refers to a market where securities are traded after being initially offered to the public in the primary market and/or listed on the stock exchange. Majority of the trading is done in the secondary market. Secondary market comprises equity markets and the debt markets.

Selective Credit Controls Measures used by the central bank of a country to channel the flow of credit to particular sectors, usually the priority sectors, such as agriculture, infrastructure, exports etc.

Settlement Guarantee Settlement guarantee is the guarantee provided by the clearing corporation for settlement of all trades even if a party defaults to deliver securities or pay cash.

Shadow Price It is an imputed value for a commodity based on the opportunity costs of the resources used to produce it. Such values are of particular significance in resolving problems of resource allocation with respect to the effect on welfare.

Share Capital It is the amount of money raised by a company by issuing shares. The authorised share capital is the amount that a company is allowed to issue as laid down in its Articles of Association. The issued share capital is the amount actually issued i.e., the number of issued shares multiplied by their par value. Fully paid share capital is the amount raised by payment of the full par value of the issued shares.

Social Impact Assessment An assessment of the social impacts on the local communities of a proposed project or development.

Social Issues Social issues include, for example, workplace health and safety, employee retention, labour rights, human rights, wages and working conditions at outsourced operations.

Social Security Provision by the state, out of taxation, for welfare assistance to those in need, as a result of illness, unemployment, or old age. National insurance is a kind of social security.

Socialism The political doctrine that dictates that the means of production (machines, materials and output) should be owned by society or by the state. Soviet Russia, between 1917 and 1990, practised socialism.

Splitting Consolidation The process of splitting shares that have a high face value into shares of a lower face value is known as splitting. The reverse process of combining shares that have a low face value into one share of higher value is known as consolidation.

Spot Trading Trading by delivery of shares and payment for the same on the date of purchase or on the next day.

Stabilisation Policy It is a government economic policy aimed at reducing the cyclical and other fluctuations that take place in a market economy.

Stakeholders All parties either impacted by or those that have an impact on the business. Shareholders, employees, consumers, dealers, creditors, society at large, the government are all stakeholders.

Stakeholder Engagement Systematic interaction with stakeholders on a continual basis to understand their concerns and devise mechanisms to address those concerns in consultation with the relevant stakeholders, such as shareholders, employees, creditors, customers, dealers and the government.

Statutory Liquidity Ratio (SLR) The SLR requires banks to maintain a specified percentage of their net total demand and time liabilities in the form of designated liquid assets.

Stop Transfer The instruction given by a registered holder of shares of the company to stop the transfer of shares, as a result of theft, loss etc.

Subsidies Payments by government to firms or households that provide or consume a commodity. For example, government may subsidise fertilizer by paying for a part of the price on it by marginal farmers.

Sustainability Ability of an organisation to operate in perpetuity.

Sustainable Development Integrated holistic long-term (incorporating inter and intra generational concerns) development including economic, social and environment development. The concept also refers to match the needs of the present without compromising the ability of future generations to meet their own needs.

Tariff Tax or a duty on imports, which can be levied either on physical units, e.g., per tonne (specific), or on value (ad valorem). It could be imposed for a variety of reasons including; to raise government revenue, to protect domestic industry from subsidised or low-wage imports, to boost domestic employment, or to ease a deficit on the balance of payments.

The Central Listing Authority (CLA) It is set up to address the issue of multiple listing of the same security and to bring about uniformity in the due diligence exercise in scrutinising all listing applications on any stock exchange. The functions of CLA as enumerated in SEBI (Central Listing Authority) Regulations, 2003 include: (a) Processing the application made by any body corporate, mutual fund or collective investment scheme for the letter of recommendation to get listed at the stock exchange. (b) Making recommendations as to listing conditions, and (c) Any other function that may be specified by the SEBI Board from time to time.

Trade Guarantee Trade guarantee is the guarantee provided by the clearing corporation for all trades that are executed on the Exchange. In contrast, the settlement guarantee guarantees the settlement of trade after multilateral netting.

Trade Union It is an organisation of workers who come together to promote their interests. Trade unions negotiate on behalf of their members in collective bargaining with employers, and in the event of a dispute, may put pressure on employers by withdrawing labour (i.e. strike) or by some less drastic form of action (i.e. go-slow, work to rule).

Trading for Delivery Trading conducted with an intention to deliver shares as opposed to a position that is squared off within the settlement.

Transfer Deed A transfer deed is a form that is used for effecting transfer of shares or debentures and is valid for a specified period. It should be sent to the company along with the share certificate for registering the transfer. The transfer deed must be duly stamped and signed by, or on behalf of, the transferor and transferee and complete in all respects.

Transfer Earnings The amount a factor of production would receive in its next best employment, the difference between that and its current earning being regarded as rent.

Transfer Payment Payment made by any public authority other than one made in exchange for goods or services produced. This is not a part of national income. Examples: unemployment insurance and old age pensions.

Transmission Transmission is the lawful process by which the ownership of securities is transferred to the legal heir/s of the deceased.

Transparency Openness in business operation.

Treasury Bills Short-term (up to one year) bearer discount security issued by governments as a means of financing their cash requirements.

Unique Client Code In order to facilitate maintaining database of their clients, it is

mandatory for all brokers to use unique client code which will act as an exclusive identification for the client.

Wage-price Flexibility A situation in which (money) wages and prices are flexible (they can increase or decrease freely and quickly). The effect of wage-price flexibility is that the market for labour and the markets for goods and services will always be in equilibrium.

Welfare A private-enterprise economy in which large-scale governmental action is welfare-oriented. Welfare-state goals include, among other things, maintenance of a minimum living standard for all citizens, production of social goods and services, control of business cycles, etc.

Welfare State A nation that provides to all at least the minimum standards in respect of education, health, housing, pensions and other social benefits.

Zero Coupon Bond Bond issued at a discount and repaid at a face value. No periodic interest is paid. The difference between the issue price and redemption price represents the return to the holder. The buyer of these bonds receives only one payment, at the maturity of the bond.

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NAME INDEX

A

Aaronson, Susan Ariel, 456
Aiswarya Padmanabhan, 328
Andrei Shleifer, 61, 197

B

Babic, V., 494
Balasubramanian, N., 35, 256, 530
Balasubramanian, S., 141
Beuselinck, Christof, 306
Bhat, Harish, 35, 328
Brennan, Niamh, 306

C

Cadbury, Adrian, 40, 61
Clarkson, MBE, 417
Collins, James C., 230
Cowton, Christopher, 393
Clive, Smallman, 96

D

De Silanes, Florencio Lopez, 197
Delsofo, Marc, 306
DiPiazza, Samuel A., 268
Drinan, Robert F., S.J., 393
Dyck, Alexander, 368

E

Eric, Bergloef, 197

F

Farrell, Anne, M., 306
Fernando, A. C., 61, 62, 197, 230, 274, 417, 456
Fond, Mark L. De, 197
Fr. Louis Xavier, S.J., 320
Fr. Paul De La Gueriviere, S.J., 417
Fr. Peter Hans Kolvenbach, 417
Friedman, Milton, 42, 49, 64, 395, 406, 417
Fritzsche, David J., 393

G

Garg, Subhash, 62
Gera, M. R., 62
Green, Mark, 341, 347

H

Hanson, J. L., 61
Harold, J., 262
Hung, Mingy, 197

J

Jack, Kizer E., 274
James, Scheiner H., 274
Janosevic, S., 494
Jayati, Sarkar, 86, 96

K

Kapoor, N. D., 262, 275
Katsh, 347
Katsh, Salem M., 347
Kedia, B. L., 35
Khanna, Vikramaditya. S., 35
Konana, Prabhudev, 62
Kudaisya, M., 35

L

Lala, R. M., 393
Lee, Thomas, A., 306
Log, Tata, 35
Luigi, 368

M

Machold, S., 96
Mail, J. Fred Weston, 262
Mahapatra. S., 417
Mallin, Christine A., 35
Manigart, Sophil, 306
Michelle, Quinn, 62
Millstein, 347
Millstein, Ira M., 347
Minnow, N., 494
Mitchel, J. Harold, 262
Mittal, K. M., 417
Monks, R. A. G., 61, 494
Mukherjee, 35
Mukherjee, Sanjoy, 96
Mulla, Zubin, 393
Mukherjee. D., 35

N

Nader, Ralph, 341, 347

O

O'Neal, D., 495

P

Parikh, Kirit S., 169
Paril, R. H., 141
Petkoski, Djordija, 417
Pooras, Jerry J., 230
Porta, Rafael La, 161, 162

Q

Quinn, Michelle, 62

R

Rajagopalan, R., 96, 230, 262, 275, 456
Rake, Mike, 274
Ramachandran, Sushma, 62
Ramsay, Ian, 62
Rangarajan, C., 62
Reed, Darrly, 96
Reeves, James T., 456
Rituparna, Raj, 393
Robert, Vishney, 197
Roger, Crisp, 393
Rubak, Josh, 368

S

Samuelson, Paul, 395
Sanchez, Alfonso Vargas, 96
Sarath, Gollanapalli, 274
Sarkar, 96

Sapna Chadah, 456
Shrivastava, Harsh, 417
Shultz, Susan F., 247, 262
Singh, Devi, 62
Singh, S. S., 456
Sir Adrian, Cadbury, 62
Spadaccin, Michael, 35
Smith, Adam, 65, 395, 417, 420
Staffelter, Hof, 11
Stapledon, Geof, 62
Subrata, 86, 96
Sullivan, John D., 41, 52, 61, 347
Sundarajan, S., 104
Suvakar, Panda, 361

T

Tricker, B., 494
Twose, Nigel, 417

V

Vaidyanathan, S., 169
Vasudevan, A. K., 96
Venkateswaran, Shankar, 417
Vittal, N., 141

W

Weiss, Joseph W., 393
Weston, Mitchell, 262
Wolfensohn, J., 40

Y

Yatish, Rajawat, K., 62

SUBJECT INDEX

A

Abuse of dominance, 451
Academic standpoint, 38
Accounting standards, 38, 101
Act of philanthropy, 403
Adequate information, 66, 223
Adverse effects, 431, 358
Advertising code principles, 362
Advertising standards, 360, 361
Agency theory, 65, 66, 68, 71, 72, 73, 479
Agency costs, 201
AIG insurance accounting
    fraud case, 296
Anti-corruption strategies, 475
Articles of association, 7
Asia Pacific economic co-operation
    (APEC), 46
Audit, 264
  objectives of, 264
  types of, 265
  cost, 271
  internal, 271
  quality, 273
Auditors, 264
  defining, 265
  duties of, 266
  role of, 264
  internal, 265
  independent, 265
  government, 266
  responsibilities of, 266
Audit failures, 267
Audit firm, 267
  responsibilities of, 267
Audit partner rotation, 115, 128

B

Bankruptcy, 4, 101, 161, 163, 193, 194, 219,
    223, 224, 225, 226, 252, 267, 291, 297,
    298, 304, 323, 446, 447, 448, 449, 459,
    468, 472, 474
Basel committee, 52
Best practices, 51, 84, 102, 104, 105, 111,
    124, 134, 241, 272, 282, 319, 334,
    355, 378
Biodiversity, 407
Birla committee, 283
Board of directors, 5, 6, 17, 28, 33, 37, 38,
    42, 45, 47, 48, 51, 52, 53, 54, 55, 56, 64,
    66, 73, 74, 75, 76, 77, 78, 79, 84, 85, 89,
    93, 102, 105, 112, 115, 481, 482, 485,
    486, 489, 490, 496, 504, 505 506, 507,
    508, 510, 511, 518, 520, 524, 525
Board procedures, 125, 192, 241, 246
Board processes, 46, 155, 221
Breach of statutory duties, 238
Bribery, 41, 292, 311, 319, 372, 376, 382, 383
Broad perceptions, 42
Broader vision, 46, 48
Business ethics, 44, 48, 49, 57, 69, 70, 73,
    227, 249, 342, 372, 373, 375, 383, 387,
    403, 463, 509
Business organisation; forms of, 9

C

Cadbury committee, 49
Capital market, 134, 135, 146, 164, 165,
    169, 170, 176, 177, 186, 187, 195, 207,
    286, 287, 289, 296, 303, 304
Capitalism, 13, 14, 32, 42, 330, 376,
    420, 493
Caux round table, 228
Chaebol, 31, 34
Changing situations, 387
Charitable causes, 396, 405
Charter, 110, 128, 161, 243, 271
Chartered company, 6
Chief executive officers (CEOs), 232
Cigarette code, 363
Co-determination, 215, 216
Co-directors, 239
Commercial policy, 419, 428
Committee of sponsoring organisations
    (COSO), 49
Common welfare programmes, 403
Company, 4
  characteristics of, 5–6
  holding, 8
  private, 7
  public, 7
  subsidiary, 8
  types of, 6
Companies,
  chartered, 6
  limited by shares, 6
  limited by guarantee, 7
  registered, 6
  statutory, 6
Company director, 247, 281, 468, 486
Company law in India, 16
Comparative study, 48, 50
Competition commission of India, 192,
    451, 452
Competitive markets, 43, 468, 474
Composition of boards, 356
Concentrated debt, 225
Concepts of governance, 141
Conflicts of interest, 105, 137, 332, 336,
    337, 383, 385, 461, 466, 524
Conservation, 401, 433, 513
Consumer demand, 356
Contract law, 467, 472
Control model, 39
Co-operative form of business
    organisation, 10
Corporate constitutionalism, 467
Corporate excellence, 388
Corporate governance, 37
  and creditors, 223
  and employees, 215
  and institutional investors, 219
  and the Government, 228
  Board of directors and, 249
  definition, 38
  financial reporting and, 279–304
  framework, 232
  in the banking sector, 52
  issues in, 53
  overview, 36–60
  relevance of, 56–57
  theories and models of, 63–95
Corporate governance rating, 146, 188
Corporate scams, 49, 98, 140, 196, 267, 291,
    319, 364, 459
Corporate social responsibility, 147, 158,
    159, 228, 258, 396, 398, 404, 408, 409,
    411, 416
Corporate stakeholders, 37
Corporate strategy, 44
Corporates, 98, 109, 111, 128, 134, 135, 140,
    193, 215, 225
Corrective advertising, 364
Corruption, 295
Cost audit methodology, 272
Cost audit, 271, 272, 273
C. R. Bhansali accounting fraud
    case, 303
Creditor incentives, 223, 224
Creditor monitoring and control, 223, 224
Credo, 94
CSR, 318, 394, 396, 397, 398, 399, 401, 406,
    407, 408, 409, 410, 411

D

de facto, 261, 451
Debt collection, 223, 224, 448
Decision making, 280, 311, 326, 339, 377,
    380, 381, 400
Deficiencies, 120, 121, 185, 359
Developing countries, 39, 41, 58, 59, 440,
    453, 467, 472, 473, 474

Development of financial markets, 43, 468
Dialogue, 270, 387
Different roles of government, 331
Diffused debt, 225
Directors' liability to the company, 238
Directors' remuneration, 51, 106, 109, 118, 124, 241, 253, 255, 282
Disabilities, 239
Disclosure standards, 188, 474
Disclosures, 59, 60, 65, 66, 86, 114, 119, 120, 122, 124, 126, 127, 128, 129, 130, 134, 136, 138, 148, 150, 152, 157, 162
Disinvestment policy, 23
  objectives of, 23
Disqualifications, 128, 235
Domestic institutional investors (DIIs), 28

E

Economic environment, 493
Economic growth, 32, 43, 161, 228, 331, 333, 335, 345, 376, 411, 427, 428, 431, 432, 466, 467, 497
Economic power, 27, 332
Effective corporate governance, 64, 109, 114, 160, 216, 274, 346, 470, 472, 473, 482
Effective enforcement, 177, 341, 493
Effective market system, 177
Emerging economies, 59, 163, 223, 287, 467, 468, 478
Enactment of laws, 345
End by itself, 342
Enforcement capacity, 475, 528
Enron debacle, 140, 269
Ensuring compliance, 60, 177
Ensuring corporate governance, 41, 53, 127, 229, 247, 475
Entrepreneurial role, 331, 332
Environmental concerns, 398, 408, 409
Environmental issues, 357, 406
Environmental performance, 117, 338
Environmental preservation, 249
Equitable treatment of shareholders, 47
Equity-sharing, 216
Ethical education, 387
Ethical organisations, 387, 388
Ethical practices, 258, 367, 372, 374, 387, 388, 460
Ethics and values, 264, 379
Ethics in advertising, 357, 367
Ethics within organisation, 377
Evolution of ethics, 373
Executive director, 54
Executive pay, 162
Exit mechanisms, 468, 474
External stakeholders, 37

F

Family-owned businesses, 256
Fiduciary principle, 45
Financial involvement, 426
Fiscal policy, 428, 430, 431
Foreclosure, 223, 474, 468
Foreign companies, 9
Foreign institutional investors (FIIs), 28
Fourth estate, 349, 352, 475
Framing public policy, 425
Fullest possible disclosure, 363
Future outlook, 280

G

Global corporations, 406
Global role, 398
Globalisation, 44, 59, 113, 343, 398, 410
Good governance, 27, 41, 58, 59, 85, 87, 89, 91
Goodwill, 92, 123, 153, 186, 215, 227, 362
Governance challenges, 477
Governance framework, 40, 44, 47, 60, 111
Governance issues relating to the board, 249
Governance mechanisms, 57, 67, 73, 84, 85
Governance models, 75
Governance practices, 27, 38, 40, 41, 43
Governance problems, 57, 120, 355
Governance settings, 478
Government agencies, 79, 90, 92, 161
Government auditors, 266
Government companies, 9
Government regulation, 324, 332, 335
Government regulators, 336, 354
Grievance redressal process, 209
Grievance redressal mechanisms, 165
Greenbury committee, 282
Grievance redressal process, 209
Group of ten countries, 52
Guidelines, 41, 46, 48, 50, 51

H

Hampel committee, 242
Harshad Mehta stock scam, 300
High productivity, 387
Historical perspective, 36, 48
History of modern corporate form of business, 11
Holding company, 8

I

Independent auditors, 265
Indian accounting standards, 286
Indian companies, 9
Indian companies act 2013, 253
Industrial pollution, 411
Industrial pollution prevention, 411
Information technology, 138, 177, 299, 343
Initial public offering (IPO), 284
Insider system, 469
Insider trading, 489
Institutional framework, 319, 444, 447, 459, 472, 479, 491
Institutional investors, 28, 48, 56
Internal audit, 271
Internal auditors, 125, 265, 274
Internal stakeholders, 37
International accounting standard board (IASB), 286
  objectives of, 287
  requirements, 287
International financial reporting standards (IFRS), 286
International issues, 410
Investment decisions, 135, 220, 223, 384
Investor confidence, 46, 52, 166, 264
Investor protection, 18, 23, 130, 160
Investors' preference, 58

J

Joint stock company form, 10
Jurisdiction, 60, 85, 163, 166, 452
Justification, 399, 433
Jute boom, 16, 17

K

Key strategies, 260
Ketan Parekh stock scam, 303
Kmart accounting scandal case, 293
Kumar Mangalam Birla committee, 221

L

Lacunae, 166
Law enforcement, 161, 165, 357
Laws and regulations, 60
Legal entity, 4, 5
Legal position, 234
Legal position of a director, 234
Lehman brother accounting fraud case, 297
Liabilities of the directors, 237
Liability to the company, 238
Life cycle development, 44
Limiting corporate power, 341
Limited liability concept, 13
Lockheed Martin bribery case, 292
Long-term shareholder value, 201

M

Management structure, 232
Mandatory recommendations, 124, 126, 131
Market model, 38
McKinsey, 38, 40, 100, 113, 222
Media credibility, 356, 367
Media, 348–367
Mindset, 200, 339
Misgovernance, 38, 41, 458, 461, 467
Modern company form in India, 16
Modern ideas, 49
Monetary policy, 409, 428
Multinational corporations, 83, 521

N

Narayana Murthy committee, 206, 252
National stock exchange of India limited (NSE), 25
Natural environment, 14
Negative image, 377
New economy, 44
New era, 261
New millennium, 52
New millennium, 52
Nominee directors, 237, 245
Non-audit services, 56, 115, 271
Non-executive director, 54
Non-government companies, 9
Non-mandatory recommendations, 124, 126

O

Objectives of an audit, 264
Obligation to customers, 92
Obligation to employees, 90
Obligation to investors, 89
Obligation to society, 85
OECD, 40, 111, 112
  principles, 244–245
Olympus corporation accounting scandal, 294
Organisation of economic co-operation and development (OECD), 40
Organisational involvement, 427
Other mechanisms, 355
Outsider system, 470
Oversight board, 114, 129, 487
Ownership concentration, 492
Ownership patterns in India, 26

P

Participation, 91, 217
Partnership form, 9
Partnerships, 226, 410, 448, 461
Penalties, 116, 135, 315, 341, 437
Perceptional differences, 43
Pioneering Indian boards, 259
Pluralistic model, 400
Policy decision making, 425
Political governance, 334
Political influence, 72
Political involvement, 426
Pollution control, 375, 404, 414
Pollution, 386, 434, 435
Post liberalization period, 20
Powers of the board, 51, 190, 210, 236
Press, 354, 355
Principle of accountability, 45
Principle of dignity, 45
Principle of fairness, 44
Private company, 7
Private sector, 223, 354, 401, 477
Proactive, 41, 254, 259, 308, 311, 345
Product market, 330, 451
Profit-sharing, 216, 386
Prohibition of tax-free payments, 255
Promotional role, 332
Property rights, 41, 69, 112, 331, 453, 472
Proprietary form of business, 9
Propriety principle, 45
Public awareness, 46, 256, 259, 403, 411
Public company, 5, 7, 114, 184, 255, 296, 386, 487
Public company, 7
Public examination, 316
Public governance, 334, 342, 353
Public opinion, 354, 401
Public policy, 42, 419, 420, 421, 422
Public sector companies, 18

Q

Qualifications, 235, 181, 248
Quality audit, 273

R

Rationale for a review, 129
Recent trends, 361
Registered companies, 6
Regulations, 44, 60, 56, 59, 78, 115, 157, 177, 226, 302, 338, 351, 400, 443, 473, 530, 551
Regulatory role, 331, 337, 347
Related issues, 53, 55
Reliability principle, 45
Remuneration committee, 46, 105, 125, 241, 253, 514
Remuneration packages, 245, 253, 254, 464
Reputational agents, 475
Reserve bank, 165, 409, 489
Responsiveness principles, 45
Restraints of power, 334
Restructuring, 77, 223, 272, 447, 514
Ricoh India accounting fraud case, 299
Rights of shareholders, 46, 112, 202, 205
Rights to information, 162
Risk management, 52, 131, 138, 152, 183, 283, 464, 509, 513
Role model, 346, 404
Role of auditors, 264, 269, 282, 356
Role of the board, 247
Role of stakeholders, 47, 112
Routine mechanisms, 475

S

Sales promotion, 362
Sarbanes–Oxley act (SOA), 53
Satyam computers accounting fraud case, 301
Scrutiny, 57, 57, 84, 170, 351, 352, 373
Sebi's initiatives, 124, 527
Secondary market reforms, 146
Securities and exchange commission (SEC), 49, 52
Securities markets, 474, 490
Security exchange board of India (SEBI), 20
Selective coverage, 356, 367
Serious fraud office, 84, 128
Severance payments, 55, 254
Shaping of public policies, 421
Shareholder, 6, 28, 30, 32, 40, 46, 47, 69, 113
  rights of, 202
  responsibilities of, 204, 205
Shareholding categories, 27
Shell companies, 258
Social concern, 73, 88, 403, 421
Social entity theory, 400
Social environment, 408, 428
Sociological theory, 70
Sound securities markets, 474
Stakeholder relationships, 476
Stakeholders, 37, 46, 47, 53, 56, 69, 112, 130, 199, 200, 280, 380, 388, 402, 407, 476, 505
  external, 37
  corporate, 37
  internal, 37
Stakeholders' interests, 69, 345, 402, 476
Standards of governance, 135
State intervention, 333
Statutory companies, 6
Stewardship theory, 66, 67, 73, 353
Stock exchanges, 17
Strategic public policy involvement, 427

Strong public image, 387
Strong team work, 387
Subsidiary company, 8
Substantiation, 362, 363
Sustainable development, 48, 49, 339, 396, 406, 409
Sustainable economic development, 44
Sustainable practices, 337, 547, 550, 551
Systematic implementation, 398

T

Tax evasion, 385, 290, 505
Tax-free payments, 255
Team production solution, 217
Toshiba accounting scandal case, 293
Trade unions, 216, 216, 409, 436, 437, 506
Transition economies, 40, 458, 466, 477, 478, 479
Transparency principle, 44
Transparency, 22, 40, 44, 47, 90, 112, 257, 264, 280, 398, 454
Transparency, 44
Transparent and fair privatisation procedures, 474
Trusteeship model, 399
Tyco international accounting scandal case, 295

U

Ultra vires acts, 238
Unethical behaviour, 153, 376, 381, 384
Unethical issues, 383
Unfair trade practices, 88, 218, 218, 260, 335, 445
Unlimited companies, 7
Unlimited liability, 18, 33

V

Vanguard of rendering social service, 404
Voluntary associations, 4

W

Waste management, 268, 391
Wealth creation, 215, 397
Well-informed media, 475
Well-functioning judicial system, 475
Well-regulated banking sector, 473
Why and wherefore, 468
World bank, 42, 46, 111, 302, 342, 447, 469, 514
WorldCom, 291

X

Xerox's accounting manipulation case, 292

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